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James W. Dean*

Five Challenges for China in the 1990s

There are many economic challenges facing China in its transformation to a market economy. Professor Dean discusses five of the most important of these challenges and the opportunities which they present.

Since 1978, China has gradually but decisively moved from a planned economy to a market economy. But it was only in October 1992, at the 14th Party Congress, that China's leadership officially endorsed "market socialism". This is now a ubiquitous slogan: one hears and reads it many times each day during even a short stay in Beijing. The symbolism is important. Many in the West underestimate the energy and commitment that can be mobilized in the Chinese culture and political system by a simple announcement from the Communist Party leadership that the market is not only to be tolerated, but even to be encouraged. To some in the capitalist West, the "socialist market" is a contradiction in terms. How can a market economy be anything but capitalist? But to the Chinese, the phrase is not contradictory. The market is seen as a means to a socialist end.

In America, President Clinton has set himself the challenge of restoring some "socialism" to the US economy after the extensive withdrawal of government from the economy under Presidents Reagan and Bush. Mr. Clinton would never characterize his challenge as the restoration of socialism, since the "s" word is unacceptable in American politics. But in essence this is what he wishes to do. In China, Mr. Deng faces the challenge of introducing more of the market into a socialist system. And in China the "m" word, "market", is now acceptable.

Nevertheless, the implementation of a socialist market economy poses many challenges. The pace of reforms has been gradual, not the "big bang" heard recently in parts of Eastern Europe and the former

Soviet Union. There is no doubt the reforms have worked – after all for eleven years now China's growth has been the highest in the world (with the single exception of Botswana in Southern Africa, which discovered diamonds!)

But *completing* the reforms may prove traumatic. China is under particular pressure to accelerate its reforms by the requirements of the GATT, which it wishes desperately to rejoin. For example, China's decision to abandon its dual currency system, and allow the renminbi to float at market rates, was prompted in part by pressure from Geneva. However, accelerated reforms could accelerate inflation, increase unemployment and engender political unrest. In late May 1994, security surrounding universities, state enterprises and other vulnerable venues was being tightened in anticipation of the five-year anniversary of the June 4 demonstrations and subsequent massacre in and around Tiananmen Square. And on the other side of the Pacific, Washington was monitoring Beijing's heightened vigilance with an eye to human rights abuses. Nevertheless, on May 26, just before the June 3 deadline, President Clinton announced that the US would not only renew Most Favored Nation (MFN) trading status for China, but abandon the link between human rights and trade that has hitherto mandated an annual review.

China's 15 years of gradual reforms have allowed a thriving parallel economy to mushroom, but state-owned enterprises still account for about 25% of GDP. Almost 40% of them are losing money, putting severe pressure on the Bank of China to resort to inflationary finance. China is forced to face tough issues that can no longer be postponed: layoffs, bankruptcies, currency devaluation, banking reform and inflation. Here are some of the immediate challenges.

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Challenge Number One

The first and basic challenge facing China in the 1990s is to accelerate her movement toward the free market, internally and externally, sufficiently to be re-admitted to the GATT, and beyond that, to meet the goals of the 14th and 15th Party Congresses. But just as for every yang called for by heaven, earth provides an accommodating yin, so does every challenge suggest an opportunity.

The opportunity afforded China for the 1990s is to realize the full efficiency of free trade: free trade with the rest of the world as protection from competition is removed both by foreigners and by China, and free trade between the various regions in China as barriers to trade within China are removed and the market economy becomes more complete.

Joining the GATT will increase pressure on China to become more efficient in internal trade and production. This will be a great opportunity for China in the 1990s. But China is not about to abandon the "socialist" aspect of her new slogan. China's experts have studied capitalist economies very carefully, and are well aware of their failures as well as their successes. Socialism, for all its failures to deliver efficiency, and thus high levels of consumption for workers, has nevertheless been concerned to keep workers employed.

Challenge Number Two

The second challenge facing China in the 1990s is to accelerate movement toward efficiency, but with minimal unemployment. How can China eliminate its loss-making firms without causing workers in these firms to lose their jobs? China views the recent chaos in Poland and current chaos in the former Soviet Union with considerable horror.

