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The Transition from Socialism in China and
Central Eastern Europe Compared**

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May 1994



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LESSONS FOR WHOM, FROM WHOM?: The Transition from Socialism in China and Central Eastern Europe Compared*

Introduction:

The deep recession in Europe's emerging market economies (EMEs) is still at the heart of the policy debate in transition economics. While much of the literature concerns itself with internal obstacles to sustained growth in Central Eastern Europe (Buch et al., 1994), the contrasting experience of economics transition in China has motivated a number of recent papers arguing that there are important lessons to be learnt for EMEs from "further East" (e.g. McMillan and Naughton, 1992; Naughton, 1993).

This paper attempts to compare the Chinese reforms since 1978 to the radical transition process in EMEs since the late 1980s. In an effort to overcome the "professional schizophrenia on socialist reforms" (Singh, 1991) we review the Chinese case to shed light on three questions: First, why has recession in the wake of liberalisation so far been avoided in China? Second, what does this imply for the causes of recession in EMEs? Third, what insights can be gained for the appropriate timing and sequencing of economic reforms from the contrast of gradualism in China to the "Big Bangs" in Central Eastern Europe?¹ The answer we give in this paper is that there are few lessons from China for Central Eastern Europe. Nonetheless, we shall point at some specific reform areas where useful comparisons can be made, thus laying the ground for future comparative analysis.

Our argument is developed in three parts. The first section provides an overview over the Chinese reform experience until 1993. The second section contrasts the starting points of economic transformation in China and Central Eastern Europe and highlights eight structural and institutional factors that worked in China's

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¹ We should note at the outset that we shall be referring primarily to the Czech Republic, Hungary, and Poland in our comparison. Among these three, Hungary did not follow a Big Bang strategy. We have contrasted its reform path to that followed by the Czech Republic in Raiser (1993a)

favour. Section three takes up the question what additional role economic policy might have played in bringing about the Chinese reform success. While we credit the Chinese government with having followed a reform strategy that did not inhibit China's given growth potential, we retain substantial doubts both about the optimality and about the transferrability of the timing, sequencing, and intensity of its reform measures.

SECTION 1: An Overview Over Chinese Reforms 1978-93

By all standards, economic development in China during the last 15 years has been extremely rapid. GDP growth has averaged 9 per cent per annum, per capita National Income has increased by over 2.5 times. Since the mid-1980s a strong source of growth have been exports, as their share in GDP increased from 8 per cent in 1980 to 20 per cent in 1992. At the same time, severe macroeconomic imbalances have been limited and unemployment has been largely avoided. Table 1 contrasts this "success" to developments in Central Eastern Europe since 1990.

Chinese economic reforms may be subdivided into four phases (Bell and Kochhar, 1992; Hussain, 1992). The beginning of reforms is conventionally dated to 1978. While some trends, such as the progressive decentralisation of decision making and the rise of rural collective enterprises, date back to the 1960s and 1970s (e.g. Byrd and Lin, 1990), the first significant departure from the principles of a command economy occurred with the introduction of the household responsibility system (HRS) in agriculture in 1978. Under this system, communally-owned land was leased to households for a fixed period of time.² After contributions to the community's supply quota, collective services and agricultural taxes had been deducted, the residual output could be freely disposed on the market. The first phase lasted until 1983, during which dramatic improvements in agricultural productivity and rising real incomes in rural areas led to a surge in output of township and village enterprises (TVEs).³ The first phase also saw the creation of four special economic zones (SEZs) in Guangdong and Fujian provinces and experiments with increased autonomy in

² The initial contract period was five years. After 1984 this was extended to 15 years for annual crops and 50 years for tree crops. Since 1988 the transfer of usufruct land rights is legal (Bell and Kochhar, 1992).

³ Their output value increased from Y49.3 billion in 1978 to Y101.7 billion by 1983 (Byrd and Lin, 1990, pp. 10-11).

Table 1 — Selected Macroeconomic Indicators for Economies in Transition

| Country | Period | Growth of GDP, per cent per annum average | Inflation rate, CPI, per cent, per annum average | Fiscal balance, average, per cent of GDP | Industrial production, cumulative change, per cent | Industrial employment, cumulative change, per cent | Growth of value of exports, per cent, cumulative change (in US\$) | Share of investment in GDP, period average, per cent |
|-----------------------------|-----------|---|--|--|--|--|---|--|
| China ^a | (1978-92) | 9.2 | 6.2 | -0.5 | 462 (13.3) per annum | 63.3 | 709 (17.7) per annum | 32.7 |
| Czech Republic ^b | (1990-93) | -4.8 | 24.5 | -4.0 (CSFR) 1990-92 | -35.3 | -30 | -9.2 | 15.7 (CSFR) |
| Hungary ^c | (1970-89) | 2.8 (NMP) | 8.0 | -1.5 (1981-89) | 100.1 (3.7) per annum | - | 483 (8.3) per annum | 32 |
| | (1990-93) | -4.6 | 27.1 | -5.6 | -28 | -40 | +20 | 22.7 |
| Poland ^d | (1982-89) | 3.7 (NMP) | 46.3 | -2.2 | 29.2 (3.7) per annum | - | 22.5 (2.9) per annum | 29.5 |
| | (1990-93) | -3.2 | 182.6 | -3.8 | -25.5 | -31 | +78 | 20.8 |
| USSR ^e | (1985-89) | 2.5 | 3.7 | - | 17.1 (3.2) per annum | - | 16.3 (3.0) per annum | 32.5 |
| Russia ^f | (1992-93) | -10.5 | 604.5 | - | -37.8 | - | -26.6 | 20 |

