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China: An Evolving Market Economy - A Review of Reform Experience

Prepared by Michael Bell and Kalpana Kochhar 1/

Authorized for Distribution by Ichiro Otani

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Abstract

This paper examines China's reform experience since 1978, reviewing major initiatives taken and assessing their impact on economic structure and their implications for macroeconomic management and stability. It identifies some of the special conditions before and during the reform process that impinged on China's capacity to implement reforms, and, in particular, those where China may differ from other countries undertaking reform, including former CPEs. A further consideration is the choice of the sequence and pace of reform and the structural and institutional changes that are needed to reorient the economy towards the market.

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Summary

For three decades after the 1949 revolution, China pursued socialist economic development based on self-reliance and the centrally directed allocation of resources. In the late 1970s, China's policymakers recognized the untenability of this approach and began to overhaul the economic system.

They undertook the reforms without a detailed blueprint under a style that was generally incremental and experimental. Despite the absence of a blueprint, the authorities recognized the importance of the market and the strength of individual incentives to stimulate production. At the same time, their resistance to widespread private ownership led to a search for solutions that simulated the institutions of a market economy while retaining public ownership.

A key element of reform involved gradually opening China to the rest of the world, which policymakers viewed as a means of acquiring modern technology. In the area of domestic reform, China first experimented in the rural areas, and then, when new mechanisms were successful, extended the reforms to other sectors. Partly for this reason, progress in the various areas of reform has not been uniform.

There can be little doubt that the reforms had a positive effect on China's economic performance. In contrast with other reforming countries, where output collapsed, unemployment rose, and real incomes declined, China's output growth accelerated and living standards improved, in some cases dramatically. However, the gradual approach and the resultant incompleteness of reform perpetuated some distortions and contributed to pronounced macroeconomic cycles marked by inflation and external disequilibrium. Because indirect instruments were ineffective for macroeconomic management, the authorities reverted to administrative means to contain excess demand, thereby slowing the pace of reforms.

China's reform experience differs from that of other countries undertaking structural reform for a number of reasons, including favorable initial macroeconomic conditions; continuation of the prereform political order; a very small external debt burden; and the benefit of having withdrawn from the CMEA arrangements many years earlier. Thus, the favorable results of China's reform to date cannot necessarily be attributed wholly to the more gradual approach that it has followed.

Beginning in early 1992, the pace of reform accelerated markedly, indicating the onset of a new stage in China's reform efforts. Detailed analysis of developments during 1992, including the decisions of the Fourteenth Party Congress in October 1992 will be the subject of a further study.

I. Introduction ^{1/}

For three decades after the 1949 revolution, China pursued a strategy of socialist economic development based on self-reliance and the centrally directed allocation of resources to key sectors through largely administrative means. In the late 1970s, even though most political and economic institutions remained intact, China's policy-makers recognized the untenability of traditional methods of economic management and began to overhaul the economic system. While maintaining the overall framework of predominant public ownership, China adopted a policy of opening up trade and investment links with the rest of the world and began to reform its domestic economic structure. In the context of these reforms, China gradually relaxed mandatory central planning, decentralized economic decision making, allowed market forces to influence an increasing number of prices, permitted a larger role to the nonstate sector, and began transforming institutions and structures critical for the conduct of macroeconomic policy including fiscal policy, the financial sector, and the trade and payments systems.

In large measure, the reforms proceeded without a detailed blueprint under a style that was generally incremental and experimental. It seems almost certain that at no time did China's leadership consider adopting a "big bang" approach, given that the absence of an immediate macroeconomic crisis--as was to occur in other reforming CPEs--permitted other options. Much of the early reform consisted of piecemeal measures involving experiments in selected sectors and regions of the country. However, the widespread preference for a gradual approach, did not prevent a growing acceptance by China's policy-makers of the need for comprehensive reform.

The first steps of domestic reform consisted of experimentation in the rural areas, which was then generalized and extended into other sectors as lessons were learned. However, progress was not uniform and the authorities have been hesitant to proceed with nationwide reform until new mechanisms have been shown to succeed. This approach, combined with varying degrees of enthusiasm on the part of provincial authorities and the comparative advantages of the provinces across the country, has led to considerable regional variation in the pace of reform and may have contributed to considerable disparities in regional development.

Despite the absence of a detailed blueprint, the authorities were cognizant of the importance of the market and the strength of individual incentives to stimulate production, a perception that was reinforced as time progressed. At the same time, there was intense resistance to any form of

^{1/} It should be noted that the term "country" used in this paper does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.

widespread private ownership. This led to a search for solutions that simulated the institutions of a market economy, while retaining dominant public ownership albeit in a greatly decentralized form.

There can be little doubt that the reforms had a positive effect on China's economic performance. In contrast with other cases where output collapsed, unemployment rose, and real incomes declined, China's output growth accelerated and living standards improved, in some cases dramatically. However, the gradual approach and the resultant incompleteness of reform perpetuated some distortions and contributed to pronounced macroeconomic cycles which were marked by surges in credit growth, inflation, and external disequilibrium. The inadequacy of indirect instruments to effect macroeconomic management meant that in responding to excess demand the authorities reverted to administrative means, thereby slowing the pace at which reform could proceed.

This paper undertakes a largely retrospective review of China's reform experience since 1978. It provides an overview of the major reforms undertaken and seeks to identify some of the special conditions which may have affected China's capacity to implement reforms, and in particular those where China may differ from other countries implementing reform, including former CPEs. A further consideration is the choice of the sequence and pace of reform and the structural or institutional changes that are needed to move the economy toward a market orientation.

It should be noted that in 1992, there has been a pronounced acceleration in the pace of reform and of opening the economy to foreign investment; indeed the agenda for the Fourteenth Congress of the Communist Party of China in October 1992 (an approximately quinquennial event) sets the stage for more rapid and sustained progress in reform in the coming years. The decisions of this Congress will serve to ratify a process of more vigorous opening up and reform that was set in motion in late 1991 and was given a further boost by initiatives by Mr. Deng Hsiao Ping in early 1992. Although this paper discusses a few of the reforms announced during 1992, it cannot do justice to the new wave of reform that appears now to be under way. Thus this paper is a precursor to further work on reform and opening up in China which will reflect developments in 1992 more fully. 1/

The rest of the paper is structured as follows: Section II reviews the conditions at the start of the reform era; Section III contains an overview of the reform process and a more detailed presentation of the main measures implemented during the period; Section IV assesses the impact of the reforms on the structure of the economy and their implications for macroeconomic management and stability; Section V examines selected features of the economic environment that were of particular note during the reform era; Section VI describes a number of the elements of reform which are being

1/ It is anticipated that this will take the form of an Occasional Paper to be issued in Spring 1993.

addressed as China expands its reform agenda, while Section VII contains an assessment and conclusions.

II. Initial Conditions

The Soviet-style "command" economy model was initially chosen to guide the development strategy, following the establishment of the People's Republic of China in 1949, but in time Chinese leaders became increasingly disenchanted with some aspects of this model, particularly the high degree of centralization. The central planning apparatus was overhauled in 1957; the central government retained control over important large- and medium-scale industrial enterprises, but for other enterprises, particularly those engaged in light manufacturing, control was transferred to local authorities. Although there were periods before 1978 when central control was tightened and then loosened again, China never returned to being centrally planned to the same degree as the former Soviet Union or some Eastern European countries.

What was the economic legacy of the development strategy pursued in the two and half decades prior to 1978? Despite the depression and famine following the Great Leap Forward (1958-59) and the political upheavals of the Cultural Revolution, China had achieved growth rates averaging 6 percent per annum between 1952 and 1978 (Table 1), albeit with significant variability. Measured inflation was for the most part low, and government budget deficits and external imbalances were rarely large. Measured in terms of the production of electric power, cement and steel, China's industrial base in the late 1970s was comparable to that of Japan and the Soviet Union in the 1960s, and the record on income distribution and on social indicators compared favorably with those of middle-income countries. Reflecting an aversion to foreign borrowing during the three decades prior to 1978, China entered the reform period with virtually no external debt-- the total stock of debt in 1978 is estimated to have been 12 percent of exports. ^{1/} This stood in contrast to other developing countries in Eastern Europe and elsewhere where relatively heavy external borrowing was used primarily to finance consumption and inefficient investment (Table 2). In short, the Chinese economy, unlike those of other former centrally planned economies did not find itself in a deep crisis of macroeconomic instability just prior to the implementation of reforms. Thus, the question arises as to the factors that provided the impetus for economic reforms and that explain their scope.

The reform process that began in 1978 had both economic and political precipitants. Although no crisis was apparent at the macroeconomic level, there was growing discontent with the system, especially in the rural areas. The recorded economic growth prior to 1978 was achieved largely by increasing the amounts of labor and capital employed, with little or no

^{1/} See Cheng (1982).

Table 1. China: Selected Macroeconomic Indicators, 1952-1991

(Annual percentage change, unless otherwise specified)

	Real net material product	General retail prices	Government budget balance 1/	Exports 2/	Imports 2/	Trade balance 2/
1952	1.3	0.8	1.1	-0.3
1953	14.0	3.4	0.4	1.0	1.4	-0.4
1954	5.8	2.3	2.2	1.1	1.3	-0.2
1955	6.4	1.0	0.3	1.4	1.7	-0.3
1956	14.1	--	-0.2	1.6	1.6	0.0
1957	4.5	1.5	0.7	1.6	1.5	0.1
1958	22.0	0.2	-1.9	2.0	1.9	0.1
1959	8.2	0.9	-5.3	2.3	2.1	0.2
1960	-1.4	3.1	-6.7	1.9	2.0	-0.1
1961	-29.7	16.2	-1.1	1.5	1.5	0.0
1962	-6.5	3.8	0.9	1.5	1.2	0.3
1963	10.7	-5.9	0.3	1.6	1.3	0.3
1964	16.5	-3.7	0.0	1.9	1.5	0.4
1965	16.9	-2.7	0.5	2.2	2.0	0.2
1966	17.0	-0.3	1.0	2.4	2.2	0.2
1967	-7.2	-0.7	-1.5	2.1	2.0	0.1
1968	-6.5	0.1	0.1	2.1	2.0	0.1
1969	19.3	-1.1	0.0	2.2	1.8	0.4
1970	23.3	-0.2	0.7	2.3	2.3	0.0
1971	7.0	-0.8	0.6	2.6	2.2	0.4
1972	2.9	-0.2	0.0	3.4	2.9	0.5
1973	8.3	0.6	0.0	5.8	5.2	0.6
1974	1.1	0.5	-0.3	6.9	7.6	-0.7
1975	8.3	0.2	-0.2	7.3	7.5	-0.2
1976	-2.7	0.3	-1.2	6.9	6.6	0.3
1977	7.8	2.0	1.1	7.6	7.2	0.4
1978	12.3	0.7	0.3	9.8	10.9	-1.1
1979	7.0	2.0	-5.1	13.7	15.7	-2.0
1980	6.4	6.0	-3.5	18.1	20.0	-1.9
1981	4.9	2.4	-0.6	22.0	22.0	0.0
1982	8.2	1.9	-0.7	22.3	19.3	3.0
1983	10.0	1.5	-0.9	22.2	21.4	0.8
1984	13.6	2.8	-0.8	26.1	27.4	-1.3
1985	13.5	8.8	0.3	27.4	42.2	-14.8
1986	7.7	6.0	-0.9	30.9	42.9	-12.0
1987	10.2	7.3	-0.9	39.4	43.2	-3.8
1988	11.1	18.6	-0.7	47.5	55.2	-7.7
1989	3.5	17.8	-0.7	52.5	59.1	-6.6
1990	4.8	2.1	-1.0	62.1	53.4	8.7
1991	7.2	2.9	...	71.9	63.8	8.1

Sources: China Statistical Yearbook, 1991

1/ Revenue minus expenditure in percent of net material product

2/ In billions of US dollars

Table 2. Selected Countries: Debt and debt service indicators, 1980-1990

	1980	1985	1986	1987	1988	1989	1990
<u>External debt as a ratio to GNP</u>							
China	1.5	5.7	8.5	11.6	11.3	10.7	14.4
Argentina	48.4	84.2	70.5	76.4	66.5	119.1	61.7
Brazil	31.2	49.0	43.7	42.3	34.3	25.6	22.8
Czechoslovakia	...	11.7	12.0	12.8	14.4	15.7	18.6
Hungary	44.8	70.2	74	77.9	69.5	73.7	65.6
India	11.9	19.3	21.3	22.0	21.7	24.5	25.0
Indonesia	28.0	43.8	55.9	72.1	65.8	61.1	66.4
Korea	48.7	52.5	45.5	31.0	21.1	15.6	14.4
Malaysia	28.0	71.9	87.7	81.7	64.2	53.8	48.3
Mexico	30.5	55.2	82.5	82.1	60.4	47.2	42.1
Poland	...	48.7	51.5	69.9	64	66.7	82.4
Thailand	26.0	47.8	45.4	42.4	37.0	34.4	32.6
<u>Debt service ratios</u>							
China	4.4	7.7	8.2	8.5	8.7	9.8	10.3
Argentina	37.3	58.9	76.2	74.3	44.5	36.2	34.1
Brazil	63.1	38.6	47.0	41.9	48.2	29.8	21.8
Czechoslovakia	...	8.6	8.0	7.9	8.8	9.6	10.4
Hungary	18.9	36.8	37.9	31.1	28.9	27.6	48.7
India	9.3	22.7	32.0	29.4	29.8	26.5	26.8
Indonesia	13.9	29.8	38.7	38.7	41.2	35.0	30.9
Korea	19.7	27.3	26.7	32.3	14.8	11.8	10.7
Malaysia	6.3	30.7	22.5	21.2	23.3	16.0	11.7
Mexico	49.5	51.5	54.2	40.1	48.0	37.9	27.8
Poland	...	15.5	12.8	14.2	10.6	9.4	4.9
Thailand	18.9	31.9	30.1	22.0	20.2	16.3	17.2

Source: World Debt Tables, 1990

growth in total factor productivity. Moreover, there were sharp swings in output growth associated primarily with the waves of centralization and decentralization. The economy faced chronic and fundamental economic difficulties, many similar to those encountered by other centrally planned economies, including a distorted pricing system, inefficient resource allocation, concentration of investment in heavy industry at the expense of basic infrastructure and the resultant bottlenecks, stagnation in agricultural production with shortages of non-grain products, isolation from foreign competition, a pervasive emphasis on quantity rather than on quality, and slow growth in consumption with sometimes acute shortages of consumer goods and housing.

China's economic growth during the 1960s and the first half of the 1970s was much lower than its East Asian neighbors (Table 3). Moreover, due to the essentially autarkic regime of the previous three decades, China had made little technological progress. Chinese leaders increasingly recognized that unless the technological disparity between China and her neighbors was effectively addressed, these output gaps would only widen.

Following the death of Chairman Mao in 1976, internal political conditions in China proved to be powerful forces leading to change. Although there was little disagreement between the two factions that had emerged within the Communist Party about the key economic problems that needed to be addressed, there was considerable division as to the nature of the economic system that should be promoted in China. The reform faction, headed by Deng Xiaoping, advocated fundamental restructuring of the economy and the explicit repudiation of the Cultural Revolution, while others advocated a more modest pace of reforms and some still favored minimal deviation from Mao's doctrines. The adoption of the 1978 reform program reflected the ascendancy gained by the reform faction at that time. 1/

III. Elements of Reform Since 1978 2/

1. An overview

Although much of China's economic reform involved changes in the domestic economic structure, a key element throughout the reform period, was the policy of "opening up" to the rest of the world. As in most areas of reform, this proceeded on a selective basis through experimentation, but it would in time affect China's exchange, trade and payments systems, and would entail a shift in attitude toward the role of foreign financing. Indeed the process of opening the economy--which was initially confined to selected coastal regions--was viewed by many policy-makers as a means of acquiring the technology that would enable China to modernize its economy while

1/ The basic guidelines for the direction of reforms were laid out during the Third Plenum of the Eleventh Party Central Committee in December 1978.