But China has the opportunity to offer a particularly Asian solution here. Ever since its industrialization, Japan's "zaibatsu" have offered workers continuous employment even when the particular products they produce become unprofitable. Japanese zaibatsu achieve this by moving workers from one line of work to another. This is possible because the zaibatsu produce a wide variety of horizontally diversified products.

China is beginning to experiment with a similar, though certainly not identical approach. Unprofitable state enterprises are shifting their production to profitable lines of production as demands shift. For example, a large sewing machine factory in Tainjin has

shifted from producing household sewing machines to industrial sewing machines. No one makes their own clothing any more in China – factory made clothing is just too cheap! Market signals have accelerated these kinds of production shifts as even state-owned firms have become more sensitive to their profits and losses. But under socialism workers have not been fired, they have simply been retrained.

A second Chinese approach is to merge one loss-making firm with another. Yet a third is for a joint venture to take over the firm. Again, in both cases, workers keep their jobs. China has undergone a full 15 years of reform without causing unemployment! Although bankruptcy law was introduced in 1988, it has been applied to only a few firms.

However, about 40% of the output of state enterprises, accounting for perhaps 25% of GDP, is produced unprofitably. These enterprises may have to be shut down, and workers may well become unemployed. How will this be handled?

China has two systems for handling unemployment: one for temporary unemployment and one for permanent. A state firm which has no more use for its workers temporarily pays them 60% of their former wage until they are permanently laid off. In the meantime, workers are encouraged to find alternative work, and most do, particularly in the consumer service sector: in retailing, restauranting and a hundred other activities that were so undeveloped before the reforms. The number of restaurants in Beijing has mushroomed from just a few hundred before ten years ago to almost 30,000 today!

New enterprise is emerging every day. One of the latest is a burst of entrepreneurial cadre who will wash cars on the spot – a brand new opportunity for Beijing's underemployed and a brand new service for Beijing's new class of car owners. And the car washers consider their lot improved since their new work pays them much more than the old "iron" wages in state or collective employment.¹

The final possibility is that the worker is permanently retired from the loss-making firm. For 3 or 4 years now, China has levied a 1% tax on salaries primarily to fund unemployment insurance. The fund is now overflowing, so much so that it is being drawn upon to build new office towers and the like. Thus far, laid-off workers have readily found employment – very often self-employment – long before they have had to draw unemployment benefits.

This phenomenon is the great virtue of an economy

growing at 10% per year. In other words, rapid reform of the economy, far from causing unemployment, is generating so much growth that it is creating new employment, and at much higher wages than before. Maintaining high growth is paramount to the adjustment process. This brings us to the third challenge.

Challenge Number Three

In reducing the role of state enterprise, minimizing unemployment is not the only challenge. There is also the challenge of deciding what roles government should continue to play. And these government activities must be paid for, despite the loss of revenue from state enterprise.

In 1988, about one half of state revenues came directly from enterprise income. Now, almost none does. Government revenues declined from 35% of GNP in 1978 to only 18% in 1991. And government expenditure has exceeded government revenue in every year but one since 1979: in 1990 by 15 bn. yuan, out of a total budget of 340 bn. It will be a major challenge to cover the deficit without resorting to monetary creation, as has happened in so many other developing countries.

In the arcane world of academic economics, recent work on growth theory has thrown light on the appropriate role for government. Until recently, growth theory had progressed little since work by the Nobel prize-winning economist Robert Solow in the 1960s. Solow identified labor and capital as measurable inputs into the growth process, and showed that an increase in savings and investment, and thus capital accumulation, would raise the growth rate temporarily but not permanently. Since 1985, work by Professors Paul Romer of Berkeley, Robert Lucas of Chicago and David Aschauer of Rochester has argued that certain kinds of capital investment can raise growth rates

permanently.² Such investment yields returns that cannot be captured exclusively by owners of the capital: the returns are partially "externalized" to the economy as a whole or to society at large. Such investment is best financed (though not necessarily best managed!) by governments.