^a Data for China are from SSB (1992), Harold and Lall (1993) for 1992 figures and IFS (1993) for the CPI data. Loans to the Central Government is included under revenues, which biases the fiscal deficit downwards. Investment shares refer to "Accumulation" in SSB (1992). — ^b Data are from PlanEcon (1993), except for fiscal balance and investment for Czechoslovakia as a whole from IFS (1993). Exports excluding shipments to Slovakia increased 20 per cent in 1991-93. — ^c The first row encompasses the period after the New Economic Mechanism introduced in 1968. GDP data are net material product from Marer et al. (1992). Data in the second row are from PlanEcon (1993). — ^d The first row includes the period of partial liberalisation since 1982 (see Gomulka, 1986). Data are from Marer et al. (1992). Fiscal data from IFS (1993). Note that 1982 is a trough year which biases performance upwards. Data in the second row are from PlanEcon (1993). Export performance is overstated by the exclusion of CMEA trade. — ^e Data for the USSR begin with Gorbachev's ascent to power in 1985. No figures for 1990-91 were available in Marer et al. (1992). — ^f Data from PlanEcon (1994). Employment data are highly unreliable for Russia, official unemployment currently stands at 2 per cent of the labour force. Exports exclude inter-republican trade within the former Soviet Union.

various state-owned organisations on a selective basis (Hussain, 1990).

In late 1983, reform efforts shifted emphasis to the urban and industrial sectors of the economy. Maybe most importantly, the "dual track" pricing system was introduced in state-owned industry. A nominal quota for fixed price deliveries through the plan was set by the central government. Regional governments further issued price guidelines for transactions with state purchasing agencies, while the remainder of output could be sold at free market prices. In 1988, the percentage of transactions covered by these three categories were 30, 25 and 45 per cent respectively (Bell and Kochhar, 1992). Additionally, profit transfers by SOEs to the central government were replaced by direct (profit) and indirect (turnover) taxation. From 1986 the contract responsibility system (CRS) allowed enterprises to negotiate fixed supply quotas and tax obligations above which additional earnings could be retained.⁴ Enterprises were also given increased autonomy in the financing of investment. The share of budgetary appropriations in SOE investment sources fell from 41 per cent in 1983 to 15 per cent in 1988, the major difference being taken up by the domestic banking system (Hussain, 1990).⁵ In 1984 the People's Bank of China was given the functions of a central bank, while commercial banking was delegated to four specialised banks (Bowles and White, 1989). The development of China's capital market in this period further included the spread of trust and investment companies (TICs) and the issuance of treasury bonds and a number of additional public securities. In the area of foreign trade, the status of a SEZ was accorded to 14 coastal cities in 1984. The central government's control over foreign trade was reduced by giving some autonomy to the foreign trade corporations (FTCs). As a result their number increased from only 12 in the early 1980s to 700 by the mid-1980s and about 5000 by 1988. However, due to remaining exchange rate controls most FTCs were loss-making. Access to foreign currencies was the main motivation behind the spread of the FTCs, as import and export licensing remained pervasive (Lardy, 1992; Fukasaku and Wall, 1993). Throughout this phase the Chinese government allowed enterprises to retain an increasing share of export

⁴ While the official marginal profit tax rate was 55 per cent the CRS introduced a substantial amount of variation and discretion into SOEs' tax rates. As with most reform measures taken in this period, the verdict on the CRS's effectiveness in creating appropriate incentives for SOEs remains open (Section 3).

⁵ The share of domestic bank loans in total fixed capital investment rose from 14 per cent in 1983 to 24 per cent in 1988. Around 40 per cent of fixed investment was provided by internal funds of SOEs. Since 1985, foreign sources accounted for an increasing share of fixed capital investment, standing at 9.0 per cent in 1988 (Hussain, 1992).

earnings. Retention quotas which varied widely across ownership, locality, and industrial branch could then be traded at a parallel, depreciated exchange rate in Foreign Exchange Adjustment Centres (FEAC). The premium on foreign exchange in this parallel market was 80 per cent in 1988 (Bell and Kochhar, 1992).