2/ This section draws heavily on and updates Blejer et al(1991).

Table 3. Selected countries: Growth rates of GNP and GNP per capita, 1960-76
(Annual percentage change)

	GNP	GNP per capita
Korea	9.6	7.3
Singapore	9.5	7.5
Japan	9.1	8.0
Taiwan, Province of China	9.0	6.2
Hong Kong	8.7	6.4
Thailand	7.7	4.6
Malaysia	6.7	3.9
Pakistan	6.1	3.2
China	5.7	3.6
Philippines	5.4	2.4
Indonesia	5.2	3.1
India	3.5	1.2
Myanmar	2.9	0.7

Source: World Bank Atlas, 1978, and China Statistical Yearbook, 1991

maintaining domestic economic structures intact. This may help to explain an apparent lack of integration between reforms affecting domestic and external aspects of the economy, at least in the early stages of the reform process.

China's reform efforts may conveniently be viewed in several distinct periods. In the first, starting in late 1978, the household responsibility system--under which communally owned land was contracted to households for fixed time periods--evolved in the rural areas from the previous arrangements where individual farmers had been allowed small privately managed plots. In parallel, incentives (agricultural procurement prices) were increased substantially, and households were given greater freedom to sell their products in the free market. As the favorable results of this experimentation became evident, the authorities encouraged the growth of rural enterprises as a means of absorbing the surplus labor released from agriculture by rising farm productivity. This allowed the development of the township and village enterprises (TVEs), which were to become the most dynamic component of the industrial sector in the following years.

With the second phase of reform starting in 1983, the authorities began the more difficult task of introducing new forms of economic management into the urban and industrial sectors of the economy, with particular emphasis on the state-owned enterprises. Reforms, many of which were intended to increase enterprise autonomy, were initiated in the areas of prices, wages, and taxation. During this period, a "two-track" pricing system introduced many enterprises to market forces, while enterprises were permitted to retain their profits, instead becoming subject to tax and assuming responsibility for financing their investment. During 1986-88, these practices were crystallized into the contract responsibility system (CRS). In parallel, wide-ranging reforms took place in the financial sector, as the banking system emerged from the prevailing monolithic banking structure.

The third phase, from mid-1988 to mid-1991 represented a period of retrenchment. Plans had been laid for a new round of price reforms, but, in the light of the surge of inflation in 1987-88, these were deferred, and there was some reversal of earlier reforms as price controls were tightened or recentralized under a "rectification" program that was introduced in 1988 to restore macroeconomic stability. In late 1990 and 1991, there was some evidence of a renewed momentum to press forward with reforms: adjustments were made to administered prices; significant moves of trade liberalization were introduced; and initiatives were launched to assist the ailing state enterprises.

In late 1991, the authorities signalled the end of the rectification program, and during the succeeding months a number of initiatives and measures indicated that a fourth phase of reforms was underway. Further impetus to reform was provided in early 1992 in speeches by Mr. Deng Hsiao Ping which were widely interpreted as signalling an important policy shift on the part of the authorities. These economic reforms were the focal point of the Fourteenth Party Congress convened in October 1992, whose decisions

will set the orientation of policy in China for the next five years. To a large extent the Congress will do no more than endorse decisions and events that are already in progress. Already, in 1992 specific measures announced have included: the "opening up" of a number of new regions; opening new sectors to foreign participation; further trade liberalization; accelerated price reform; an overhaul of enterprise taxation; and new regulations for the state owned enterprises. In addition, many developments of an institutional, regional, or sectoral nature indicated the presence of a groundswell of reform at the microeconomic level. Further evidence of the new momentum lies in the surge in direct foreign investment--both commitments and actual inflows--that occurred in the first half of 1992.

The remainder of this section reviews in more detail the key reforms undertaken since 1978, which are summarized in Appendix Table 1.

2. Opening up and the external sector

a. Opening up

One of the key features of Chinese reform was the gradual opening of the economy that occurred and the concomitant change in the official attitudes to foreign investment. As noted above, the approach was initially conceived with the relatively modest goals of transferring technology to China, of boosting export earning to acquire essential imports for industry, and to minimize recourse to foreign borrowing. The investment was initially focussed in the coastal regions of China, specifically four special economic zones (SEZs, three in Guangdong and one in Fujian) that were established for the purpose--to a degree modelled after export processing zones in other Asian countries--and which offered preferential tax arrangements. During 1983-84 it was decided to extend foreign investment privileges to 14 coastal cities, and to Hainan Island, which was eventually established as a separate province, and designated as an SEZ in 1988.

These zones were also used as laboratories for market-oriented reform measures, on the presumption that they could be isolated from the rest of the economy. However, their strong performance and growing provincial autonomy in government led to pressures for greater integration with the domestic economy. A major step in this direction was the establishment in 1990 of the Pudong development zone (in Shanghai) which, while retaining an outward orientation, is a much larger undertaking with explicit linkages to the surrounding domestic economy. In 1992, the authorities announced their intention to open a number of interior cities and border regions to foreign trade and investment. Further aspects of China's regional policy are discussed in Section V.2.

The process of opening the economy necessitated the reform of policies and institutions in the external sector. China has undertaken progressive and extensive reform of its exchange and trade systems, which nonetheless remain complex, restrictive and lacking in transparency. Assessing the precise degree of liberalization is complicated in a system where the

implementation of policies is highly decentralized. While it is clear that, in principle, China's exchange and trade system remains subject to many restrictions and distortions, the speed and degree of China's integration in the global economy would suggest that the actual application of external policies tends to be relatively liberal, albeit selectively so.

b. Trade system

Until 1978, China's foreign trade was conducted through 12 state-owned foreign trade corporations (FTCs) organized along product lines. These corporations procured and traded the quantities directed by the central plan and all profits and losses were absorbed by the state budget. In turn, production enterprises, which did not have direct access to foreign markets, were given production targets under the plan for supply to the FTCs. By this system, the tradable goods sector was insulated from the rest of the world, and the trade plan provided a means by which the balance of payments could be controlled.

Under the reforms, the FTCs were progressively given greater autonomy and steps began to be taken to make them more accountable for their operations, while administration of the system was decentralized to the provincial authorities, who were given authority to establish their own FTCs. By 1989, most local branches of national FTCs had become independent entities responsible for their financial results, bringing the number of FTCs to about 4,000 (Appendix Table 1, Section 1).

At the same time, the degree of mandatory planning was being reduced and an element of guidance planning was introduced. The mandatory plan continues to provide for specified exports and imports of key commodities, while the guidance plans assign targets to provinces and FTCs for the values of exports and imports of a range of products (in some provinces the guidance was given de facto mandatory status by the local governments). ^{1/} As the role of the trade plan has declined, direct control over exports and imports has continued through a licensing system for both exports and imports; external trade taxes have also played an increasing role in influencing the quantity and commodity composition of trade flows.

During 1991 and early 1992, a number of new measures were taken to liberalize trade, in part stimulated by China's efforts to make its trade conform with international practices in the context of its application to resume its membership in the GATT (Appendix Table 1, Section 1).

^{1/} In 1991, the mandatory plan covered about 30 percent of exports and 20 percent of imports; the guidance plan accounted for 15 percent and 20 percent respectively.

c. Exchange system

During the early stages of reform, various arrangements were tested for sharing foreign exchange with the objective of improving incentives for exports. A retention system evolved, under which exporters surrender their actual foreign exchange, and are issued retention quotas by the State Administration for Exchange Control (SAEC) equivalent to a portion of such earnings. In the period through 1990, a complex set of regulations had developed that allocated foreign exchange differently according to industrial type and provincial location (i.e. the coastal provinces were more favored). In 1991 a significant simplification occurred under which a uniform retention rate for enterprises was set throughout the country, and standard formulae were established for the sharing of foreign exchange between the center and the localities.

Until 1980, several exchange rates were used for trade transactions between the FTCs and domestic enterprise with which they were trading. In 1981, a single exchange rate was established for the internal settlement of trade transactions which remained more depreciated than the official exchange rate. Over the succeeding three years the official exchange rate was progressively devalued, and in 1984 the rates were unified.

A dual exchange rate reemerged in 1986 with the establishment of the foreign exchange adjustment centers (FEACs) at which approved enterprises were permitted to buy and sell retention quotas at rates that were, in principle, determined on the market. Initially, participation was limited to foreign-funded enterprises as a means of enabling them to meet a prevailing exchange control requirement that they should maintain a balanced foreign exchange position. In 1988, as experience was gained, all enterprises with foreign exchange retention quotas were granted access to the centers. Through 1988, the premium on the exchange rate at the FEACs widened (to 80 percent), reflecting an increased number of participants at the same time as aggregate demand was surging. In 1989, the premium fell sharply, and thereafter the differential between the two rates narrowed slowly (to 8 percent), but widened in mid-1992 (to about 20 percent).

With the new exchange arrangements in 1986, the official exchange rate was in effect pegged to the U.S. dollar. ^{1/} There were two devaluations in 1989 (21 percent) and 1990 (9 percent), and in 1991, small frequent adjustments in the official rate began to be made. The authorities have indicated that the ultimate goal is unification of the exchange rate, but no timetable has been specified, nor is it clear at what level a unified rate would be set.

^{1/} Formally the exchange rate has been classified by the IMF as a more flexible arrangement (other managed float) since 1987 (e.g. see the IMF Annual Report on Exchange Arrangements and Restrictions, (various issues)).

3. Agriculture

Until 1979, agricultural production was organized under communes which were further divided into brigades and production teams (of 20-30 households), the latter being the basic unit of production. Production decisions were passed down from higher level authorities and often did not take local conditions into account. Techniques of production were generally labor-intensive, being based on methods long-traditional among the rural population. Worker remuneration was based on the income of the commune and did not reflect individual productivity, although households were allowed small private plots on which they could produce goods for own-consumption or sale at rural trade fairs. Under this system, agricultural growth in the pre-reform era was barely sufficient to keep up with population growth.

Under the reforms initiated in 1979, private plots were enlarged, more diverse production was encouraged, and restrictions on rural markets were relaxed (Appendix Table 1, Section 2). Experiments with various forms of incentives to individuals or households eventually led to the emergence of the household responsibility system (HRS) as the dominant arrangement by 1984. Under this system, plots of collectively owned land were made available to households for a fixed period under contracts which obliged the household to supply a share of the production team's mandatory production quota, to pay agricultural taxes, and to contribute to collective services. 1/ The remaining output could be disposed by the household on the free market, or by selling to the state at negotiated prices. In the last three to four years, considerable attention was focussed on the development of agricultural wholesale markets as a means of reducing the role of state involvement in agricultural production and procurement and gradual progress is being made in developing forward and futures trading.

So successful was the initial liberalization of the agricultural sector in realizing diversification into nongrain crops, that grain production stagnated in the mid-1980s. After a short-lived move away from rigid quotas in 1985 when grain procurement by the state fell, farmers were again required to sell fixed amounts of grain to the state at fixed prices. The state's concern with maintaining grain production over the long term influenced its allocation of state investment in agriculture and led to an increase in the procurement prices offered by state agencies in the late 1980s. As a result, grain production surpassed previous levels in 1990, prompting the introduction of a market price support mechanism because the market price of grain had fallen below the state procurement price, threatening farm incomes.

1/ The initial contract period of five years was extended to 15 years for annual crops and to 50 years for tree crops in 1984. The transfer of land use rights was legalized in 1988 to encourage private farm investment. A further adaptation in recent years is discussed in Section V below.

One important cost arose from a lack of comprehensiveness in the reforms. Although procurement prices were increased substantially, the prices to urban consumers of grain and edible oil sold under ration were not adjusted and, as a result, subsidies rose sharply. Eventually, in 1991 and again in 1992, large percentage increases in the ration prices of these goods were implemented for the first time in about 25 years, bringing the urban sales price up to the procurement price, but still leaving subsidies on distribution and processing costs.

4. Prices and mandatory planning

Until 1979, since most prices were controlled by the state, with only infrequent changes, domestic prices did not reflect either relative scarcities or prices on international markets. The prices of consumer goods were kept low to protect welfare, and industrial products and raw materials were allocated by widespread mandatory planning. Price reform has consisted of adjustments to administered prices as well as partial liberalization.

The first steps of price reform involved substantial adjustments to agricultural procurement prices, and were followed by increases in the prices of many non-staple food items, although the prices of grain and edible oil sold under ration were not changed until 1991. The next major stage in the transition toward a more liberal pricing structure was the development of the two-track pricing system. First introduced in the rural areas, under this system farmers would sell their products (especially grain) up to the quota amount to the state at the state-fixed price, and could then sell above-quota amounts on the open market or to the state at negotiated prices. For several years, the system was largely confined to agriculture and a few enterprises on an experimental basis. In 1984, this two-track pricing was extended to cover a widening range of commodities, and over time, the proportion of goods subject to mandatory planning was gradually reduced. By 1988, 53 percent by value of retail sales were transacted at market prices, 1/ 28 percent took place at fixed prices, with the remainder being subject to "state-guidance" (Appendix Table 1, Section 3). Progress on price reform subsequently slowed under the rectification program.

The prices of industrial materials have also been partially liberalized, although to a lesser extent than at the retail levels, at least through 1991. The two-track system contributed to increased efficiency, by providing clearer signals for production decisions at the margin than plan prices. However, these gains are offset first, by the incentives for

1/ Market prices are not entirely free of official intervention, there being three further groups of commodities. There is a small group of perhaps 20-30 items where producers are obliged to report their intention to increase prices. A second group consists of items where there is strong seasonal demand, and periodically price caps are imposed. Other commodities are free of any official intervention.

enterprises to negotiate high levels of inputs and low levels of output, and second, by the scope for corruption that the system offers. Such persistent distortions led the authorities to decide to phase out the two-track system, and as a first step, the prices of several industrial raw materials were unified in 1991, as the authorities took advantage of the excess supply which had led to market prices falling close to or below the state price. No time-table has yet been set for the complete abolition of the system, but in September 1992 the authorities announced the liberalization of the price of a large number of industrial inputs representing over four-fifths of all such commodities previously under control. 1/ For the remainder of goods it may be expected that the role of mandatory planning would be eroded by the continuation of two processes: increases in the prices of goods allocated under the plan, 2/ and reductions in the proportions of goods allocated in this way.

The implementation of price guidelines has generally been left to provincial governments 3/ so that the intensity of price control varies across regions of the country; for instance, some provinces had decontrolled many non-staple food prices by 1988. The authorities are also shifting away from direct price controls into "indirect" price management through the use of buffer stocks of certain basic commodities at the provincial level. First used in the case of grain, it is planned to extend the device to other foodstuffs and some raw materials in an effort to contain inflation to targeted levels. A further consequence of devolving price-setting powers to local governments--rather than the market--has been the emergence of market fragmentation, with a tendency for inter-provincial barriers to develop against the movement of goods that remain subject to mandatory planning.

5. The enterprise sector

a. Nonstate enterprises

The various forms of nonstate enterprise--township and village enterprises (TVEs), foreign funded enterprises, and private businesses--have proved to be the most dynamic sector of the economy. Restrictions affecting nonagricultural activities were progressively rolled back, allowing rapid growth of rural enterprises, absorption of surplus labor, and rising foreign exchange earnings. From the start, TVEs were allowed to retain profits and achieved significant productivity gains through reinvested earnings. In

1/ Media releases indicated that of the 737 types of industrial inputs under control at the end of 1991, 89 would remain under state control with a further 21 set by local authorities. The relative importance of these, for instance in terms of the value of industrial output, was not announced.

2/ For instance petroleum, coal, and gas prices were adjusted by 20, 45, and 65 percent respectively in 1990 although their prices remained far below international levels.