Examples of "externalizing" capital investment are infrastructure projects such as roads, railroads, ports and sewers; research and development; environmental projects and, most importantly, education. One could also argue that governments should ensure some degree of income equality, or at least redistribute income sufficiently to eliminate desperate poverty that leads to social unrest and crime, and reduces national income and perhaps the rate of growth of national income as well.

Interestingly, these are the kinds of roles for government that President Clinton has argued were neglected in the USA during the 1980s, and that his Administration hopes to revive. China is a long way from abandoning such roles for government, but there will come a point when she must decide which roles to retain and which to leave to private capitalism. The "socialist market economy" may well become an increasingly accurate description of modern economies, both in the traditionally capitalist countries and the traditionally communist countries.

To reiterate, the important conclusion of the new growth theory is that investment in externalizing capital goods *permanently* raises growth rates. Will the new China be able to afford, or, more accurately, to fund, such investment?

Government Funding

The problem of funding government as state enterprises shrink is common to most restructuring economies. In countries like Poland that have taken the "big bang" route to restructuring, government has found itself in fiscal crisis without access to the profits of state firms; in desperation, government has printed money to pay its bills, and severe inflation has ensued. Although official Chinese statistics cite a 22% inflation rate for 1993, the money supply has increased by 50%. The inflation of 1987-88 was traumatic and had to be followed by even more traumatic austerity in 1988-89. Some see Tiananmen Square as a by-product of that trauma.

The central government's funding is tenuous.

¹ This may be less true for certain occupations in certain state enterprises. Indeed, Professor Huo of the CICIR argues, citing World Bank studies, that China's wage-to-interest-rate ratio has long been artificially low, encouraging capital-labour ratios in state enterprises that are higher than would result from market-determined wages and interest rates. He argues that the total benefits package of state and state enterprise employment is often so comfortable that employees are reluctant to leave. A typical package includes access to coveted subsidized rental housing. It has been calculated that the average state enterprise employee would need savings of 300,000 to enable him to duplicate his benefits package (housing prices are already unaffordable to most in the large cities). Of course security-conscious employees would be prone to stay on, whereas risk-takers might seek self-employment. And as wage differentials widen in favour of the private sector, this phenomenon will become less prevalent. Moreover the 60% wage paid to the temporarily laid off reduces the opportunity costs of seeking alternative employment. Recall that alternative employment is encouraged even as the 60% is being drawn.

² The seminal article is Paul M. Romer: Increasing Returns and Long-Run Growth, in: Journal of Political Economy, October 1986, Vol. 94, pp. 1002-1037

Currently, a tax rate of 55% applies to state and local enterprises and to collectives and these account for 60%+ and 20%+ of government revenue. Domestic private sector firms are taxed at 35% and yield 10%+ of the government's revenue. Joint ventures with foreigners are taxed at 0% for the first two years and 15% for the next three, and have thus far yielded virtually nothing to state coffers.

In the long run, in the interests of efficiency, tax rates between all categories of enterprise must be equalized. Already, Beijing newspapers are rife with rumours of "shell" joint ventures, 100% funded by Chinese money that is "round tripped" to and from Hong Kong or elsewhere.

The new income taxes schedule now starts at 20%

for incomes above 400 yuan (\$80) per month and rises to 50%. It yields very little revenue to the central government. China's opportunity lies in developing efficient collection systems, perhaps by paying all wages into bank accounts, or perhaps by enforcing withholding by employers. But neither practice is yet in place. However, China has recently instituted an ingenious "capital asset tax" which applies to the current value of both old and new state capital. The fixed assets of state enterprises are taxed at a rate somewhat above the rate of interest, as is new capital "lent" to such enterprises by government.

The bond and stock markets are primitive but growing rapidly. Almost daily the newspapers report on yet another enterprise that has chosen the bond or

Hans-Georg Ehrhart/Anna Kreikemeyer/Andrei V. Zagorski (Eds.)

Crisis Management in the CIS: Whither Russia?