The third phase, stretching from mid-1988 to mid-1991, was a period of retrenchment. Since 1978, Chinese economic reforms were accompanied by sharp macroeconomic swings (Khor, 1992). Up to 1987, the inflationary peak of a macroeconomic cycle was typically followed by an interlude of monetary contraction after which the reform impetus gained renewed momentum (Naughton, 1991). Initial signs of overheating in 1987 did not prompt the expected government reaction, however. Only when retail price inflation accelerated from 18.5 per cent in 1987 to over 20 per cent in early 1988 did the authorities abruptly change course and several previous reforms were reversed. Price controls were tightened, and the central bank reigned in decisively to stop regional banks from exceeding the credit quotas allocated to them under the credit plan. While the so-called "rectification" programme was successful in reducing retail price inflation to 2.1 per cent in 1989 (after an average of 17.8 per cent in 1988), the monetary squeeze affected primarily the TVEs. Over 300 000 are estimated to have gone bankrupt during this period, their fixed capital investment fell by 25 per cent in 1989, compared to a 9 per cent fall in SOEs (Li, 1991). Within the public sector a Y120 billion credit relief operation was initiated in the fourth quarter of 1989 to write off non-performing inter-enterprise credits (Portyakov, 1991).⁶ The government also used indirect means to control excess demand, such as an increase in the treasury bond yield from 8 to 14 per cent. Two devaluations of the exchange rate to the US dollar by 21 per cent in 1989 and 9 per cent in 1990 were effected to curb the rising trade deficit. Overall, however, this phase saw the reassertion of direct control over the economy.⁷

⁶ While a bankruptcy law is in place in China since 1988, its application to SOEs has so far been shunned. During 1989-91, typically, troubled SOEs were rescued under the "mutual pledges" system, involving financial bail-outs in return for guaranteed sales to the state. In 1991, 3000 inefficient enterprises were merged with others (Bell and Kochhar, 1992; see also Section 3).

⁷ To the authorities the political disaster of the Tien-amen incident signalled the dangers of increasing marketisation, while to most Western economists the 1987- 1988 inflation exemplifies the pitfalls of partial reform.

The fourth phase encompasses the two years since the start of 1992. The end of the rectification program was officially signalled by Deng Hsiao Ping's tour through the Southern provinces in Spring 1992. Particularly since the endorsement of the goal of "market socialism" at the 14th Party Congress in October 1992, the pace of change has been high. In the area of price reform, the increases in urban rents by 200-300 per cent in April 1992 and prices of grain and edible oil by 240 and 100 per cent respectively between May 1991 and April 1992 stand out (Hussain, 1992; World Bank, 1993). Energy prices and freight rates were also adjusted, but in relative terms the increase merely caught up with overall domestic price increases since the mid-1980s and a substantial gap to world market prices remains. By the end of 1992, 70 per cent of all consumer goods and agricultural products and 58 per cent of all producer goods were traded on the free market (Rajaram, 1992).⁸ It is planned that the dual pricing system be abolished for most products during the course of 1994.

Enterprise reforms have received strong emphasis during 1992 with the formulation of a framework for the corporatisation of SOEs. This would typically involve the guarantee of managers' autonomy in the crucial areas of investment, import/export, and personnel and reduce the scope for excess taxation by local or federal supervising agencies. The ultimate goal seems to be to transform Chinese SOEs into shareholding companies, ownership and control being divided between local and central governments, SOE workers, and possibly foreign investors (Harrold and Lall, 1993; Ma, 1993). Whether shares would be tradable remains unclear, however. Moreover, the continuing practise to respond to SOE inefficiency by mergers and the formation of enterprise groups raises doubts as to whom would assume liability for the losses of the reorganised companies. Meanwhile, China has also embarked on a modest programme of small scale privatisation.⁹ The CRS remains in place but tax rates

⁸ In a more recent publication the World Bank estimates the proportion of final goods sales still subject to mandatory pricing at 10 per cent for consumer goods, 15 per cent for agricultural goods, and 20 per cent for sales of materials. Increases in energy prices during 1992 and the full liberalisation of grain prices in 25 per cent of all counties in early 1993 may account for as much as two thirds of retail price increases in 1992/3 (Harrold and Lall, 1993).

⁹ Closely linked to enterprise reforms is the delinking of SOEs from their social security functions and the liberalisation of labour markets. So far, however, the three irons (the iron chair, i.e. position, the iron wage, and the iron rice bowl) seem to show little rust. As of 1992, only 25 per cent of the urban labour force was on labour contracts, and SOEs have, if anything, expanded their investment in the provision of social services to their workers as in-kind wage payments (e.g. Woo et al., 1993).

were unified to 33 per cent in 1992. A new tax system, introduced on an experimental basis in 1993, would separate corporate income tax from dividend payments to the enterprise's founding organ. An additional issue for future reform is tax sharing between local and central governments (Harrold and Lall, 1993).