3/ With the exception of the rectification program when many controls were recentralized.

addition, TVEs were initially given concessional tax treatment, supplemented by access to bank credit. One notable departure from the past was the freedom granted to TVEs to sell their products at market prices. Another was the change in the wage system. Previously, wages were paid to production teams, and were then distributed to individual members of the team. The newly established TVEs shifted to direct and performance-based wage payments, greatly improving individual incentives and productivity.

The key to the TVEs' early success lay not in any change in ownership-- they remain owned by the collectives-- but in the extent to which market forces were allowed to sculpt their development. First, the supervising government agency had every incentive to ensure the success of the enterprise since it was a source of revenue. Second, the TVEs faced a hard budget constraint; the townships did not have the resources to support failing enterprises, the banks would similarly be disinclined to extend credit in the absence of government financing, and unlike SOEs, TVEs have no "captive" markets for their products or inputs. Indeed, during the rectification program, bank credit to TVEs was largely suspended, and many of them closed with considerable loss of employment. Third, they were not obliged to provide social support services to the same extent as the state enterprises, and were able to employ according to need and to determine their own wage levels (which generally were higher than in the state sector).

b. State-owned enterprises (SOEs)

Until reforms were initiated, the SOEs had little autonomy. Their production, pricing, and investment decisions were subject to the planning process, they transferred all surplus funds to the state budget, and they relied on the budget for subsidies to cover losses and grants for investment. There were few incentives available to workers or management; wages were set by centrally determined scales, and managers' main responsibility was to fulfil production quotas.

Early reforms aimed to increase enterprise autonomy and accountability. After some initial experimentation, in 1983 it was decided to introduce a variant of the responsibility system that had evolved in the rural areas. Automatic profit transfers to the budget were phased out in favor of direct taxation, and from 1986 the Government reduced the extent of day-to-day intervention through the introduction of contracts for large and medium sized enterprises. ^{1/} Under this contract responsibility system (CRS), targets were specified for the enterprise over a three or four year period concerning its performance, its production quota to the state, and financial obligations to the Government--ordinarily taxes and dividends (Appendix Table 1, Section 4). While this may have had a positive impact on

^{1/} At the same time, it introduced various forms of leasing arrangements for smaller enterprises, and, to a very limited degree, the incorporation of joint stock companies.

enterprise efficiency, it also undermined the tax system, since the notional rate of corporate tax (55 percent) was rarely applied; instead most enterprise income tax took the form of contractual obligations. Moreover, to soften the impact of the increased borrowing for financing enterprise investment, loan amortization (as well as finance charges) was made tax deductible. The first generation of these contracts, signed by at least 90 percent of the enterprises, was in place by 1988.

To accompany these changes, a bankruptcy law was enacted in 1986, and became effective in 1988, but it has hardly been used against state-owned enterprises. In 1988 the authorities also enacted an Enterprise Law which seeks to transform the SOEs into fully autonomous legal entities that are responsible for their own profits and losses. Detailed regulations giving effect to the broad provisions of the law began to be implemented in 1992.

Although the initial impact of the reforms was a recovery in the output of the SOEs, price controls persisted, production quotas for sale to the state remained part of the contracts, the SOEs had access to certain amounts of cheap raw materials, credit was readily available for investment or working capital purposes, the budget provided support for loss-making enterprises, and little advantage was taken of reforms to wage and employment practices. In addition SOEs faced an uneven competitive environment, in that marginal tax rates varied substantially, costs differed according to each enterprise's access to raw materials at state fixed prices, while sales receipts depended on the proportion of output than could be sold on the free market. In short, the SOEs continued to face a soft budget constraint.

The incompleteness of the reforms jeopardized macroeconomic management, with SOEs contributing to the rapid rate of credit expansion in the late 1980s and early 1990s, mounting demands on the state budget to cover enterprise losses, low revenue buoyancy, the accumulation of large inventories of unmarketable goods (either because of excess production or low quality), and the associated growth of inter-enterprise arrears. To address these problems, the authorities announced some 20 measures during 1991, 12 of which were to improve the operations and external environment of the SOEs (Table 4), the others aimed at facilitating the operation of market forces on the SOEs. Some measures, such as reducing mandatory planning, were further steps toward a market economy, but others, such as preferential access to credit and tax concessions continued existing interventionist policies. Indeed, during the rectification program of 1988 and 1989, a large number of SOEs were given preferential access to credit and raw materials under a "mutual pledge" or "double-guarantee" system, which obliged them to deliver specified amounts of their output to the state.

Experiments were started in the early 1990s with new forms of contracting that would separate taxes from profit, end the deduction of loan amortization, and allow a lower uniform tax rate (33 percent as opposed to 55 percent). Under the new generation of contracts in 1990-91, the authorities chose to retain the existing form of contracting, although it

Table 4. China: Twelve Measures to Deal with the Enterprise Problem

- (1) Allocating more funds for technical transformation;
- (2) Reducing mandatory plan quotas for selected enterprises;
- (3) Increasing depreciation rates for selected enterprises;
- (4) Increasing funds for product development;
- (5) Providing additional working capital for certain enterprises;
- (6) Lowering interest rates in selected cases;
- (7) Granting external trading rights to some enterprises;
- (8) Implementing a policy of double-guarantee 1/ for 234 key enterprises;
- (9) Clearing inter-enterprise debt;
- (10) Establishing 100 enterprise groups;
- (11) Reducing enterprise burden by eliminating ad hoc levies and charges by local authorities; and
- (12) Reducing the income tax rate of enterprises from 55 percent to 33 percent.

1/ Guaranteed access to raw materials at state-fixed prices in return for guaranteed delivery by the enterprise to the state.

was found that many enterprises were unwilling to undertake commitments of more than one or two years because of their financial difficulties.

6. Social and employment policies

Reform of the enterprises has profound implications for the social support network and for employment. Until the early 1990s, with the exception of a few experiments and modest adaptations, employment policies and the social support system were left largely unchanged from the patterns existing before reforms were initiated.

The reform process is often characterized as breaking the "three irons" within the state sector: the "iron rice bowl" (guaranteed employment, housing, and welfare services); the "iron chair" (secure positions for officials); and "iron wages" (wages that are not linked to productivity). Most of the burden of this support system falls on the work unit, rather than on the Government directly. Since enterprise reform entails the possibility of greater labor mobility, bankruptcy, and unemployment, an important element of the current reform proposals is that the availability of housing, pensions, and welfare services (education, medical, etc.) should cease to be the direct responsibility of the employer.

With respect to employment and wages, the intention is to promote productivity-based remuneration and to terminate cast-iron guarantees of jobs. This would mean the end of automatic wage increments, and greater use of productivity bonuses, which have been permitted for some years, but which, because of the soft budget constraint, may not have been used effectively (Appendix Table 1, Section 5). Enterprises have been allowed to employ on a contractual basis for some years, but still only a small proportion of jobs are filled in this way. Typical arrangements would involve a higher wage in return for less job security (a contract of one to five years duration being the norm), and no access to the social support system of regular employees (housing, pensions, and welfare).

At present, the proposals to construct a social safety net are largely at the experimental stage (Appendix Table 1, Sections 6 and 7). Housing reform is taking place in several cities, including Shanghai, where the emphasis has been on raising rents (while also adjusting wages to partially offset the increases) rather than on changing the ownership structure. In early 1992, there was a nationwide increase in rents, the first of several adjustments over five years designed to bring rents in to line with operating costs. Pension schemes have been implemented in a large number of cities, but the coverage is far from universal, since it excludes individuals, contract workers, and employees of TVEs and other rural enterprises. Unemployment schemes have also been initiated on an experimental basis since 1986.

7. Fiscal reform

In the pre-reform era, fiscal policy had little role in macroeconomic management, its function being largely to facilitate the administrative allocation of resources. It achieved this by regulating the rate of capital accumulation and by aiming to keep household incomes in line with the availability of consumer goods. Tax policy was not of great consequence since there were no individual or enterprise income taxes; instead enterprises were obliged to remit all profits to the state.

The most profound reforms in the fiscal area came during the mid-1980s in the area of enterprise taxation as described in Section III.5b above and Appendix Table 1, Section 8. As noted by Blejer and Szapary (1989) the contract responsibility system introduced for the state enterprises, implied that: (i) the marginal tax rate varied widely among enterprises (declining as above-target profit rises); (ii) the average tax rate faced by enterprises declined over time as inflation was underestimated in the first generation of contracts; (iii) as a result, the long-term income elasticity of enterprise tax fell below unity; and (iv) a strong discretionary element was introduced as enterprises sought to negotiate more favorable tax contracts. The current arrangements can be regarded as a transitional stage en route to a fully transparent tax system, and although there has been little further system-wide reform since 1988 some experimentation with alternative arrangements has been undertaken (see Section III.5b above).

In one major step of simplification, the taxation of all foreign enterprises and joint ventures was brought onto an equal footing in 1991, and the eventual intention is to unify the taxation of all foreign-funded and domestic enterprises. In other areas of taxation, the Government intends to extend the value-added tax to all industries, although it is not clear whether this would include at the same time achieving a substantial simplification in the indirect tax system.

The adjustments in 1991 and 1992 in the prices of grain and edible oil--which accounted for the major part of food subsidies--will have a significant budgetary impact. However, a large subsidy element will remain until the retail price is adjusted to cover all costs including processing and distribution. Moreover, the impact on expenditure is being offset by the Government's recent strategy of establishing buffer stocks for stabilizing retail prices.

Considerable attention has been focussed on resource sharing between the center and provincial governments. One objective is to preserve an adequate degree of fiscal control for the central government and another for the center to have more resources at its disposal to implement the priorities of the central government including transfers to deficit provinces. The contracts signed with the provinces in 1988 implicitly contained a pro-cyclical bias, such that expenditure was likely to increase

when revenue earnings in the provinces are high. ^{1/} Although a new generation of contracts should have become effective in 1991, thus far the existing contracts have been extended for a period. Meanwhile, in 1992, the authorities adopted experimental tax systems in nine provinces which seek to delineate more clearly the taxes that accrue to the central government, the provinces, and those that are shared.

8. Financial sector

a. Banking system

Until 1978, the banking system had only a limited role, acting as the means for providing the credit needed by the enterprises to implement the physical plan. As enterprises acquired greater responsibility for implementing their own investment programs (with diminishing access to budgetary funds), greater scope opened up for banking system involvement. However, for the first few years of the reform period, there was little change from a banking system in which the People's Bank of China (PBC) acted as a monobank, functioning as both central bank and commercial bank. At the same time there were three other specialized banks, whose activities were sharply demarcated into agriculture, state construction, and foreign exchange management.

In 1984, the PBC was established as a central bank, and its commercial banking functions were transferred to a newly created bank (Appendix Table 1, Section 9). At the same time, the specialized banks were gradually allowed to engage in general banking activities including, from 1986, foreign transactions. Thus, although considerable specialization remained, the basis for a competitive environment began to be laid, as new banks at the provincial level and two universal banks were set up.

After the major reforms of the mid-1980s, the pace of reform in the financial sector slowed appreciably after 1988 under the rectification program. Considerable recentralization took place, the role of directed credit became more significant, and there was some loss of competition within the banking sector with more uniformity in interest rates and a sharpening in the demarcation lines among the specialized banks. In late 1990 and 1991, there was a certain relaxation in some of the rigidities: the restrictions on lending to nonpriority sectors were relaxed (allowing TVEs renewed access to credit), and provincial branches were given limited discretion in allocating credit among banks. Nonetheless, the banking sector remains subject to substantial state direction. There is only a rudimentary inter-bank market, operating largely at the provincial level;

^{1/} Although there are a number of variants, the typical contract between the provinces and the center is similar to that with the enterprises, in the sense that revenue transfers are contracted according to revenue in a base year with annual increments agreed upon ex-ante.

the central bank still plays a dominant role in intermediating between surplus and deficit provinces.

b. Nonbank financial institutions

There has been considerable growth in the nonbank sector through most of the period since 1978. Trust and investment companies (TICs), whose activities include domestic currency loans, direct investment and trust business (in which the TIC acts as an intermediary in lending between two enterprises), expanded particularly rapidly after the mid-1980s. So rapid was this growth that the Government temporarily restricted operations of the TICs in order to investigate their financial condition. With a few exceptions, the TICs were judged to be in sound financial condition, and their operations were soon normalized. This episode illustrates the inadequate state of development of the supervision of financial institutions (including banks). Other financial institutions have been established, engaging in leasing, insurance, and securities transactions, and some financial companies were formed by enterprise groups to handle a range of financial services for these groups.

International trust and investment corporations have operated since 1979, including a number at the provincial level particularly in the coastal regions. Their function is largely to raise funds from foreign sources to finance foreign funded enterprises through loans and equity participation; they have been the primary source for most international bond issues made by China during the 1980s.

c. Securities markets

The first issues of securities in 1981 were exclusively treasury bonds sold involuntarily to enterprises and individuals. In the case of individuals, the yields were relatively attractive compared with the available alternative of bank deposits. The Government later began to issue bonds whose proceeds were earmarked for key investment projects. Experimentation with the issuance of enterprise "shares" began in 1982 for private enterprises and in 1985 for state enterprises. ^{1/} The development of secondary markets in government securities had been encouraged by the authorities since 1988, and in 1990 these were enhanced by the opening of securities exchanges in Shanghai and Shenzhen which permitted trading in government bonds and in enterprise shares. In early 1992 foreigners were allowed access to these exchanges to procure and trade in special issues of enterprise shares ("B" shares). Attempts to open other securities exchanges in 1992 have been slowed by the authorities who have wanted to proceed cautiously, although more enterprises are being encouraged to list on the existing exchanges.

^{1/} These shares did not convey any right of ownership but paid interest and a dividend.

d. Monetary policy instruments

Prior to the reforms, monetary policy was implemented through a credit plan--the financial counterpart of the physical plan specifying output targets--and a cash plan, which took into account various factors affecting the demand for currency. Due to the fixity of prices, the demand for money (currency) was highly correlated with cash incomes. An excess supply of money had little impact on prices or the balance of payments and manifested itself in the form of an involuntary increase in savings deposits.

The changing institutional structure of the financial system, and the gradual increase in the openness of the economic system has enhanced the importance of monetary policy in demand management. The principal instruments of monetary policy include direct controls on credit and interest rates, and indirect instruments, notably reserve requirements and PBC lending to banks. However, since indirect instruments of monetary policy have yet to be fully developed and deployed, the credit plan continues to be the principal instrument of monetary policy, with changes in interest rates and in reserve requirements being of secondary importance.

IV. Economic Impact of Reforms

China's reforms were manifested in impressive output gains, particularly in agriculture, in the nonstate industrial sector, and in external trade. On the negative side, the industrial sector has been retarded by the slow pace of reform in the state owned enterprise sector. Moreover, the relatively gradual pace of reform and the inadequacy of instruments of macroeconomic control has been reflected in the recurring periods of economic instability. This section focuses on the impact of reforms on the level and structure of real economic activity, and on the implications of the reforms for macroeconomic management and stability.