Political and social instability on the territory of the former Soviet Union is aggravated by violent conflicts. In these Russia is playing a central role. Due to its potentials it is in a structurally hegemonial position while being itself deeply involved in a long-term process of internal change. At the same time Russia is striving for a reintegration within the framework of the Commonwealth of Independent States (CIS) and is also engaged in armed conflicts in the "near abroad". On the one hand, the West is interested in the integration of Russia and in the containment or the resolution of these conflicts within collective security systems. On the other hand, it is restraining itself from becoming more engaged in the CIS.

Which background do the violent conflicts in the CIS have? Which role does Russia play in the crisis management? What is the behaviour of the international community? Is Europe going to be divided into new spheres of influence? These questions are examined by experts from noted research institutes, policy advisers, diplomats and military men. The book provides topical and indispensable background information for all those who are interested in Russian policy and the security of Europe.

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“share ownership” avenue to expansion. And since the 14th Party Congress, such resort to the market is considered eminently laudable. Private citizens of all stripes and walks of life lust after bond and share ownership. Income from capital is no longer disgraceful – rather it is a much sought after supplement to the value of one’s labour.

Since early on in the reform period, regional and local governments have been permitted to keep profits and taxes from enterprises and collectives under their jurisdictions. This is beginning to bear fruit; the devolution of incentives works to attune industry and infrastructure to regional needs. Even railroads have been built by regional initiative; for example in Inner Mongolia and in Guangzhou province. Manchuria has successfully funded and managed growing border trade with Russia.

But regional fiscal finance also has its dark side. China’s regional governments compete vigorously for tax revenues, and the result is proliferating regional protectionism. China’s natural geographic barriers to internal trade, given her underdeveloped highways and railroads, are compounded by tariff and non-tariff barriers, and competing subsidies created by regional governments. One consequence is diseconomic scales of production: for example, China now produces literally hundreds of brands of cigarettes.

Challenge Number Four

China’s fourth challenge in the 1990s is to channel the cash savings of ordinary people into productive investment. This means developing a much more extensive banking system, diverse financial instruments and markets for them. An indication of current excess demand for financial instruments as a store of wealth is Beijing’s thriving outdoor market in postage stamps. This is an unproductive outlet for people’s savings, and also leads to frustrating disappointment as dramatic speculative gains are followed by dramatic losses since “investment” in stamps is not channelled into real investment in productive projects.

Not only must the Chinese people’s growing cash savings be channelled into investment, they must be immobilized in the sense that they must be turned into less liquid forms. Although China’s mushrooming proliferation of goods and services has so far ensured that her monetary assets are not inflationary, as they have been in Russia, they nevertheless constitute a “monetary overhang” in the sense that any change in people’s spending habits – an increase in the rate of

consumption financed by an increase in the velocity of money – is potentially inflationary. It would be prudent to have a much larger fraction of financial wealth tied up in less liquid instruments.

China now has the opportunity to reform its banking system, and to introduce broad-based markets for financial instruments.

China’s commercial banking system is chopped up between the sectors it serves: construction, agriculture, regional development and so on. Moreover, each sector and region is typically served by just one monopoly bank. What is needed is competition, both within sectors and between sectors. Thus there ought to be more than one bank servicing construction, but beyond that, particular banks ought to serve a much wider range of sectors than they now do. Similar reforms are needed in regional banking. “Regional” banks should be encouraged to open branches outside their home bases, both for gathering deposits and for making loans. The CITIC – which monopolizes investment banking – ought to have competition. Foreign banks should be able to operate in yuan, not just foreign currencies. Before long, home ownership will be a serious possibility in China and banks will have to begin offering mortgages.

The People’s Bank of China became a central bank in 1985, but it still makes direct loans and thus allocates credit, rather than distributing it evenhandedly to commercial banks and leaving allocation to the market. Conversely, the various “commercial” banks – construction, agriculture and so forth – are still able to create credit somewhat independently of the central bank. Also, local and regional state enterprises have been able to drive monetary creation via their connections to regional banks.