In the area of financial markets the opening of the Shanghai and Shenzhen stock exchanges in 1990 were significant land-marks. However, the role of equity finance remains marginal (Bi, 1993). The economic revival since 1991 has also seen the proliferation of non-banking financial institutions. This considerably weakens macroeconomic control, a point to which we will return in Section 3. Overall, the pace of reform in this area has been slow and the government seems to opt for a very cautious and experimental stance in increasing bank autonomy and introducing competition in financial markets.

In the area of foreign trade and exchange rate policy, reforms have proceeded at an accelerated pace since 1991. While the share of trade subject to licensing was temporarily increased from 1989-91, covering 55 per cent of exports and 40 per cent of imports in the latter year, as part of the preparations to join the GATT, China has recently liberalised and harmonised its trade regime. This has been done primarily through extending tariff exemptions and export tax rebates to an increasing number of industrial branches. For specific goods, however, protection may still be substantial (Fukasaku and Wall, 1993). In the foreign exchange market the swap rate premium fell to 8 per cent in late 1991, and since January 1994 the government has abolished all exchange controls.¹⁰ This can be seen as the logical step of enlarging access to the FEACs and increasing retention quotas for enterprises outside the SEZs. The opening-up process gained additional momentum from the establishment of the Pudong investment zone in 1990 and the expansion of border trade with China's Western neighbours, notably Russia.

Overall the Chinese process of increasing marketisation of the economy has been gradual and has followed a cyclical pattern. As China progresses into the 1990s, the pace of reforms seems to have accelerated, but, at the same time, the amplitude of the corresponding macroeconomic cycles has increased. In 1994, China is again facing an overheated economy. The remainder of this paper seeks

¹⁰ Recent reports suggest that for foreigners a higher exchange rate may still apply, leading to substantial discrimination of outside investors in China (Far Eastern Economic Review, March 17, 1994).

to account both for the remarkable success of Chinese reform efforts so far, and for the growing macroeconomic instability associated with each new round of reforms.

SECTION 2: Transformation With or Without Crisis: The Role of Initial Conditions

By their very nature, cross country comparisons of economic reform experiences are counterfactual exercises. In order to draw meaningful lessons from a comparison of two countries or groups of countries, initial conditions must be contrasted and the implications of transferring a specific reform strategy from country A to country B must be considered. In this section, we ask whether China can be compared to Central Eastern Europe at all and what initial conditions or exogenous factors worked in China's favour.

Initial conditions may be divided into macroeconomic, structural, and political factors. Macroeconomic conditions determine whether economic reforms that aim at raising the efficiency of domestic producers have to be combined with a stabilisation programme. Structural characteristics give an indication of the degree of domestic distortions and the extent to which there are remaining idle resources that may be mobilised during the reform process. Political factors influence the acceptability of certain reform measures and describe the possible sources of resistance and the distribution of power. More generally, they may also encompass the level of credibility of the government presiding over the reform, and exogenous motivational forces, such as the euphoria following a broad based political struggle, or the perception of a military or economic threat from outside.

There are essentially two opposing views on the role of initial conditions in explaining Chinese economic performance over the past 15 years (see Naughton, 1993). The first holds that due to favourable circumstances China was bound to grow, almost regardless of the policy stance followed. The second view reckognises important initial differences between China and EMEs, but argues that, given the initial circumstances, China's reform strategy turned out to be the right one. A strong version of this second view would place more emphasis on the policy choice of the Chinese government, while a weaker formulation may contend that China did at least not inhibit the inherent dynamic of its economy from coming through.

The following factors are commonly cited to have worked in China's favour:

1) China entered the 1980s in a remarkably stable position. China's growth performance from 1952-75 was respectable at 6 per cent per annum or 3.9 per cent per capita. Growth was even higher in the two years preceding the start of economic reforms, namely 7 per cent in 1977 and 12 per cent in 1978 (Fan, 1993). This contrasts sharply with Central Eastern Europe during the 1980s. Apart from Hungary and Yugoslavia, where some reforms were introduced during the late 1960s, the former centrally planned economies (CPEs) started to experiment with market incentives in an environment of macroeconomic stagnation. Thus, the late Communist governments in Central Eastern Europe were under strong pressure to deliver rapid improvements in economic performance, while the resources that might be mobilised with incremental liberalisation measures were much scarcer than in China (see below).

2) Growth in China was almost fully financed by domestic savings, and investment rates were an impressive 30 per cent on average over the 1952-75 period (Dernberger, 1988). Consequently, the ratio of foreign indebtedness to GDP was only 4 per cent in 1980. In comparison, Hungary's debt to GDP ratio was 44.8 per cent in 1980 and 73.7 per cent in 1989. Poland's external debt stood at 66.7 per cent of GDP on the eve of reform, while Czechoslovakia kept its foreign indebtedness in check at 15.7 per cent of GDP in 1989 (Bell and Kochhar, 1992).¹¹ Hence, in most of the CPEs, domestic investment during the 1980s relied more and more on foreign sources, creating a liability that reduced the availability of domestic savings for the transformation period.