1. Impact of reforms on the structure of economic activity

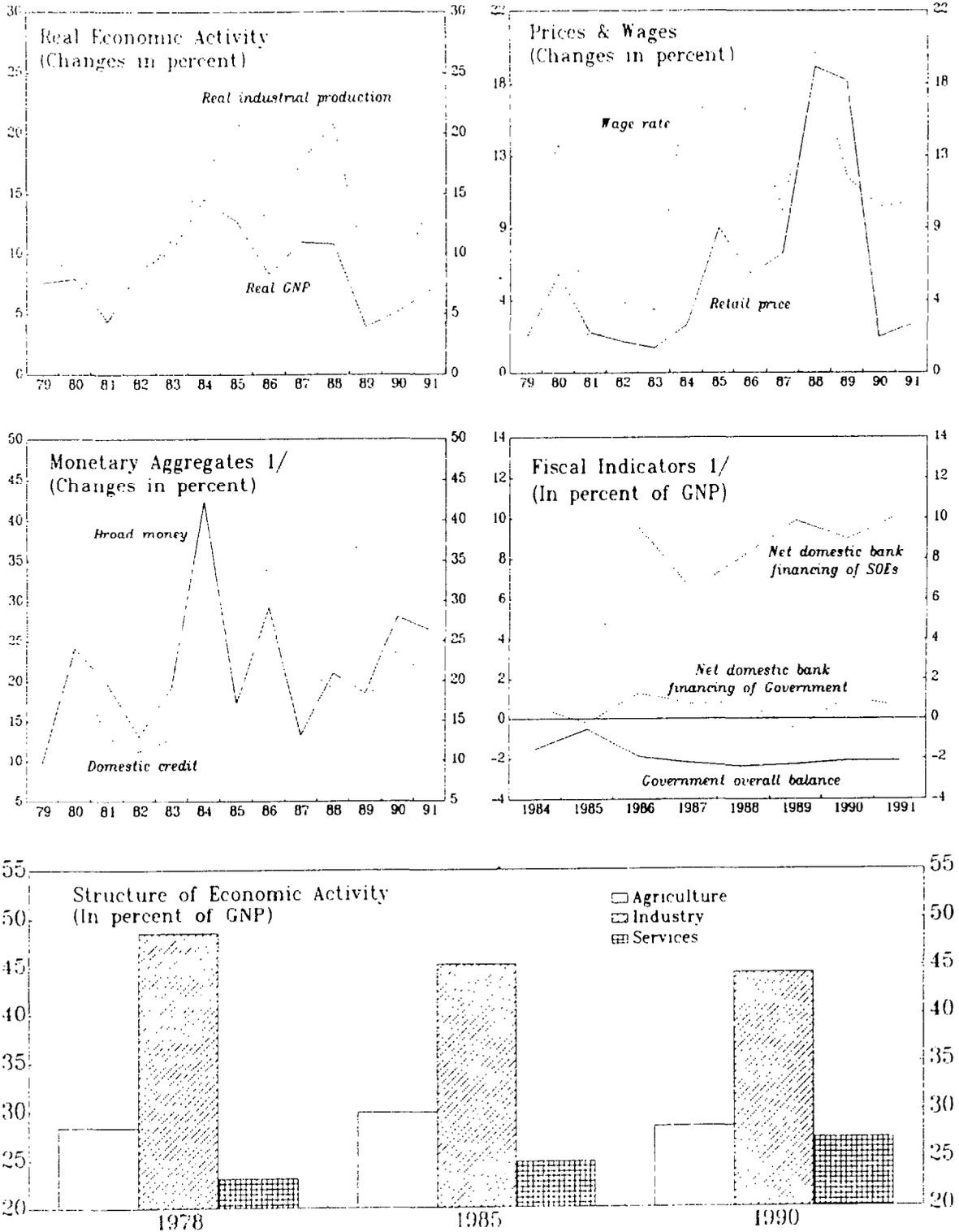
After the inception of the reforms, there was a marked acceleration in real growth--growth rates of real net material product rose from an average of about 6 percent in the 25 years between 1953 and 1978 to nearly 9 percent between 1979 and 1991 (Table 1 and Charts 1 & 2). This acceleration was pre-dominantly due to a sharp increase in the growth of total factor productivity, although increases in the growth rate of capital stock also contributed. 1/ An important goal of the reform effort was to facilitate the import of technology to modernize the economy. The growth in productivity was undoubtedly reinforced by the resultant technological progress.

1/ Perkins (1988) estimates that productivity growth accounted for over 40 percent of total growth in real net material product between 1977 and 1985, while growth in the labor force and in the capital stock accounted for the remainder.

CHART 1

CHINA

SELECTED ECONOMIC INDICATORS, 1979-91



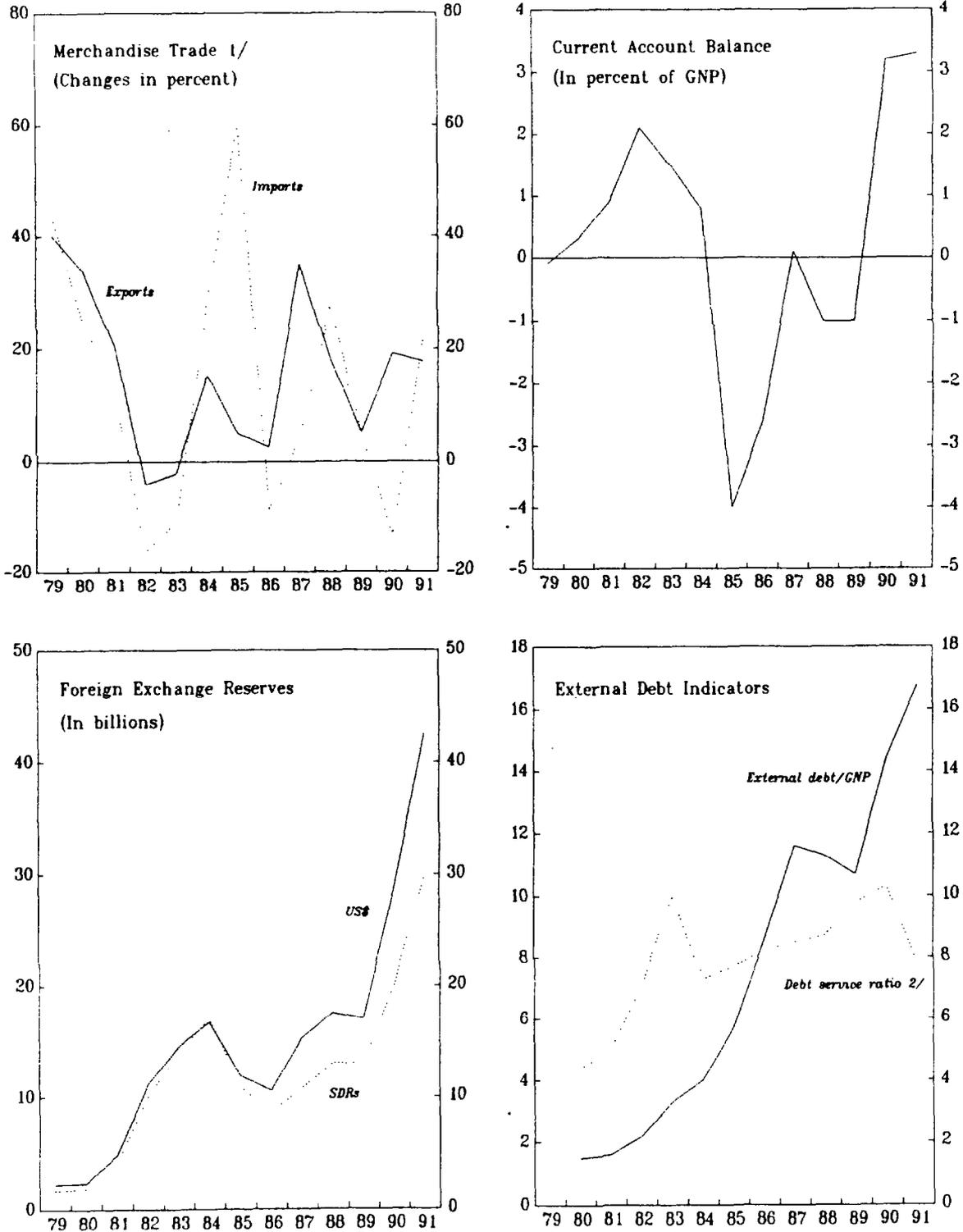
Sources: Data provided by the Chinese authorities; and staff estimates.

1/ End of period.

CHART 2

CHINA

SELECTED EXTERNAL INDICATORS, 1979-91



Sources: China Statistical Yearbook, 1991; International Financial Statics; and World Debt Tables, 1990.

1/ In U.S. dollar terms.
2/ In percent of exports of goods and services.

The sector which made the most significant contribution to the increase in productivity and output growth in the early years of the reform was agriculture. Between 1978 and 1984, output in the agricultural sector grew by an annual average of about 8.8 percent. 1/ These impressive gains can be attributed to both the introduction of improved individual incentives embodied in the household responsibility system as well as to increases in procurement prices. 2/ The growth of total agricultural production moderated to an average of about 4 percent from 1985 to 1991, reflecting a number of factors: a smaller improvement in the relative prices of agricultural products (especially grain) than in earlier years; the resumption of the practice of requiring farmers to sell grain to the state at below-market prices; low investment in agriculture and related infrastructure by farmers who have tended to invest in housing, and by collectives which may have preferred to invest in TVEs; the outflow of the labor force from the cropping sector; increasing fragmentation of land holdings; and the difficulty of replicating the one-time productivity gains arising from the termination of the commune system.

The post-1978 period also witnessed more rapid growth in industrial output, but closer analysis reveals that the most significant impact came from the non state-owned enterprises, including TVEs, individual and foreign funded enterprises. The initial impact of the reforms on the state-owned enterprises was to increase the rate of growth of output from an average of 6 percent between 1980 and 1983 to over 10 percent during 1984-88. However, the SOEs did not show the same dynamism as the agricultural and non state-owned industrial sectors. Table 5 shows the declining share of state-owned enterprises in the gross value of industrial output from near 80 percent in 1978 to less than 55 percent in 1990. Between 1989 and 1991, gross value of output of the SOEs grew by an average of 5 percent, while that of non-state owned industries grew by nearly 15 percent.

The primary problem lies in the fact that the objective functions of large- and medium-scale state-owned enterprises are not limited to maximizing profits, but include a host of other social and economic objectives. State-owned enterprises are not only a major source of employment but also perform social welfare functions, such as providing housing, medical care and education to its employees. As a result, although there is a bankruptcy law in place, it has been used sparingly. The state, for its part, has provided protection to the SOE sector through its pricing policies. Also, there has been little significant "hardening" of enterprise

1/ The output of TVEs was included in this aggregate until 1984.

2/ Lin (1992) examines the relative importance of various components of the reform on agricultural growth in China between 1978 and 1984. He finds that the dominant source of output growth was the shift from the production team system to the HRS. Changes in procurement and market prices, as well as the improved availability of fertilizers and other inputs also had a significant impact on output growth.

Table 5. China: Gross Value of Industrial Output by
Form of Ownership

(In percent of total)

	1978	1980	1985	1990
State	80.7	78.7	64.9	54.6
Collective	19.2	20.7	32.1	35.6
Of which:				
Township and village enterprises	(...)	(...)	(14.6)	(20.2)
Other rural and urban collectives	(...)	(...)	(17.5)	(15.4)
Individual	...	--	1.8	5.4
Other <u>1/</u>	...	0.6	1.2	4.4

Source: China: Statistical Yearbook, various issues.

1/ Includes foreign enterprises.

budget constraints. As a result, the state-owned industrial sector contains many overstaffed and inefficient enterprises producing goods of substandard quality, incurring losses both on account of distortions caused by pricing policies as well as of fundamental inefficiency associated with the lack of competition, undertaking inappropriate investments, and unable to compete with the more dynamic non-state industrial sector.

The opportunities provided by the reforms in the agricultural sector for the development of "sideline" activities in the rural areas laid the foundation for rural enterprises, or township and village enterprises (TVEs). (Section III.5a above). Conceived as a means of absorbing surplus labor associated with rising agricultural productivity, their dynamic growth was a largely unanticipated phenomenon. Their growth may be attributed to a number of factors, including their concentration on consumer goods that were in high demand, ready availability of labor, the limited capital requirements, and the freedom from government controls. Moreover, there were no constraints imposed by the need to overhaul existing institutions or to renew capital stock as has been the case in the SOEs. Finally, as noted above, although the TVEs remained publicly owned (albeit at a lower level of government), they have faced a much harder budget constraint than the SOEs.

Post-reform inflation performance has been influenced by both cost-push and demand-pull factors, arising, inter-alia, from agriculture and enterprise reforms, revisions to administered prices, and currency depreciation together with reforms of the price systems that affected the degree of pass-through of imported inflation to domestic prices. This issue is discussed in more detail in Section IV.2 below.

The rapid growth during the first half of the 1980s led to a dramatic reduction in the incidence of poverty, from 28 percent in 1978 to less than 9 percent in 1984. ^{1/} The large productivity and output gains in the agricultural sector resulted in a decline in the incidence of rural poverty from 33 percent in 1978 to about 11 percent in 1984. Since then, however, there has been little progress on this front, despite strong growth in rural output, primarily because the once-and-for-all benefits of agricultural reforms have been reaped and the TVEs, which are the main source of continued growth in rural areas, have not developed in remote areas, to which poverty is now largely confined. As for the effect of reforms on income inequality, the Gini coefficient for rural households increased slightly between the early 1980s and 1990, indicating an increase in income inequality. Also, data on differential regional growth rates suggest that income disparities may have widened. However, the existence of significant interprovincial budgetary transfers may have served to ameliorate this development.

Next to the dramatic increases in per capita incomes and living standards in the post-1978 period, China's most impressive achievements have

^{1/} See World Bank (1992a).

been on the external front, notably in its export performance. Exports as a ratio to GNP increased from 5 percent in 1978 to nearly 20 percent in 1991, with the bulk of exports being of labor-intensive light manufactured goods. More than in other reform areas, the export promotion strategy has evolved without a blueprint or plan but rather through a learning process. The strategy was similar to the one pursued in the domestic reform process-- focusing on decentralization by allowing foreign trade entities greater independence and responsibility for their financial performance, and on exposing foreign trade corporations to greater competition by reducing their monopoly role.

Reforms of the exchange system also played a vital role in stimulating export growth. Before 1981, there was virtually no link between domestic and world market prices. With the introduction of the two-tier pricing system, world market prices became increasingly passed through to domestic prices, and, as such, the disincentive effects of an overvalued exchange rate became more and more apparent. The official rate was devalued in 1986, 1989 and 1990 and, since mid-1991, is being adjusted more frequently. By the end of 1991, the real effective official exchange rate was 70 percent more depreciated than in 1980. Although the system is still far from being market determined, the establishment of the FEACs, the gradual expansion of eligible participants in these FEACs, the introduction of and the subsequent near-unification of foreign currency retention quotas, the introduction of a program of import liberalization through the reduction of quantitative restrictions, and the objective of gradually unifying the FEAC rate and the official rate have been significant steps in that direction. In addition, the adoption of policies to encourage export-oriented foreign direct investment, particularly in special economic zones, coastal open cities, and development areas have been largely instrumental in generating the rapid export growth.

2. Impact of reforms on macroeconomic management and stability ^{1/}

Since 1978, China has experienced a number of periods of macroeconomic instability which have interacted with the implementation of reform. It should be noted that macroeconomic cycles are not unique to China or to the post-reform period, although their characteristics have been altered by the advent of reform. In the pre-reform period, owing to pervasive price and trade controls, the cycles were manifested in wide swings in the growth of output. In the post-reform period, not unexpectedly, the cyclical episodes have been characterized by fluctuations in the inflation rate and the balance of payments, with less pronounced swings in output growth. Although it is difficult to assess which type of instability imposes higher costs on the economy, the Chinese authorities themselves, perhaps as a consequence of the hyperinflationary experience of the late 1940s, attach great importance to price stability. The authorities' concern that too

^{1/} This section draws on Khor (1991).

rapid a place of reform might exacerbate inflation is heightened by the desire to avoid a repetition of the social turbulence of earlier years.