In short, there is room for reform along the interfaces between central banking, commercial banking and government enterprises. Such reform should strengthen the ability of the People’s Bank of China to control the aggregate volume of credit, and eliminate the ability of commercial banks and state enterprises to drive monetary creation from the demand side.

Challenge Number Five

A fifth challenge for China is to make the yuan convertible without triggering capital flight. China is under strong pressure to create convertibility as a condition for re-joining the GATT.

A necessary condition to avoid capital flight is that the convertibility be firmly and widely believed by Chinese residents to be permanent. Otherwise, there will be a rush to convert to foreign exchange while the window is open.

A second condition that would greatly reduce the risk of convertibility would be wide and easy availability of domestic financial instruments. China is palpably a good place to invest – with the highest sustained growth rate in the world it has to be – but the absence of financial instruments blocks access to investment opportunities for the small, casual saver. Thus even if the yuan were believed to be permanently “hard”, ordinary citizens might well choose foreign currency denominated investment.

A third condition for convertibility without capital flight is that the value of the yuan be in equilibrium. This can only strictly be the case if it is allowed to float at current market values. If, instead, the yuan is pegged by the Chinese exchange authorities at a fixed rate, it must be a rate which reflects long-run market reality – that is a rate at which the central bank is neither losing nor accumulating official reserves of foreign currency. If the yuan is pegged too high, at a rate that leads to continuous losses of official reserves, capital flight will surely occur.

A convertible yuan would greatly simplify and expand China's import and export trade, which is why the GATT is urging convertibility. There is a current tendency amongst Chinese economists and policy-makers to argue that convertibility for trade might be desirable but that capital convertibility is not.

This argument presumably derives from a fear of capital flight. If the conditions laid out above can be met, and I believe they can within a very short time, capital account convertibility can yield at least the magnitude of benefits that will flow from current account convertibility. To begin with, foreign investment – both direct and portfolio – will be much easier to attract without the need to create special – and corruptible – windows for interest, dividends and profits to be paid out to foreign investors. Moreover, foreign portfolio investors need assurance that their principal can ultimately be converted back to foreign currency, and this assurance is always less than fully credible in the absence of general convertibility.

Finally, the flow of investment is by no means one-way. China increasingly is establishing beach-head investment abroad – partly to emplace showcases for Chinese products, partly to secure access to raw materials, and partly to garner experience with

multinational enterprise. Complete convertibility of the yuan would make China's overseas investment much simpler and free it from the constraints surrounding the allocation of foreign exchange.

Conclusions

Many more economic challenges will face China in the 1990s and beyond – this article lists only five. It has not, for example, discussed price reform – the fact that key inputs and outputs are still sold at prices that are fixed by the state at well below market values. These prices apply largely to raw materials, to grain and rice, and to energy prices, notably coal and oil. And fixed prices are rapidly being phased out. In September 1992, the number of raw-materials inputs subject to price controls was cut to 89, so that 75% of such inputs are now sold at market prices. In December 1993, state-run grain stores in Beijing abruptly stopped selling flour, and the price tripled within one day.

Nevertheless, key materials prices are still far below world prices, and manufactured goods prices are far above. Gasoline is priced at about 20 US cents per litre. Automobiles cost three to eight times more than in Europe or North America. China uses more energy relative to its GDP than any country in the world. This is wasteful, short-sighted and dangerous to the environment.

But by and large, the challenges for China are greatly outweighed by the opportunities she faces. She faces the opportunity to move wholeheartedly to a market economy with dramatic improvements in her standard of living – improvements that have been underway for 15 years and show no sign of abating. She also faces the opportunity to establish a market economy without the worst ravages of capitalism in its embryonic phases – without the cycles of unemployment and inflation that plagued Europe and America in the early stages of their development, that have plagued so many developing economies in modern times, and that threaten Eastern Europe and the former Soviet Union today.

China has the opportunity to direct development to outlying and rural areas rather than create seething cities with sordid slums. She also has the space and size to protect her natural environment despite her huge population. She has managed to control population growth, and to mitigate investment to cities, but not without costs to individual freedoms. These are challenges that only China can confront, and we wish her well.