3) Although China relied less on foreign capital inflows to finance investment it had far better access to Western markets and technology than the CPEs. Its dependence on CMEA trade was low. In 1991, when the CMEA collapsed, China recorded a 72 per cent increase in exports (Bell and Kochhar, 1992). Roughly 70 per cent of China's trade left via Hong Kong by the late 1980s and 60 per cent of the inflow of foreign direct investment came from Hong Kong Chinese (Fukasaku and Wall, 1993). The extended network of overseas Chinese is an important asset, both in terms of access to foreign finance and to human capital that compares favourably with the painful rearrangement of trading relations in Central Eastern Europe.¹²

¹¹ China's debt service ratio of 7.7 per cent in the mid-1980s was comparable to Czechoslovakia's of 8.6 per cent but significantly lower than Poland's at 15.5 per cent and Hungary's at 36.8 per cent.

¹² While the positive impact of trade on China's economic performance cannot be denied, the size of the trade losses resulting from CMEA disintegration for Central and Eastern

4) Domestically, too, the Mao era was probably one of remarkable stability. The government budget was largely balanced throughout the 1960s and 1970s in contrast to the growing deficits recorded in European CPEs during the 1980s. Particularly in Poland, Russia, and Yugoslavia, the continued subsidisation of loss making SOEs and real wage increases far ahead of productivity growth turned repressed inflation into rampant open inflation even before the liberalisation of prices. The ensuing need for a drastic stabilisation programme might have imposed output costs in EMEs that were avoided in China.¹³ Arguably, monetary and fiscal management has become less prudent in the 1980s. The dramatic increase in the ratio of currency to GDP and the decline of income velocity of M2 point at a remaining problem of repressed inflation (Feltenstein and Ha, 1991). Bruno (1992) suggests that a ratio of M2 to GDP above 40 per cent could serve as an indication for a monetary overhang in the European CPEs. In 1978 the corresponding figure for China was 37 per cent, in 1992 it had risen to over 100 per cent.¹⁴

5) In the late 1970s, China had an economic structure resembling more the typical Asian developing country than the highly industrialised European CPEs. Thus in 1978, agriculture produced 32.8 per cent of Chinese National Income and employed over 70 per cent of the labour force (Table 2). Moreover, labour productivity in agriculture had declined during the Cultural Revolution, so that the initial boost in agricultural production during 1978-83 could be managed with a decreasing rural labour force. By contrast, the share of the labour force in agriculture in Poland was 29 per cent in 1980, in Hungary 18 per cent and in Czechoslovakia only 13 per cent (World Bank, 1988). By the late 1980s

Europe is still debated. According to Bruno (1992), trade losses would account for 30-50 per cent of the total decline in GDP in the region. As an explanation for the persistent recession, however, trade is not sufficient.

¹³ Note that the example of Hungary which recorded a recession, inspite of having chosen a more accommodating monetary stance, weakens the case for a demand-led explanation of recession in EMEs. This would also reduce the role of initial macroeconomic stability for explaining China's success.

¹⁴ A different view attributes this increase to the successful monetisation of the Chinese economy (e.g. Harrold and Lall, 1993; McKinnon, 1994). However, while in the 1970s the rate of increase in the supply of retail goods was 1.1 times the rate of increase in money supply, in the 1980s this ratio fell to 0.6 per cent. The increasing demand for monetary assets could thus reflect shortages and the lack of alternative outlets for savings. In the light of increasing inflation, the monetisation process might be reversed in the future (Section 3).

Table 2 — Economic Structure in China 1952-91, per cent at total

| | 1952 | 1957 | 1978 | 1980 | 1985 | 1991 |
|---------------------------------------|------|------|----------------|----------------|----------------|----------------|
| National income produced ^a | | | | | | |
| Agriculture | 57.7 | 46.8 | 32.8 (28.4) | 36.0 (30.4) | 35.5 (29.7) | 32.7 (26.6) |
| Industry | 19.5 | 28.3 | 49.4 (48.6) | 45.9 (49.0) | 45.1 (45.2) | 47.8 (46.1) |
| Construction | 3.6 | 5.0 | 4.2 | 5.0 | 5.8 | 6.5 |
| Transport and commerce | 19.1 | 19.9 | 13.7 (23.0) | 10.1 (20.6) | 14.6 (24.8) | 13.0 (27.2) |
| Employment ^b | | | | | | |
| Agriculture | 83.5 | 81.2 | 70.6 | 68.9 | 62.5 | 59.9 |
| Industry | 7.4 | 8.9 | 15.2 | 15.8 | 16.6 | 16.9 |
| Construction | — | — | 2.2 | 2.4 | 4.0 | 4.3 |
| Transport and commerce | — | — | 4.7 | 5.1 | 7.2 | 7.9 |
| Other | 9.1 | 9.9 | 7.3 | 7.8 | 9.7 | 11.2 |

^a Data in brackets in the lower row in years 1978-91 are shares of the primary, secondary and tertiary sector in GNP. — ^b Data for 1952 and 1957 refer to aggregate employment in primary, secondary and tertiary industry.