The macroeconomic cycles have had a number of characteristics in common: an increase in aggregate demand associated with an acceleration or new phase of reform; the ratification of the increase in aggregate demand through credit expansion; the emergence of shortages and bottlenecks in critical sectors, an acceleration in inflation and/or a deterioration of the balance of payments--"overheating"; and finally, attempts to stabilize the economy primarily through the imposition of administrative controls and a slowdown, or, in some cases, a partial reversal, of the reform process. 1/

The first cyclical episode spanned the years 1979-82. During this period, agricultural reform was initiated, and profit retention by enterprises replaced profit transfers to the state. The resultant increase in rural incomes as well as the worsening of the overall fiscal balance (the latter owing both to a decline in revenues and to a sharp increase in subsidies as higher agricultural procurement prices were not passed on to consumers) led to a surge in aggregate demand. At the same time, domestic investment growth also rose sharply (Table 6). Credit expanded rapidly to accommodate the demand growth; the seasonally adjusted annualized quarterly growth rate rose from 12.5 percent in mid-1979 to 25 percent by the end of 1979 and remained high throughout 1980 (Table 7 and Chart 3). Inflation accelerated to nearly 20 percent, on an annualized basis in the fourth quarter of 1979 and the trade balance deteriorated sharply. The authorities responded by tightening some price controls in 1980, direct credit controls and trade policies during 1981, and slashing the state's investment budget. Inflation fell, output growth moderated, and, with a short lag, import growth was compressed and the trade balance swung into surplus by the third quarter of 1981.

The second cycle covered the period from 1984 to early 1986. Beginning in 1984, the two-tier pricing system was introduced, enterprises were granted greater autonomy in setting wages, a two-tier banking system was established, and a phased liberalization of the foreign trade regime was initiated. Again, aggregate demand grew sharply as enterprises, subject to their customary "soft" budget constraints, granted large increases in wages and increased their investment spending. At the same time, the PBC had not been vested with the operational or institutional instruments necessary to effectively control credit expansion in the new, more decentralized banking system. Credit expansion rose from an annualized rate of 9 percent in the first quarter to 76 percent by the fourth quarter of 1984. The decentralization of foreign trade decisions led to a spillover of excess demand into the balance of payments. By mid-1985, inflation and import growth had accelerated sharply. Once again, the authorities responded by

1/ It is notable that in two of the cycles in which external imbalances were pronounced, China made use of Fund resources (under first credit tranche stand-by arrangements) in 1981 and 1986.

Table 6. China: Selected macroeconomic indicators, 1979-1991

(Annual percentage change, unless otherwise specified)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Real GNP	7.6	7.9	4.4	8.7	10.3	14.6	12.7	8.3	11.0	10.8	3.9	5.2	7.0
Real gross industrial output	8.8	9.3	4.3	7.8	11.2	16.3	21.4	11.7	17.7	20.8	8.5	7.8	14.2
Real gross domestic investment	10.4	-0.6	-5.2	10.5	12.6	21.8	40.4	9.1	8.3	11.9	1.7	0.5	4.4
Retail prices													
Period average	2.0	6.0	2.4	1.9	1.5	2.8	8.8	6.0	7.3	18.6	17.8	2.1	2.9
End of period	7.7	22.2	2.6	0.1	3.7	4.8	10.7	6.2	9.1	26.7	6.4	2.2	4.0
Domestic credit	42.2	22.3	13.1	11.2	12.8	31.4	31.3	34.1	22.3	18.9	17.1	23.7	20.2
Broad money	9.7	24.1	19.7	13.1	19.2	42.4	17.1	29.3	13.2	21.0	18.4	28.0	26.4
Merchandise exports 1/	40.1	33.7	20.5	-4.0	-2.0	15.4	5.0	2.6	34.9	18.2	5.3	19.2	17.8
Merchandise imports 1/	43.9	24.8	12.6	-16.4	-10.9	27.6	60.0	-8.7	4.3	27.4	5.3	-13.3	22.3
Trade balance (in billions of US\$)	-2.0	-1.9	0.0	3.0	0.8	-1.3	-14.8	-12.0	-3.8	-7.7	-6.6	8.7	8.1
	(In percent of GNP)												
Current account balance	-0.1	0.3	0.9	2.1	1.5	0.8	-4.0	-2.6	0.1	-1.0	-1.0	3.2	3.3
Overall budgetary balance	-5.1	-3.3	-1.3	-1.4	-1.7	-1.5	-0.5	-2.0	-2.2	-2.4	-2.4	-2.1	-2.5
Revenue	31.6	29.4	29.0	27.2	27.4	26.4	26.6	25.1	22.8	20.0	20.5	19.9	18.6
Expenditure	36.7	32.7	30.3	28.6	29.1	27.9	27.1	27.1	25.0	22.4	22.9	22.0	21.1

Sources: China Statistical Yearbook, 1991, and World Bank (1992b)

1/ In US dollar terms.

Table 7. China: Key Macroeconomic Indicators, 1979-92

(Seasonally adjusted annualized quarterly rates,
unless otherwise specified)

	Industrial Production	Domestic Credit <u>1/</u>	Retail Price Index <u>1/</u>	Import Growth <u>1/</u>	Trade Balance <u>1/</u>
1979					
1st Quarter			-2.5		
2nd Quarter		12.5	2.9		
3rd Quarter		9.3	1.7		
4th Quarter		25.2	19.8		
1980					
1st Quarter		21.1	10.9		
2nd Quarter	4.5	25.2	2.6		
3rd Quarter	6.4	21.9	3.1		
4th Quarter	-13.8	21.3	1.2		
1981					
1st Quarter	3.4	12.0	3.1		-1.5
2nd Quarter	10.8	11.7	1.7	-1.6	-1.1
3rd Quarter	14.8	15.8	3.8	-63.8	1.0
4th Quarter	21.0	13.4	1.2	-18.6	1.4
1982					
1st Quarter	0.2	12.8	5.7	14.3	0.8
2nd Quarter	0.4	14.8	1.9	33.1	0.3
3rd Quarter	2.9	12.5	-1.7	-28.4	0.9
4th Quarter	14.4	5.6	-5.8	-13.7	1.0
1983					
1st Quarter	10.3	12.7	10.4	39.8	-0.1
2nd Quarter	13.9	19.4	2.5	5.5	0.6
3rd Quarter	11.9	14.9	1.2	71.7	0.3
4th Quarter	8.9	5.6	1.2	6.4	--
1984					
1st Quarter	13.5	8.9	2.6	3.6	0.3
2nd Quarter	11.1	17.7	4.7	5.4	0.5
3rd Quarter	24.2	34.1	2.4	68.7	-0.2
4th Quarter	22.1	76.1	5.3	46.5	-1.8
1985					
1st Quarter	36.8	22.0	11.6	163.9	-2.8
2nd Quarter	11.1	12.2	16.1	41.3	-3.8
3rd Quarter	1.4	13.2	7.0	31.7	-3.8
4th Quarter	-4.6	96.5	6.7	22.8	-4.8
1986					
1st Quarter	12.7	37.4	2.1	-37.3	-3.0
2nd Quarter	11.8	43.1	-0.4	50.7	-3.5
3rd Quarter	13.9	23.2	7.2	-18.2	-2.5
4th Quarter	24.8	38.0	12.4	-9.8	-3.0
1987					
1st Quarter	8.9	23.3	3.7	-19.0	-1.0
2nd Quarter	14.2	27.1	7.0	18.4	-1.0
3rd Quarter	16.9	29.2	9.7	13.0	-0.7
4th Quarter	11.9	13.9	14.1	43.5	-1.2
1988					
1st Quarter	29.9	28.3	13.7	1.6	-0.6
2nd Quarter	10.5	34.6	21.3	33.8	-0.6
3rd Quarter	20.8	17.3	42.8	57.3	-2.5
4th Quarter	13.7	1.6	28.7	48.0	-4.3
1989					
1st Quarter	1.0	19.6	18.1	-25.3	-1.9
2nd Quarter	7.9	15.5	7.8	59.9	-3.9
3rd Quarter	-0.2	11.3	6.6	-36.4	-0.7
4th Quarter	-6.4	24.7	-1.8	-37.2	-0.1
1990					
1st Quarter	2.4	27.5	3.8	-9.2	-0.7
2nd Quarter	20.4	20.4	2.4	7.1	1.7
3rd Quarter	5.7	29.0	-2.0	10.6	2.3
4th Quarter	30.1	20.0	2.9	0.7	3.8
1991					
1st Quarter	3.4	21.7	1.7	34.3	2.2
2nd Quarter	13.5	19.5	7.0	23.3	1.3
3rd Quarter	12.3	23.3	5.3	21.8	2.5
4th Quarter	12.7	16.1	2.9	22.6	1.8
1992					
1st Quarter	56.9	24.5	5.0	6.4	1.2
2nd Quarter	-1.4	27.0	5.7	25.1	1.3

1/ In billions of U.S. dollars.

tightening credit, foreign trade and exchange controls, as well as by raising interest rates and devaluing the renminbi.

The next cyclical upturn began in 1986 and ran through late 1988. Major reform initiatives included the introduction of the contract responsibility system for enterprises, the lowering of restrictions on the operations of specialized banks, the establishment of universal banks and the first FEACs. Largely reflecting a sharp deterioration in the overall budgetary balance, aggregate demand growth accelerated. The increases in several administered prices in early 1988 were implemented in an already overheated economy and exacerbated existing inflationary expectations; the quarterly inflation rate soared from an annual rate of 14 percent in the first quarter of 1988 to 21 percent in the second quarter and reached an alarming 43 percent in the third quarter. The authorities' response was a system-wide retrenchment--the rectification program--under which administrative controls on imports and credit were tightened, state investment expenditure was cut, interest rates increased and the renminbi was devalued by 21 percent. Inflation, and the growth rates of industrial production and imports slowed and the external balance turned sharply into surplus.

The most recent retrenchment was the most pronounced because it was associated with renewed debate within the leadership about China's reform process during which fundamental questions were raised including considerations of ownership and even broader political issues. This led to a hiatus of almost three years, but in later 1991 and 1992 reform quickened and there were clear signs--including surging investment--of accelerating demand, raising the possibility that overheating could emerge again.

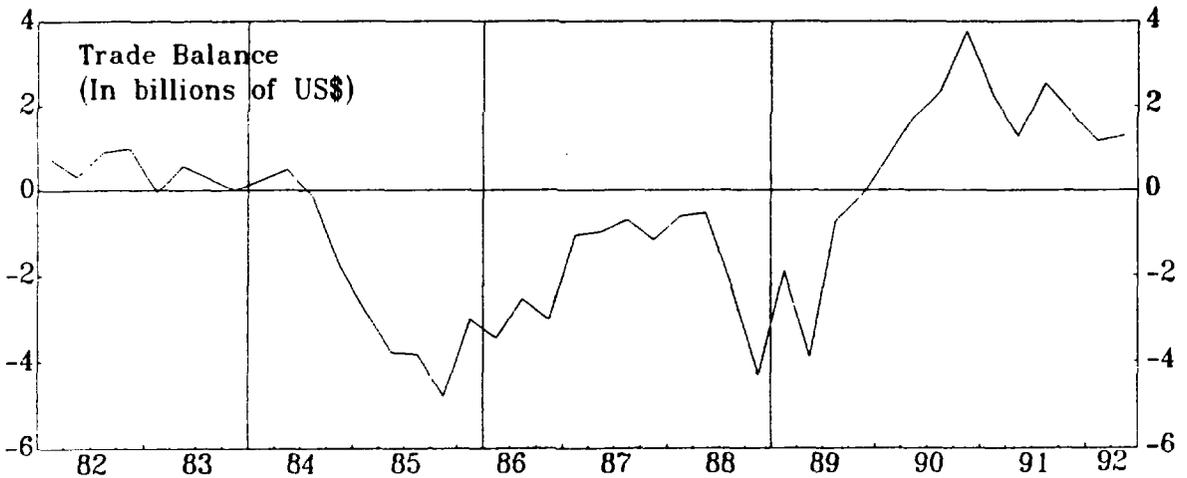
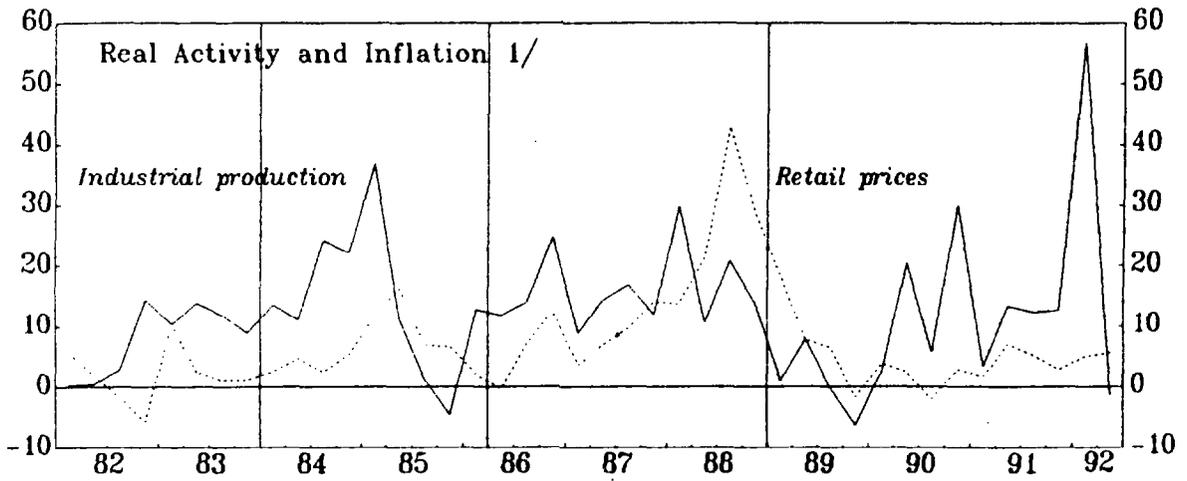
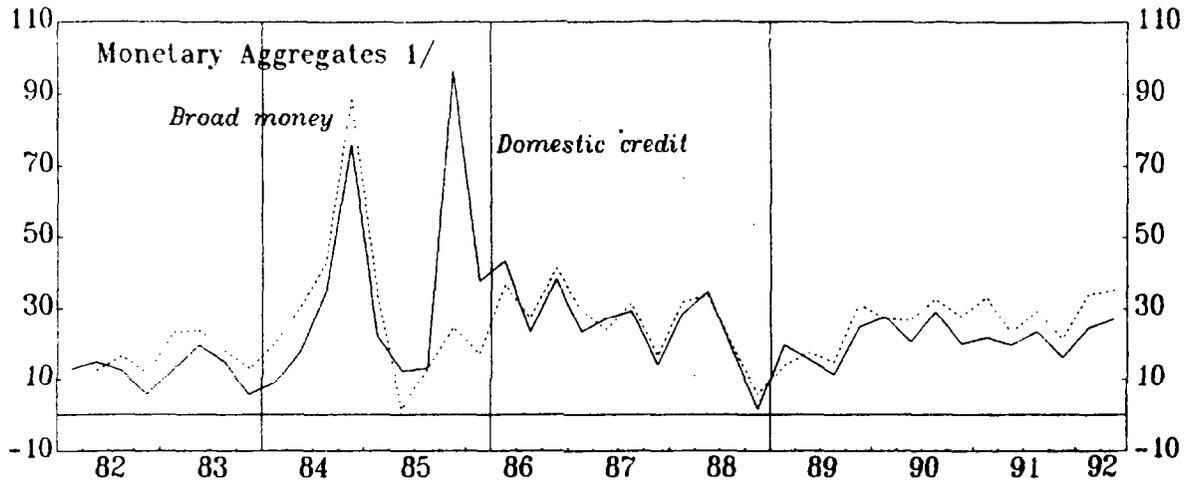
In large part, the cycles in the post-1978 period can be attributed to macroeconomic management that is hampered by the incompleteness of the reforms. In particular, the inadequacy of existing indirect instruments to regulate aggregate demand has meant that stability has had to be restored largely through administrative means with deleterious consequences for the pace and credibility of the reform process. At each stage in the reform process, reforms emphasizing decentralization and devolution of powers, and diminishing the role of the plan were followed by a surge in aggregate demand--reflecting wage increases and feverish growth in investment. In general, acceleration in the reform process has tended to be taken as a carte blanche for more rapid investment both by the state and non-state sector. At the same time, the authorities have been slow to develop indirect methods of effective, nondistortionary macroeconomic control and, where they exist, have not used them extensively.