Source: SSB (1992).

agriculture's share in GDP was below 10 per cent in all Central European countries except Poland.¹⁵ The huge pool of agricultural labour represented an invaluable resource for China's rapid growth in the 1980s that is absent in the EMEs.

6) Within industry as well, China's economic structure differed from the typical heavy industry bias in the former CPEs (Sachs and Woo, 1993). This was reflected in a more diversified economic structure, both in terms of ownership and scale. In 1978, China's SOEs accounted for 77.6 per cent of total industrial output and 78.4 per cent of industrial employment (Table 3). While this figure

¹⁵ From a sociological point of view an interesting comparison concerns the rate of urbanisation. The dramatic changes in China during the 1980s are exemplified by the increase in the urban population from 25 per cent of the total in 1985 to 60 per cent in 1991. Central Eastern Europe and the Soviet Union, on the other hand, were thoroughly urbanised as early as the 1960s. This was bound to increase the political pressures for real wage increases. It is, indeed, remarkable that real wages in China were 0.7 per cent below their 1952 level in 1978. I am indebted to Vitaly Nayshul for this point.

was high compared to other developing countries, it was lower than in any of the former CPEs, where SOEs accounted for over 90 per cent of industrial employment. Indeed, as agriculture in CPEs (except Poland) was typically organised in huge kolchozes, the rural labour force might well be considered part of the state-owned sector, too. The significance of state ownership derives from the observation that all socialist economies, China included, have tended to heavily subsidise state sector employment. The weight of these subsidies evidently increases with the share of employment in SOEs, leading to macroeconomic instability and greater political resistance against industrial reforms. Moreover, as competition is limited, SOEs tend to be vastly inefficient in the use of resources. If Chinese SOEs were similarly inefficient as their European counterparts, then China's industrial development would obviously benefit greatly from the existence of a dynamic non-state sector at the start of economic reforms. Table 3 reveals the structural change in Chinese industry since 1978. The share of output produced by Collective Owned Enterprises (COEs) increased from 22.4 per cent in 1978 to 35.7 per cent in 1991.¹⁶ Even more outstanding is the performance of the individually owned businesses, whose contribution to total output rose from only 1.8 per cent in 1985 to 5.7 per cent in 1991. In retail sales, the share of COEs and individual business units even exceeded that of SOEs as early as 1985. In EMEs the current recovery also relies on the dynamism of the private sector, a sector that was largely created after the start of economic transformation. It is no surprise in this respect that Poland, with a private sector share in GDP of 28.6 per cent as early as 1989, currently displays the highest growth rate in the region.¹⁷

7) In terms of scale, China's industrialisation strategy differed significantly from the Stalinist development path in CPEs. The share of medium- and small-scale

¹⁶ COEs are subdivided into TVEs and joint-ventures by Chinese statistics. Their classification as private enterprises would be misleading, as local governments retain substantial influence over managerial decisions and ultimately have full ownership rights. However, the outstanding characteristic of all COEs is that they operate outside the plan and typically face a hard budget constraint (Byrd and Lin, 1990). This lies at the heart of their dynamic development and contrasts the whole sector to the SOEs.

¹⁷ At the same time, Poland has probably dealt worst with its SOEs, making it prone to continuing macroeconomic instability (Raiser, 1993b).

Table 3 — Ownership Structure of Chinese Industry, Output and Employment, 1978-91

| | 1978 | 1980 | 1985 | 1990 | 1991 |
|---|--|----------------|----------------|----------------|----------------|
| | Gross output value ^a in per cent of total (Retail sales in per cent of total) | | | | |
| State-owned units (SOEs) | 77.6 (54.6) | 76.0 (51.4) | 64.9 (40.4) | 54.6 (39.6) | 52.9 (40.2) |
| Collective-owned units (COEs) | 22.4 (43.3) | 23.5 (44.6) | 32.1 (37.2) | 35.6 (31.7) | 33.7 (30.0) |
| of which: | | | | | |
| - Township | — | — | 7.8 | 10.2 | 10.3 |
| - Village | — | — | 6.8 | 10.0 | 10.3 |
| Joint Ventures | — | 0.6 | 3.0 | 9.8 | 10.4 |
| Individual business units | (0.1) | (0.7) | 1.8 (15.4) | 5.4 (18.9) | 5.7 (19.6) |
| Other ^b | — | — | 1.2 | 4.4 | 5.7 |
| | Employment (Staff and workers) in per cent of total | | | | |
| State-owned units (SOEs) | 78.4 | 76.8 | 72.7 | 73.6 | 73.5 |
| Collective-owned units (COEs) | 21.6 | 23.2 | 26.9 | 25.2 | 25.0 |
| Memorandum: Staff and workers total in 1,000,000 | 94.99 | 104.44 | 123.38 | 140.59 | 145.08 |
| Individual urban labourers | 0.15 | 0.81 | 4.50 | 6.71 | 7.60 |
| Rural labourers | 306.38 | 318.36 | 370.65 | 420.10 | 430.93 |

^a Data are calculated in current prices. — ^b Foreign invested firms, domestic joint ventures.

Source: SSB (1992).

enterprises in industrial production was as high as 49.4 per cent in 1978 (Table 4). Since then, the impact of reforms has led to a further diversification of China's industrial structure increasing particularly the share of small scale and rural industrial enterprises typical for a developing economy (Naughton, 1993). By contrast, industrial reforms in EMEs typically involve the decentralisation of huge conglomerates, often employing the population of an entire region. Apart from the political barriers this imposes on structural adjustment, it also has detrimental effects on factor mobility during the transformation, as substantial resources may be blocked in one firm. Note, however, that the share of big SOEs in industrial production has increased in China during 1978-1991. As these firms

Table 4 — Industrial Structure by Firm Size and Ownership,
per cent of Total Output^a

| | 1978 | 1991 |
|--------------------------|------|------|
| Large-scale sector | 41.5 | 43.6 |
| - State | 41.5 | 40.7 |
| - Other | 0.0 | 2.9 |
| Urban medium/small scale | 49.4 | 25.1 |
| - State | 35.8 | 12.1 |
| - Collective | 13.6 | 13.0 |
| Rural medium/small scale | 8.7 | 20.6 |
| - Township | 4.8 | 10.3 |
| - Village | 3.9 | 10.3 |
| Other medium/small scale | 0.0 | 2.9 |
| Very small scale | 0.4 | 7.8 |

^a 1978 shares are calculated in 1970 constant prices. 1991 data are in current prices. The classifications do not correspond to Chinese statistics. A large proportion of medium-sized firms were reclassified as large. See Naughton (1993) for details.

Source: Naughton (1993).

raise the largest concerns about industrial efficiency (Stepanek, 1991; Woo et al., 1993), industrial reforms in China may yet face their biggest challenge (Section 3).

8) Turning to political conditions on the eve of reform, much has been made of the sense of imminent crisis prevalent in the China of the late 1970s (e.g. Brus, 1992; Overholt, 1993). China's political leadership emerged from the Cultural Revolution with a sense of a loss of political control. The purges of officials (vividly narrated in the fascinating book "Wild Swans" by Yung Chang (1992)) had undermined the credibility of the Communist Party apparatus. At the same time, rising urban-rural gaps in standards of living deceived the hopes of a peasantry which had been the base of Mao's ascent to power in 1949. However, in spite of the systematic terror that had governed China from 1966-1976, most Chinese retained their faith in the ability of the old administrators to get the economy running again, once the vendettas of the Gang of Four were put to an end. Political discontinuities since the late 1950s had provided the Chinese with ample examples that their economic well-being could depend crucially on whom was in charge of economic affairs. Single politicians may have been discredited, the system itself was regarded as reformable (Fan, 1993). Deng Hsiao Ping was thus able to mobilise the energies of a people that had been deprived of their chance to success, while the inner turmoil, heightened by the costly war against

Vietnam in 1979, persuaded conservative party members and the Chinese army that some economic liberalisation was unavoidable.¹⁸

Economic transformation in Central Eastern Europe started in the wake of political upheavals which precluded gradual institutional changes. Due to the failure of decentralised bureaucratic bargaining in Central Eastern during the 1980s, the credibility of the nomenklatura had been undermined before the start of reforms and its power was directly challenged by the reformers in EMEs. Under such circumstances, without a clear reform agenda, institutional uncertainty was bound to degenerate into chaos. Problems of acceptability, credibility and consistency all combined to make economic policy formulation a considerably more daunting task for reformers in EMEs. The scope for experiments was clearly limited.

The preceding discussion points at important differences between the transition experiences of China and Central Eastern Europe. It is probably no exaggeration to attribute the impressive growth record of China in a large measure to the fortitious initial conditions discussed above. It is no surprise that they match closely the experience of fast growers such as Taiwan and Korea (Riedel, 1993). However, to shun the comparison with Central Eastern Europe completely on these grounds would seem to leave abundant resources for comparative policy analysis unexploited. First, it is almost trivial to note that there are abundant examples in the developing world where economic policies not only thwarted a given growth potential but may indeed be charged with being the main cause of economic decline. This raises the question about the potential role of Chinese policy making as a catalyst for growth. The second question of interest for our purposes is whether China's policy of resource mobilisation under the conditions of transition from socialism would have presented a feasible option for EMEs that might have reduced the costs of economic reform. Thus, with respect to macroeconomic policy, some observers have doubted whether a Big Bang was the only option available to EMEs and have attributed the output decline to an overshooting of stabilisation policies (e.g. Brada and King, 1992) or the premature liberalisation of prices (McKinnon, 1994). Moreover, initial macro-