Moreover, the implementation of some aspects of the reforms, notably of the tax system, have led to perverse automatic stabilizers. For example, the introduction of the contract responsibility system, resulted in a reduction in the income elasticity of the tax system. Under the CRS, profits up to the pre-determined quota are taxed at a flat rate; profits above this limit are taxed at much lower rates. Thus, as output and profits expand, enterprises tend to retain a larger portion of their profits leading

CHART 3

CHINA

KEY MACROECONOMIC INDICATORS, 1982-92



Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Seasonally adjusted annualized quarterly growth rate.



to an income elasticity of less than unity for the enterprise profit tax. Similarly, so long as enterprises continue to face soft budget constraints, and the tax system is not broadened and rationalized, fiscal policy will have to continue to rely on expenditure cuts to control aggregate demand. Incomplete price reforms and the resultant subsidies to consumers and enterprises has implied that expenditure cuts have to be concentrated in investment outlays with deleterious consequences for basic infrastructure.

The impact of "stop-go" reforms on production and resource allocation is disguised by measured growth rates, which, albeit fluctuating, remained positive even in the trough of the cycles. First, growth rates were artificially sustained in recession to protect employment by preferential credit policies. Second, measured growth rates do not reflect the continued production of large quantities of substandard and unmarketable goods by state-owned enterprises, which has given rise to interenterprise arrears and non-performing assets in banks' portfolios. Third, in light of frequent changes in the direction of policy, investment decisions tend to be based on short-term considerations, with potentially adverse implications for the efficiency of resource allocation. Fourth, without market-based instruments of macroeconomic management, the authorities have relied on direct credit controls which do not distinguish between more and less efficient borrowers and also aggravate inefficiencies by supporting some inefficient state enterprises through preferential credit. The sharp contraction in the growth of output and employment in the TVE sector during the recent "rectification" program is a case in point.

V. The Environment for Reform: Selected Features

This section reviews a number of special characteristics which are germane in comparing China's experience with reform with that of other former centrally planned economies.

1. Political conditions

In the years following the deaths of Zhou Enlai and Mao Zedong, the center of gravity of the Chinese political spectrum shifted in the direction of reform-minded elements. The new leadership was committed to economic reform and gained considerable support for their position during the Third Plenum of the Party in December 1978. Moreover, throughout the past decade, Chinese leaders have succeeded in containing bureaucratic self-interest so as to build and maintain the necessary support for the reform program. It has done so by focusing on accelerating growth with the fewest dislocations and the widest possible distribution of benefits. The leadership has often adopted a pragmatic approach, recognizing the need for reform--for example, evident from poor agricultural performance--and the merits of local initiatives, which to a degree explains the early emphasis on agricultural reforms and decentralization.

2. Regional policy

China has adopted a selective approach under which certain provinces or regions were chosen to play a leading role in the reform process. This partly reflected a strong predilection for experimentation arising from the authorities' perception of the complexity of simultaneous nationwide reform in such a large country, and their concern with avoiding instability. Moreover, a persistent theme of the reforms was a gradually increasing outward orientation (opening "to the outside world"), under which China attempted to increase its foreign exchange earning capacity. A further characteristic of the early reforms is that they were focussed in regions where there was a relatively low proportion of large state-owned enterprises subject to mandatory planning.

These features led to the emergence of the coastal provinces as the focal point of many aspects of the reform effort to the extent that they proved a driving force behind the reform process. It might also be argued that the reform process merely removed the impediments to the coastal provinces' exploiting their comparative advantages. The first step was to establish the Special Economic Zones (SEZs), giving them more financial and administrative powers, including the right to approve large scale investment projects, to grant tax concessions and other incentives to foreign-funded enterprises, and, until recently, to retain a higher proportion of foreign exchange. As the positive results of these experiments became evident, the approach was extended to a number of other "coastal open cities," ^{1/} each of which acquired the right to offer incentives to potential investors, allowing a degree of competition among localities, and potential for divergence in economic performance among provinces or regions. Indeed, it might be observed that in a number of instances that the localities, "given an inch, have taken a mile."

Two by-products of these developments were a growing disparity in economic growth among provinces, and pressure for greater autonomy for the provinces in their economic relations with the central government, particularly in matters affecting resource allocation. Net transfers between the provinces and the center are governed by contracts of three to four years' duration, and a perception remains that these transfers are not equitable. Moreover, the fact that the major part of the state's revenue is retained in the provinces diminishes the center's ability to undertake macroeconomic management through fiscal policy. This is exacerbated by the limitations placed on the PBC's capacity to contain credit expansion by local political pressure on the PBC's provincial branches.

^{1/} A more extensive development is now underway in Pudong (in Shanghai) which would result in greater degree of integration with the domestic economy. Also, in 1992, the Government has announced the "opening" of a number of inland cities, mainly in the Yangtse River Basin.

3. Enterprise ownership

A key question that has faced economic reformers in China, as elsewhere, is whether the continuation of public ownership represents an insuperable barrier to the functioning of markets and efficient resource allocation. China consistently maintained its preference for public ownership as a means of achieving its vision of a socialist planned commodity economy with Chinese characteristics. ^{1/} At the same time, during the 1980s, it modified ownership structures in a number of important respects that had major implications for enterprise management, which might be viewed as an attempt to simulate market conditions by encouraging profit-maximizing behavior.

First, there was a substantial degree of decentralization in ownership from the central government to provincial and municipal governments, particularly notable in the area of foreign trade. In some respects, the very size and complexity of the Chinese government structure may have facilitated the effective decentralization of ownership. Although public interference has not been eliminated, in practice many local governments view enterprises under their jurisdiction as a source of revenue, and so have been willing to allow profit-maximizing behavior relatively free rein.

Second, in the township and village enterprises (TVEs), the authorities have permitted the establishment of a form of public ownership that falls almost entirely outside the jurisdiction of state or provincial authorities. They are not subject to state planning norms, price setting or other forms of state intervention; conversely they do not have preferential access to credit or material supplies, nor do they benefit from investment from the central government or from guaranteed sales to the state.

Third, pure private ownership, both domestic and foreign, has begun to play a discernible role in the economy. Elements of competitive behavior have begun to seep into the domestic economy through the foreign-funded enterprises, even though they were initially strictly confined to the designated SEZs or open cities. In addition, the Government has encouraged the emergence of private entrepreneurship in some areas of the economy, particularly in the service and commerce sectors. Even in the industrial sector, the share of privately owned enterprises in industrial output tripled to over 5 percent in the five years through 1990. Private share ownership is still limited in scope, although with recent moves to open securities exchanges, it can be expected that private shareholding of state-owned companies will increase.

Fourth, among the enterprises that remain under state ownership, there has been a gradual erosion of the scope for direct intervention, as mandatory planning has been reduced, price setting powers devolved,

^{1/} At the Fourteenth Party Congress in October 1992, the Party has shifted its characterization of China to a "socialist market economy".

increasing autonomy allowed in investment decisions, and higher profit retention permitted. But, as the discussion of earlier sections suggests, in these respects there is still far to go.

4. Rural land tenure

Even more than in the case of enterprise ownership, there has been little change in the formal ownership of land, which remains almost exclusively under some form of public ownership. However, there was a fundamental change in land management systems. ^{1/} From 1949 through 1977 collectivization of land management prevailed under a three-level system in which households were organized into production teams, which were in turn organized into brigades and ultimately into communes of, on average, 4000-5000 households. Private plots were tolerated on a limited scale. Under this system, land was collectively owned, and the basic production unit was the team (of say 20-30 households).

Under the reforms of 1978, three key features may be noted: first that collective ownership was retained as a fundamental precept; second that arable land was distributed among farm households on the basis of family size and labor availability; and third, that production decisions became the responsibility of the household governed by contracts with the relevant rural collective economic organization. Although the old system of communes, brigades, and production teams was abolished, these entities were reconstituted as townships or villages, the government of which is charged with the responsibility of land management and the negotiation of contracts with the households.

The slowdown in agricultural growth in the mid-1980s gave rise to the view that the reforms might have led to too great a fragmentation of land holding, and the loss of the economies of scale that had been available under the former system. This has led to some adaptation of the system in the last 2-3 years, originating at the local level--apparently without any initiative from the center--which has led to the emergence of two types of plot in each village: one type is allocated equally to each household in the village for their private use; the other type is allocated to households under contracts that are open for bidding.

5. Access to external financing

Even with greater willingness to turn to foreign sources to finance its modernization and development process, China's policy towards external borrowing has been relatively conservative. Borrowing has remained predominantly medium and long-term from official sources and a significant proportion of it has been on concessional terms. In absolute terms, China's

^{1/} The Chinese experience with land reform is analyzed in World Bank China Department, Reform of the Land Management System, Working Paper Number 4, (unpublished).

external debt did increase dramatically, rising ten-fold in the 1980s. In particular, the rapid economic growth and import liberalization of the mid-1980s was accompanied by a surge in external indebtedness, with the share of short-term commercial debt rising sharply.

However, prudent debt management and improved monitoring capability have served to limit total debt outstanding to about 10 percent of GNP in 1990, with about 20 percent of total debt being on concessional terms. Throughout the reform period, China's debt service ratio has remained much lower than in most other developing countries. Although in the immediate wake of the events of June 1989, the market for medium- and long-term funds became tight, there appears to have been no enduring impact on creditworthiness as the external accounts strengthened and reform reappeared on the agenda.

In addition, China has had considerable success in attracting foreign direct investment which increased from below \$400 million in 1982, to over \$2.5 billion in 1991; a further large increase appears to be in prospect in 1992. In this regard, the special role played by Hong Kong and, more recently, Taiwan are noteworthy. Between 1988 and 1990, Hong Kong alone accounted for over 60 percent of foreign direct investment inflows to China, the major part being absorbed by the coastal province of Guangdong. Since 1990, investment from Taiwan has also been increasing, particularly in Fujian. These trends are no doubt attributable in large part to the cultural and geographic proximity of these territories to China.

6. Other factors

In the pre-reform period, the overriding preoccupation with self-sufficiency resulted in the growth of domestic oil production, which in turn served to insulate the Chinese economy from the effects of two oil shocks in the 1970s. Also, through much of the pre-reform period and even the early reform years, China remained a relatively closed economy with imports and exports as a ratio to GNP being less than 10 percent in 1978 and remaining below 20 percent until 1984. As a result, the economy was less vulnerable to external disturbances such as recessions in world markets, fluctuations in interest rates, etc. Moreover, the absence of bilateral payments arrangements, such as the CMEA, helped prevent the emergence of further distortions and rigidities in the trade system in addition to those generated by the pricing system and the strict administrative control of external trade and payments, and helped expose Chinese exporters to some degree of competition. On the domestic front, high rates of investment have been facilitated by a consistently high domestic saving ratio, which averaged 35 percent through the period 1980-91.

VI. Extending the Reform Agenda

China's reforms to date have been wide-ranging, having touched the major sectors of the economy, but they have remained partial in that restrictions and distortions persist throughout the economy. Indications from the Chinese leadership during late 1991 and 1992 pointed to a significant acceleration and deepening in reform. ^{1/} Recent measures have focussed on the further opening of the economy and resolving the problems of state-owned enterprises, although the reform process may still prove protracted given the emphasis on developing an adequate social safety net. However, many developments at the microeconomic level indicate that structural change may be acquiring a momentum of its own. This section reviews selectively the known intentions of the authorities and other developments pertinent to the next steps in China's reform strategy.

Considerable emphasis is being placed on opening the economy further. It has been announced that 36 localities in inland regions (along the Yangtze valley) and a further 13 in border areas, would be granted the same privileges currently enjoyed by the coastal open cities. At the same time, the authorities are permitting foreign investment in sectors previously closed to foreign capital (e.g. foreign trade, commerce, insurance, finance, aviation and some service industries). Foreign involvement in the economy is also being encouraged through allowing foreigners to purchase shares in Chinese enterprises on the two new stock exchanges. In the trade sector, a specific timetable has been established, spurred by negotiations with the GATT, for the abolition of two-thirds of import licensing by 1994, with a first step in 1992. However, this will leave some goods--both imports and exports--subject to licensing requirements and a diverse tariff structure. As to the exchange system, the authorities are contemplating the unification of the exchange rates. In the meantime, gradual extension of access to the more depreciated market-related exchange rate is envisaged, together with permitting trading in actual foreign currency rather than retention quotas.

The more open climate for foreign investment was reflected in a surge in commitments during the first half of 1992, a development that is significant not so much for its immediate balance of payments implications, but for the effects which it will bring in terms of new products and production techniques, international standards (for products and for accounting, audit and regulatory practices), and improved management and labor practices into the Chinese economy.

In the domestic economy, the focal point is the state-owned enterprises, with ramifications for pricing policy, fiscal reform, social services, housing, and labor practices. Attention is shifting from merely seeking an improvement in the internal operating efficiency of the enterprises (by imposing managerial or technical changes) in favor of

^{1/} Many of the measures mentioned in this section have now been endorsed by the Fourteenth Communist Party Congress in October 1992.

exposing them to market forces. During 1992, the authorities have published regulations to govern enterprise reform which will reduce mandatory planning and state interference in management; will make managers accountable for profits and losses; will revise the tax contracting system; and experiment with the shareholding system. At the same time steps are being taken to introduce international accounting standards (including the direct use of foreign accounting firms). Despite these developments, in the short term, government support has continued to be necessary, in some cases through additional financial assistance in the form of preferential credit arrangements and tax concessions.

Enterprise reform entails transforming existing housing and social welfare services which have in the past linked employees to the work unit. Measures will be needed to transfer the burden of social responsibility to workers and various levels of government. Schemes are being extended in many localities, but the complexity of establishing an adequate social safety net, will undoubtedly affect the pace at which enterprise reform can proceed.

Successful price reform, including replacing the two-track price system, requires the establishment of adequate markets for commodity at a national wholesale level. In the period ahead, commodities markets on a regional or national level may be expected to proliferate, drawing on the experience of the national wholesale grain market, two metals exchanges, and numerous local markets that have already been opened. However, progress will be governed by the pace of developing domestic banking and financial services markets, and the construction of adequate communications infrastructure.

Fiscal reform will revolve around changes in the tax contracting system along the lines of the experiments of recent years, involving the contracting of profits after taxation rather than before; ceasing the deductibility of loan amortization and lower tax rates. It is now expected that significant changes along these lines will be incorporated in a new enterprise tax law to be enacted in 1993. In addition, enterprise and price reform will lead to declining subsidies--both for enterprises and consumers. Efforts are being made to clarify the resource sharing arrangements between the center and the provinces.

While public pronouncements have not explicitly addressed the question of ownership, further adaptations are now being encouraged including further experimentation with shareholding schemes; leasing arrangements particularly with foreign partners; foreign portfolio investment through the stock exchanges; and the auctioning of land use rights which is now being permitted in some localities. Many of these adaptations will facilitate the transformation of land and fixed assets into financial assets with implications for the development of financial markets.

Regarding financial sector reform and strengthening the implementation of monetary policy, efforts will continue to develop the interbank and money

markets, through the introduction of new financial instruments and steps to achieve a relatively efficient and competitive banking system. In light of the evident hunger for a wider range of financial assets, securities markets are likely to be gradually opened in other cities through China, and the number of enterprises trading on them substantially increased. All these steps will contribute to the eventual move away from direct controls on credit to indirect instruments of monetary policy.

VII. Assessment and Conclusions

China has unquestionably made considerable progress in reforming many aspects of its economy. This has contributed to an economic performance marked by more rapid growth than in the pre-reform years; the progressive diversification of the economic structure; the partial opening of the economy to the rest of the world; and an external balance that remained manageable and, in the recent past, swung into considerable surplus. While these gains were made without the severe loss of output observed in many other former CPEs there have been several periods of economic instability characterized by inflation and external imbalance. In responding to these, the authorities have reverted to administrative means of control, thereby slowing reform for a period.

The impact of reform was clearest in three areas: the agricultural sector; the related growth of rural enterprises; and the external sector, particularly the growth of exports. There are three possible explanations. First, particularly in agriculture, the extent of change from pre-existing conditions was sharpest and most comprehensive. Although formal ownership did not change, the land allocation system was overhauled, incentive structures considerably strengthened, and many restrictions removed. Second, perhaps most striking in the case of the TVEs and to a certain extent in the growth of exporting activity, progress has been most evident where market forces have been allowed the greatest play. Third, in each of these areas, China was in effect resurrecting institutions and skills that had lain dormant for a generation. In agriculture, current techniques are based on those used for many generations; all sectors are benefitting from a strong entrepreneurial tradition; and the growth of the coastal regions rests on the comparative advantage that they have of location, a skilled labor force and access to foreign capital.

The areas where least progress was observed were those where the approach was tentative and incomplete, either because of the complexity of the issues involved or where the most determined efforts have been made to preserve existing institutions. It was most evident in the state enterprise sector where, despite the gradual exposure to market forces, many industries remained subject to mandatory planning and non-market pricing. These industries were protected from market forces by a soft budget constraint motivated by the political goals of maintaining employment opportunities and social stability.

There is another group of reforms where there was substantial initial progress, but which have outlived their usefulness; indeed in many cases they are the subject of renewed attention under the reform program. First, the two-track pricing system was a means of introducing market forces to the state enterprises, but had come to perpetuate distortions and market fragmentation. Second, the contract responsibility system was conceived as a means of giving enterprises greater autonomy, but it had served to undermine the tax system, and is now being overhauled. Third, in the financial sector, after an initial surge of institutional reforms, there was relatively little further progress, particularly in the development of financial instruments and markets necessary to underpin the conduct of monetary policy through indirect instruments. Likewise, the reforms have done little to provide the authorities with effective and rational fiscal policy instruments, and, in fact, may have led to traditional automatic stabilizers behaving perversely.

A number of factors are pertinent in making comparisons between China and other countries undertaking structural reform, including former CPEs:

- The initial conditions were relatively favorable. In particular, China did not initiate reform because of an immediate macroeconomic crisis. Growth had been maintained in the pre-reform period--albeit by means of very high investment--repressed inflation was not as severe as in other countries, and the balance of payments had been kept under tight control.
- The political equation was markedly different from situations where the pre-reform political order has collapsed. In China, the leadership saw economic reform as a means of preserving the political status quo; in particular, efficiency gains were needed to divert resources from investment to consumption while sustaining an adequate pace of growth. The leadership also set a very high premium on price stability, in the light of the hyperinflation of 1949.
- The gradual pace and piecemeal approach was a function of political and ideological constraints in the sense that the leadership was never unanimous in endorsing reform. Indeed if there was unanimity, it was that institutions should be replaced only when new ones were ready, giving rise to a strong tenor of pragmatism in many reforms.
- There was strong resistance to any semblance of capitalism in ownership structures, but an acceptance that market forces should be permitted to operate at least to a degree. This led to the emergence of such arrangements as the township and village enterprises, which partially simulated the institutions of a market economy and allowed relatively free rein to market forces.

- In many cases, reforms often did not originate from the central government, but instead were the ratification of developments occurring at the provincial level. The evolution of the household responsibility system is a clear case in point, but other areas including external trade reform, can be viewed in this light.

- China chose to implement the easiest reforms first, which had the benefit of increasing popular support for reform. However, as more difficult reforms are undertaken, especially in the enterprise sector, the risk of short-run output and employment losses remains.

- China started its reform without a severe debt overhang, and so was able to maximize the benefit of the sustained flow of foreign resources in support of its reform efforts, from official development assistance, commercial borrowing, and direct foreign investment. In the latter regard, China's unique relationships with Hong Kong and Taiwan Province of China have been critical in the flow of resources.

- The reforms started long after China had withdrawn from the CMEA arrangements, so that there was no major simultaneous disruption to its external trade or loss of external aid; indeed, this provided the advantage of being exposed to international competition.

- Regardless of other factors, China would not have been able to sustain the high growth rates of the post-reform period without the very high rates of domestic saving that were realized.

It is evident from this review that China's successes with reform stem from a variety of factors, and that the gradual style and pace of reform are only one--possibly minor--among these factors. Indeed, casting an assessment of China's performance in terms of a bipolar model (big bang vs. gradualism) may not be helpful, given the conditions under which China undertook its reforms. On the one hand, it could be argued that some elements of the reform program could have been implemented over a shorter period without output loss or social instability, and in some cases these would have evoked efficiency gains. For example, the agricultural reform went through several years of experimentation before the household responsibility system emerged. After the initial financial reforms of the mid-1980s, little was done to develop the necessary financial instruments and institutions for indirect macroeconomic management. Similarly, gradual price reform may have minimized welfare loss to households, but more rapid progress would have reduced the costs of a distorted price system. On the other hand, some elements of reform--institution building, recasting industrial capital stock and rebuilding infrastructure--are inescapably time-intensive. Nevertheless, even in these areas--reform of the SOEs is a case in point--China could undoubtedly have moved more quickly than has been the case. Where China may have differed from those countries that

experienced a precipitate collapse of economic structures, was that it did not initiate reforms until it was ready to replace existing institutions or mechanisms with new ones.

China's experience with macroeconomic instability during the reform period may provide some lessons for other reforming countries. Although China did not experience severe macroeconomic dislocation, and escaped output loss altogether, it has remained vulnerable to periodic bouts of inflation and external payments disequilibria. This leads to three generalizations. First, reform must be sufficiently comprehensive to include--early in the program--the development of indirect instruments with which to regulate the economy. The authorities must have sufficient confidence in these instruments to resist the temptation of reverting to administrative controls when instability threatens. Second, China's periods of instability did not stem from too rapid a pace of reform, but from excessive demand growth triggered by heightened expectations as new reforms were initiated. This suggests that new rounds of reform should not be accompanied by an indiscriminately accommodative stance of macroeconomic policies. Third, incomplete reform heightens the risk of macroeconomic imbalance, exemplified by the growing resource pressures created by the state enterprise sector.

It is possible that by 1992, China had reached the point where it could no longer avoid a more comprehensive approach, and necessitating the new wave of reform that has begun. Reform of the state enterprise sector is crucial, owing to the growing macroeconomic tensions created by its financial needs and the pressure of competition from foreign funded enterprises and the TVEs. Improving the environment in which the enterprises operate requires comprehensive, simultaneous action in a number of areas, including the price system, enterprise taxation, the financial system, monetary policy, and the social safety net. Moreover, the complete divestment of managerial and financial involvement by the State in enterprise management and the growth of private share ownership represent tentative first steps towards ultimately changing the ownership structure of enterprises. At the same time, China's strategy of opening to the rest of the world implies the need for domestic prices to be integrated with world prices, and for the development of China's large domestic market and commercial capabilities. This calls for further major liberalization of the exchange and trade regimes, opening the domestic market to greater competitive forces, thereby improving the backward linkages crucial to sustainable export-led growth.

Table 1. China: Synopsis of Reform from 1978

1978-83	1984-88	1989-present	Possible future action
1. <u>External Sector</u>			
a. <u>Exchange system</u>			
<p>Until 1981, several exchange rates were used for trade transactions between foreign trade corporations (FTCs) and domestic enterprises, depending on item traded.</p> <p>In January 1981, a single exchange rate was established for internal settlement of trade transactions (more depreciated than official rate).</p>	<p>- In 1984, exchange rate was unified.</p> <p>- Dual exchange system reintroduced in 1986:</p> <ul style="list-style-type: none"> - official rate with de facto peg to U.S. dollar; - more flexible rate determined on foreign exchange adjustment centers (FEACs) where retention quotas are traded; - FEAC premium was 53 percent at end-1987 and 80 percent at end-1988. 	<p>- Official rate: (i) devalued in December 1989 (21 percent) and in November 1990 (9 percent); (ii) from April 1991, more frequent small adjustments.</p> <p>- By end-1991 the real effective exchange rate (official) was ... percent more depreciated than in [1978]</p> <p>- FEAC premium: 17 percent at end-1989, falling gradually to 8 percent at end-1991.</p>	<p>- Eventual unification of the exchange rates. No timetable specified.</p>
<p>Much experimentation with foreign exchange sharing. In 1984 arrangements between local and central governments were formalized. In 1985, some enterprises were given the right to retain a portion of foreign earnings.</p>	<p>- Further evolution of complex quota retention system based on location by province and by priority industry.</p> <p>- Access to FEACs: initially restricted to foreign funded enterprises, but in 1988 access was extended to all domestic enterprises with foreign earnings or retention quotas.</p>	<p>- System simplified in February 1991, with uniform retention except for mechanical and electrical products.</p> <p>- Access gradually extended; by 1990 enterprises could acquire foreign currency for debt service. Individuals allowed to buy and sell at FEAC rates in 1991.</p> <p>- Computerized trading introduced in national foreign exchange swap center in Beijing.</p>	<p>- Retention and trading of actual foreign exchange to be considered. No timetable specified.</p> <p>- Progressive extension of access to the FEACs and integration of trading in all FEACs.</p>

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
b. Trade system			
<ul style="list-style-type: none"> - Foreign trade originally conducted by 12 FTCs, each enjoying monopoly in a particular area, within mandatory trade plan. Gradually this system replaced by decentralization, and diminishing role for trade plan. - Experimentation with responsibility system for FTCs begins. - Subsidies on imports and exports. 	<ul style="list-style-type: none"> - By mid-1980s foreign trade largely conducted by about 700 FTCs largely on an agency basis (i.e., FTC receives a fee for trading on behalf of domestic enterprises). - In 1988, local branches of FTCs became independent and new ones established, bringing the total number of FTCs to about 5,000. 	<ul style="list-style-type: none"> - Export subsidies abolished in 1991. - Rationalization of FTCs begun in 1989 reduces number to about 4,000. By end 1991, over 400 production enterprises could trade directly. - Responsibility system extended to all FTCs in 1991. 	
<ul style="list-style-type: none"> - Trade licensing: both imports and exports covered by system introduced in 1980. 	<ul style="list-style-type: none"> - Number of licensed imports increased from 45 to 53 in 1988. Exports: number of licensed items reduced from 221 to 159 in 1988. 	<ul style="list-style-type: none"> - Exports subject to license steadily increased to 234 items in 1991. - Proportion of trade covered by license (1991): exports--55 percent; imports--40 percent. 	<ul style="list-style-type: none"> - Plans announced in 1991 to end two thirds of import restrictions by 1994, with 16 products removed in 1992.
<ul style="list-style-type: none"> Import tariffs progressively introduced [check for more facts] 	<ul style="list-style-type: none"> - Import tariffs: range from 3-150 percent. Periodic adjustments to contain import demand. 	<ul style="list-style-type: none"> - Tariffs on 40 items reduced in 1991. - Harmonized system effective 1992, with reduced duties on 225 items. 	

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
2. <u>Agriculture</u>			
a. <u>Production</u>			
Experiments with responsibility system began in 1978. Household responsibility system (HRS) emerges as dominant form by 1983.	- Mandatory procurement replaced in 1985 by contracts with households at negotiated prices.	- Two-tier management system evolves in many localities: (a) continued HRS framework; and (b) centralized organizations (to provide better services). Some land reverts to the management of the collectives, who lease it out through bidding to maximize efficiency of utilization.	- Further evolution with goal of maximizing efficiency of land use.
b. <u>Prices and subsidies</u>			
- Procurement takes place in three tiers: contract (quota), negotiated, and market.	- By 1987, market prices dominant <u>at retail level</u> except for some goods like grain and oil supplied under urban ration.	- Support pricing machinery invoked to guarantee farm incomes in light of large grain harvest. Other prices increased (e.g., cotton).	- Adjustment of grain retail prices, eliminating difference between procurement and retail price.
- Some agricultural inputs still supplied at plan or contract prices.	- Subsidies on essential foodstuffs continue to increase sharply.	- Large adjustment in urban prices of rationed goods (grain and oil) in May 1991 and April 1992.	- National futures trading to be encouraged, to stimulate farmers' supply direct to the market.
- Market prices apply to growing number of retail items; procurement prices increased; subsidies rise.		- Gradual strengthening of wholesale markets at national, provincial, and local levels.	- Further reserves being established for price stability (e.g., in cotton, oils, sugar, wool, rubber).
		- Grain reserves established to preserve price stability.	
c. <u>Food security</u>			
- Private interprovincial trade in grain permitted, diminishing role for production targeting.	- To counteract stagnating grain output, some intervention increased-- more procurement quotas, inputs tied to specified output, state monopoly on foreign trade in grain.	- Some increase in interprovincial barriers, during rectification program. In late 1991, measures taken to reduce barriers to some agricultural goods.	- Continued pursuit of complete autarky in grain production. Target of 500 million tons by 2000.
	- Grain imports required: national policy to achieve complete autarky.	- Strong production increases in 1990-91 (partly due to good weather). Record crop in 1990 of 446 million tons.	

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
3. <u>Pricing Policy</u>			
a. <u>Enterprise pricing</u>			
<p>Selected SOEs sell a portion of output at negotiated prices on experimental basis.</p>	<p>- "Dual-track" pricing introduced: (i) fixed prices corresponding to plan quotas; (ii) guided prices in contracts with state purchasing agencies (iii) market prices for other sales.</p>	<p>- Dual-track prices of a number of commodities were unified, including cement, rubber, tin plate, special types of steel, etc. - Ratio of producer goods under fixed/guided/market pricing is down to 45:19:36 in 1991.</p>	<p>- Gradual phasing out of the dual-track pricing system. Timetable not specified, but possibly by the year 2000.</p>
b. <u>Retail and other pricing</u>			
<p>- Retail prices of most important consumer goods remain under state control. - Some adjustments in administered prices.</p>	<p>- "Dual-track" pricing introduced for many goods. In practice, three tiers of price control exist: State-fixed prices State-guided prices Market prices (in sub-tiers): Prior approval Guided prices Unrestricted By 1988, the three tiers are roughly in the ratio (30:25:45). - Greater market pricing paralleled by the rise of individual and collective retailing (from 10 percent in 1978 to 53 percent in 1987). Efficiency undermined by interprovincial barriers to trade.</p>	<p>- Under rectification program price control tightened in 1988-89: (i) fixed and guided prices subject to central (State Council) approval; (ii) 50 market prices brought under control. - Relaxation in 1990 and 1991. Prices under State Council reduced to 5. Direct control on market prices progressively eliminated by 1991. - "Indirect" measures used to realize price targets: mainly management of inventories of essential commodities. - Large increase in ration prices of grain and edible oil in May 1991 and April 1992, and adjustments to administered prices of goods and services. - Ratio of fixed/guided/market prices down to 28:17:53 by 1991. - Opening of national metals exchange and wholesale market for non-ferrous metals.</p>	<p>- Gradual increase in proportion of commodities sold at market prices. - Publication of "price law" in about two years to prevent speculation in a more market-oriented environment. - Further adjustments to grain prices (to eliminate differential between retail price and procurement price). - First step in April 1992. - Establishment of wholesale markets, including forward trading.</p>

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
4. <u>Enterprises</u>			
a. <u>Ownership issues</u>			
<ul style="list-style-type: none"> - Widespread state ownership, particularly large- and medium-sized enterprises. Various answerable to central, provincial, municipal or county authorities. - Collectives and rural enterprises answer to their local government entity. - Private enterprises are small and mainly in retail sector. - some joint stock ownership mainly by one enterprise in another, from 1986. - Foreign investment through fully-owned enterprises and joint ventures. 	<ul style="list-style-type: none"> - Securities exchanges open in Shanghai (1990) and Shenzhen (1991). - By end 1991, 6,000 share-issuing companies exist nationwide, of which 69 are listed: 11 are publicly quoted in Shanghai, 6 in Shenzhen. - From 1992, foreigners can purchase shares in Chinese enterprises. 	<ul style="list-style-type: none"> - Further securities exchanges to be opened. - Conglomerates of SOEs to be established to allow greater autonomy and efficiency. Experiments are under way in 100 of the 3,000 existing groups. - Experiments with joint stock companies and other forms of shareholding are underway. 	
b. <u>State-owned enterprises (SOEs)</u>			
<ul style="list-style-type: none"> - Experimentation with income taxation to replace direct profit transfers to the budget. 	<ul style="list-style-type: none"> - Contract responsibility system became formalized for large and medium-sized SOEs. These specify performance targets, supply quotas, and tax obligations. - By 1988, 90 percent of SOEs covered by contracts. First generation of contracts cover 3-5 years from 1988. 	<ul style="list-style-type: none"> - Second generation of contracts similar to first but shorter periods (1-2 years) because of financial problems. - Some experiments on new forms of contracting and taxation (see also section 7). Experiment involves 2,000 enterprises in 35 locations. 	<ul style="list-style-type: none"> - Twenty measures to revitalize SOEs announced in 1991 will be implemented during the Eighth Five-Year Plan. - Detailed rules and regulations being formulated to implement Enterprise Law, which will increase autonomy of enterprise management.
<ul style="list-style-type: none"> - Mandatory planning: proportion of output subject to quota declines substantially from the early 1980s. By 1987 about one third of goods (based on retail sales value) sold under the plan, down from two-thirds in 1980. But, many intermediate goods remained largely under direct control, most steel, coal and almost all petroleum. 	<ul style="list-style-type: none"> - "Mutual pledge" system established to protect key SOEs from effects of the rectification program: in late 1989 234 key enterprises receive preferences in return for guaranteed sales to the state. 	<ul style="list-style-type: none"> - Extent of mandatory planning to be reduced over the period of the Eighth Five-Year Plan. - Preferential treatment to continue for 234 key enterprises. 	
<ul style="list-style-type: none"> - Investment: Experimental approach to give SOEs greater autonomy in investment decisions, in line with greater profit retention. 	<ul style="list-style-type: none"> - Responsibility for financing investment largely shifted from the Government to the SOEs (in 1978, 60 percent government-financed, in 1987, 20 percent). SOEs allowed access to bank credit and retained earnings. 	<ul style="list-style-type: none"> - In 1989, under the rectification program, many projects were cancelled. - Restrictions on investment eased during 1990 and 1991. 	<ul style="list-style-type: none"> - Increases planned in key state construction projects.
<ul style="list-style-type: none"> - Market sanctions: enterprises largely immune from closure. 	<ul style="list-style-type: none"> - A Bankruptcy law is formulated in 1986. 	<ul style="list-style-type: none"> - Bankruptcy law becomes effective in 1988, but remains almost unused. - In 1991, 3000 inefficient enterprises were merged with others. 	<ul style="list-style-type: none"> - Intention to apply bankruptcy law more widely.

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
<p>c. <u>Township and village enterprises (TVEs)</u></p>			
<p>- Existing rural enterprises benefitted from increased investment associated with rising agricultural income and the availability of surplus labor.</p>	<p>- These enterprises designated as TVEs in 1984, being given concessional tax treatment and favorable access to credit.</p>	<p>- Credit restrictions under rectification program result in closures, a sharp drop in growth rate, and loss of employment. - Credit restrictions eased in second half of 1990. TVE growth resumes.</p>	<p>- Further development of TVEs.</p>
<p>d. <u>Retail trade</u></p>			
<p>- Private traders began to be encouraged in small shops and restaurants.</p>	<p>- In 1984-85 about three-fourths of small commercial SOEs were contracted or leased to collectives or individuals.</p>	<p>- Some controls were reintroduced under the rectification program.</p>	<p>- Privately-owned tertiary sector activities to be strongly supported.</p>

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
<u>5. Wages and Employment</u>			
<ul style="list-style-type: none"> - Employment guaranteed in state-owned enterprises and government units. - In 1978 bonuses re-introduced, capped at 3 months salary. Generally distributed on egalitarian basis, i.e. not based on individual performance. 	<ul style="list-style-type: none"> - Since 1986, recruits to SOEs can be hired under labor contracts (1-10 years' duration). Many exceptions. - Cap on bonuses replaced by tax on excessive bonuses. 	<ul style="list-style-type: none"> - In 1991, policy announced for the next five years, under which uniform wage increases would be phased out. Government would control only the amount of the increase in the total wage bill. 	<ul style="list-style-type: none"> - Cast-iron guarantees of jobs to be phased out by the year 2000. - Nominal wages to be increased as various reforms implemented, including phasing out of food and rent subsidies. Eventual complete monetization of wages.
Thus wages include:			
<ul style="list-style-type: none"> - Basic wage (centrally determined) - Component based on level and seniority in the enterprise. - Bonuses determined by enterprises or at local level. 			
<ul style="list-style-type: none"> - Wages supplemented by welfare: provision: food and rent subsidies; income in kind; other services (e.g., medical and education through the work place). 			

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
6. <u>Housing</u>			
<ul style="list-style-type: none"> - Pre 1978 system basically unchanged. Housing supplied by municipalities or by work units, involving: <ul style="list-style-type: none"> - sub-economic pricing (rent covers one fifth of operating costs); - costs of subsidies and investment borne by enterprises and Government; - nonmarket allocation of housing; - no housing finance system. 	<ul style="list-style-type: none"> - Experimental steps to raise rents (and wage supplements) in a few cities began in 1985. 	<ul style="list-style-type: none"> - Focus shifted in 1989 to sale of publicly owned housing, but at steeply discounted prices. - Urban rents raised 200-300 percent in early 1992. - Experimental housing reform began in Shanghai in 1991: Major features: <ul style="list-style-type: none"> i) Housing bonds issued to renters ii) Raising rents to cover costs. iii) Continued link between workers' housing and their work units. 	<p>Over next ten years, gradual reform involving:</p> <ul style="list-style-type: none"> - raising rents to cover costs - selling public housing to state employees (state maintains some equity in each house); - promotion of financing schemes (bonds, housing funds, and cooperatives, etc.);
7. <u>Social Security</u>			
<ul style="list-style-type: none"> - Work units (enterprises and government agencies) responsible for most social security: <ul style="list-style-type: none"> (i) pensions; (ii) job security (a proxy for unemployment benefits); (iii) welfare, often including medical and education. - Coverage not universal: excludes individuals, contract workers, employees of TVEs and other rural enterprises. 	<ul style="list-style-type: none"> - Experimentation with pension pooling in a few regions began in 1986. 	<ul style="list-style-type: none"> - By early 1990, pension pooling among enterprises in 2,200 cities had begun. - Contributory pensions are under experimentation in five coastal cities. - Experimental unemployment schemes under way in some localities to facilitate implementation of bankruptcy law. 	<p>During the Eighth Five-Year Plan:</p> <ul style="list-style-type: none"> - develop a national pension system, particularly for those not now covered. - Unemployment insurance to have wider coverage. - Refine medical care arrangements. - Comprehensive social security schemes in special economic zones.

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
8. <u>Fiscal Policy</u>			
a. <u>Resource sharing (center/provincial relations)</u>			
<p>Various forms of revenue sharing: local governments had responsibility for negotiating management contracts, including tax/profit arrangements with enterprises. Structure favored granting of tax incentives.</p>	<p>- Revenue-sharing contracts between central government and provinces started in 1987 or 1988 for 3-4 year periods. Typically, these involve an agreed base figure and annual rate of increase.</p>	<p>- New contracts due to start in 1991 under negotiation. Some experiments with clearer demarcation of center/local resources began in nine provinces in 1992.</p>	<p>- Clearer demarcation of center-local resource assignment to become universal.</p> <p>- Strengthening central control over fiscal policy.</p>
b. <u>Budget system/presentation</u>			
<p>- Consolidated budget; financing flows treated as revenue and expenditure items.</p>	<p>- No change in presentation.</p> <p>- Rapid growth of extrabudgetary funds (includes enterprises' retained earnings and government units)</p>	<p>- Two-tier system announced in 1991 separating current and capital accounts.</p>	<p>- Eventual presentation of budget according to international conventions.</p>
c. <u>Taxation</u>			
(1) <u>Enterprise taxation</u>			
<p>In 1983, taxation replaces profit transfers from enterprises to government. Enterprises assume greater responsibility for own funding own investment.</p>	<p>- From 1987, contract responsibility system applied to most medium- and large SOEs.</p> <p>- Nominal tax payments specified (undermines 55 percent tax rate).</p> <p>- Loan repayments are tax deductible.</p> <p>- Adjustment tax and other levies imposed on above-contract profits.</p>	<p>- New generation of contracts resembles previous generation, but many enterprises seek shorter contracts.</p> <p>- Experiments with new system to separate profit and tax;</p> <ul style="list-style-type: none"> - lower tax rates; - loan repayments not deductible; - contracting on after-tax profits. <p>- In 1989, extrabudgetary funds of enterprises subjected to 10 percent levy to preserve government revenue.</p>	<p>- Adoption of new tax system in early 1993. Tax rate for large and medium-sized enterprises would be 33 percent; contracting on after-tax profits; loan amortization non-deductible.</p> <p>- Some SOEs may be subject to lower tax rates in 1992.</p>

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
<u>(ii) Foreign-funded enterprises</u>			
Wholly owned foreign enterprises taxed at 20-40 percent. Joint ventures taxed at 30 percent. Various incentives (tax holidays, etc.) for new enterprises.	- No significant changes. But local governments in SEZs and open coastal cities have considerable discretion in granting additional concessions.	- The two tax scales merged in 1991, effective 1992, with tax rate unified at 33 percent.	Unification with domestic enterprise taxation expected in early 1993.
<u>(iii) Taxes on goods and services</u>			
Through 1983, indirect taxation of enterprises was conducted through a turnover tax, the consolidated industrial and commercial tax, applied to industrial production, some agricultural sales, imports, retailing, transport, communications and services.	- In 1984 three separate indirect taxes were introduced. Tax rates often set in association with prices in order to equalize profits, resulting in a wide range of tax rates as follows (1988): Value-added taxes - 12 rates Product taxes - 22 rates Business taxes - 4 rates	- Business tax rate change proposed in 1990 and 1991 for revenue purposes; not implemented. - VAT extended to petrochemicals.	VAT may be extended to all industries by 1993, while simplifying and rationalizing the rate structure. Eventual uniform rate after price reform.
<u>(iv) Taxes on construction</u>			
...	- Tax (at 10 percent) on construction undertaken outside the state investment budget.	- In 1991, an investment orientation tax introduced. Variable rates reflect investment priorities.	

Table 1. China: Synopsis of Reform from 1978 (continued)

1978-83	1984-88	1989-present	Possible future action
9. <u>Financial Sector</u>			
a. <u>Banking system</u>			
<p>Monobank system persists. Specialized banks continue to operate in sharply delineated fields.</p>	<ul style="list-style-type: none"> - In 1984, commercial banking activities removed from People's Bank of China (PBC) which becomes a central bank. Specialized banks are permitted to engage in commercial banking. - In 1986, banks established at provincial level. - In 1987, two "universal" banks permitted to compete with existing banks in all forms of business. - Networks of urban and rural credit cooperatives supervised by the industrial and agricultural banks. - From 1986, all banks allowed to engage in foreign transactions. 	<ul style="list-style-type: none"> - Through 1988, there was a gradual erosion of the sharp demarcation among banks that began to transact outside their own specialization; enterprises allowed to work with more than one bank. Limited competition in interest rates. - Under rectification program, specialization reasserted and competition in interest rates reduced. Competition continued to take the form of the provision of services. Commercial banks expanded their foreign operations. 	<ul style="list-style-type: none"> - Strengthening of macroeconomic and supervisory role of the PBC as central bank. - Reform of payments and clearing systems. - Banking Law to be enacted.
b. <u>Nonbanking institutions</u>			
	<ul style="list-style-type: none"> - Trust and investment companies established for loan and equity financing of domestic enterprises; international companies to raise foreign funds. - Insurance companies, leasing companies, and financial companies set up: many at provincial level or as part of enterprise groups. Rapid growth of IICs led to restriction of activities in 1988 to permit detailed examination of their operations. 	<ul style="list-style-type: none"> - Activities resumed in 1989 with tighter supervision from PBC. - 375 IICs in operation by end-1991, of which 120 authorized to conduct foreign transactions. 	

Table 1. China: Synopsis of Reform from 1978 (concluded)

1978-83	1984-88	1989-present	Possible future action
<u>c. Financial markets</u>			
<ul style="list-style-type: none"> - From 1981 Government securities issued through compulsory sales to enterprises and individuals (the former at low interest rates). - Enterprises were permitted to issue bonds from 1985. High yields, especially in rural areas. - Private enterprises permitted to issue shares from 1982. Shares do not convey ownership. Restrictions imposed in 1987. 	<ul style="list-style-type: none"> - Some SOEs issue shares from 1985, which do not convey ownership rights. Some restrictions imposed in 1987. - Earmarked bonds for key construction projects began in 1987. 	<ul style="list-style-type: none"> - Restrictions placed on interest rates in interbank market (a margin around the PBC overnight rate). - Secondary markets for treasury bonds opened in major cities. After slow start secondary market develops rapidly (computerized quotation and trading system established in 1990). - Experiments with voluntary placement of government bonds conducted in 1991. - Securities markets open in Shanghai (December 1990) and Shenzhen (May 1991) (see section 3). 	<ul style="list-style-type: none"> - Continue extension of voluntary government bond placement. - Development of interbank and money markets, and of new financial instruments. - More extensive listing of enterprises on the securities markets and opening markets in other cities. - Securities Law to be enacted. - Experiments with auctioning land use rights underway.
<u>d. Monetary policy</u>			
<ul style="list-style-type: none"> - Monetary policy centers on the credit plan, which is the financial counterpart of the physical plan. - Interest rates established by the PBC. 	<ul style="list-style-type: none"> - Credit plan remains central instrument of monetary policy. - De facto decentralization since provincial branches of PBC often acquiesce to credit priorities of the provinces. - Reserve requirements introduced at high levels when the new banks were established in 1984. In 1985 they were lowered and unified. - Banks permitted to adjust lending and deposit rates within margins specified by PBC. 	<ul style="list-style-type: none"> - Recentralization of decision making to the headquarters of PBC. Credit plan abruptly tightened in 1988 in the face of inflation, then relaxed to promote growth, and protect SOEs. - Some decentralization permitted to provincial branches in adjusting the allocation of plan during 1991. - Under rectification program, reserve requirements raised; then "excess reserve" requirements introduced in light of high liquidity and inflation threat. - Under rectification program, interest rates raised sharply, and interest rate competition largely eliminated. - Through 1990 and 1991, interest rates were reduced in three steps. 	<ul style="list-style-type: none"> - Introduction of open market operations initially through issuance of short-term bills. - Gradual increase in autonomy of banks. - Authorities considering further reduction in nominal interest rates. - Gradual increase in reliance on interest rates.

List of Abbreviations

CPE	Centrally Planned Economy
CRS	Contract Responsibility System
FEAC	Foreign Exchange Adjustment Center
FTC	Foreign Trade Corporation
GATT	General Agreement on Tariffs and Trade
HRS	Household Responsibility System
PBC	People's Bank of China
SAEC	State Administration for Exchange Control
SEZ	Special Economic Zone
SOE	State Owned Enterprise
TIC	Trust and Investment Company
TVE	Township and Village Enterprise

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