¹⁸ Thus Berliner (1992) notes that "the Chinese transformation began with millions of peasants and others virtually beating at the gates of the government to dismantle the restraints of the past and let them work and thrive." By contrast, in Russia, "the mass of the [...] population, while yearning for a better life, were apprehensive about losing job security and relaxed working conditions of Soviet socialism." (quoted in Sachs and Woo, 1993, p.23).

economic conditions in Central Eastern Europe varied substantially, too, and did lead to some differences in stabilisation strategies. Structurally, the question remains whether China simply faces the problems of industrial adjustment prevalent in EMEs on a smaller scale, or whether the increasing competition emanating from the non-state sector has provided for adjustment pressures in Chinese SOEs, too. Politically, the costs of transition in China may still increase as external and internal pressures for democratic reforms multiply. While we reject the view that China's success was achieved independently of the economic policies chosen, we are left to decide whether its reform strategy should be given pride of place among the factors driving China's rise or whether it simply followed and underwrote developments initiated by the dynamism of the Chinese people.

SECTION 3: Mother or Midwife - The Contribution of China's Reform Strategy to Economic Success

Reform strategies may be conveniently contrasted according to the timing and sequencing of reform measures and the intensity of the reform effort. For EMEs there was almost a unanimous consensus at the beginning of economic transformation that reforms had to proceed on several fronts at the same time in order to be effective (Funke, 1993). The typical recommendations of Western economists included upfront institutional reforms, simultaneous price liberalisation and stabilisation, and rapid privatisation. As the transformation process proceeded there was increasing recognition that institutional changes were far more difficult to implement than anticipated. Hence, deficient incentive structures, related to the delay in financial market reforms and privatisation were blamed for the protracted recession in EMEs (Begg and Portes, 1992; Schmieding, 1993; Raiser and Nunnenkamp, 1993). However, dissenting views were also increasingly voiced regarding the timing and sequencing of liberalisation and stabilisation policies. The Chinese case serves as a model case for many critics of the "Big Bangs" in Central Eastern Europe arguing that a transition without crisis was possible. The following paragraphs aim to refute their contentions.

3.1 Timing and Sequencing

The defence of gradual reforms typically rests on two arguments. First, the administrative capacity of governments, particularly in developing countries, is said to be limited. Hence, it may be important politically to concentrate the reform effort on an area where rapid success may be expected and delay more

comprehensive reforms (Jefferson and Rawski, 1992). Second, the resources that may be mobilised by an efficiency enhancing reform in one particular sector of the economy may progressively spread to other sectors and ease reforms there. Theoretically, these arguments are supported by the contention of high "substitutability" between individual reform measures. Thus, in the early stages of transition, macroeconomic stabilisation, liberalisation, and privatisation may be replaced by institutional adaptations and modifications of the planning mechanism.

For China the evidence cited in support of this view typically refers to the start of reforms in agriculture which set resources free that were the basis for the ensuing dynamic of the rural enterprise sector (Singh, 1991). Moreover, proponents of gradual reforms argue that China achieved significant efficiency gains and recorded impressive growth without the need for full blooded liberalisation at the start of reforms. The dual track pricing system is said to have produced profit incentives at the margin without necessitating the sudden replacement of old coordination mechanisms by market signals (Jefferson and Rawski, 1992). Similarly, there was no attempt at drastic macroeconomic stabilisation measures. Price stability was achieved through direct interventions in the allocation of credit and the maintenance of price controls (Naughton, 1991). Finally, privatisation of SOEs was never considered a necessary precondition for efficiency improvements in public industry. Hence, gradualists argue that SOEs are reformable and private ownership is no precondition for industrial adjustment.

The theoretical points about the substitutability of reform measures are well taken. Particularly, if one accepts a large role for institutions in economic development (see North, 1990), there may be substantial scope for government induced institutional innovations that may at times complement or even replace market signals (Raiser and Nunnenkamp, 1993). But to make that point is neither to say that the Chinese approach resulted from a consistent gradual reform strategy that was aware of substitution possibilities nor that this strategy could be easily transferred to other transition economies. On the first count, our verdict is ambiguous; on the second, it is negative.

First, the start of reforms in agriculture may have been politically expedient but it did not require a conscious reform strategy. Chinese agriculture did present abundant opportunities for rapid productivity improvements. This potential resulted on the one hand from the abundance of underemployed rural labour and on the other hand from the disastrous agricultural policies of the Mao regime

since the Great Leap forward of 1958-61. As Bell and Kochhar (1992) point out, all the Chinese government had to do was to allow peasants to return to the mode of production they were used to. Much less, still, is there reason to believe that Chinese agriculture would not have grown if industrial reforms had started earlier. Of course, one could argue that the growth of industry, particularly the dynamism of the TVEs, relied heavily on the growing incomes of the rural population, which provided an outlet for consumer goods and an important source of savings (McKinnon, 1994). Table 5 presents the sources of state bank funds in China for 1986-1991. As banks became increasingly involved in the financing of industrial sector investment, Table 5 allows one to gauge the importance of rural savings for industrial development in the second half of the 1980s. As we can see, rural household deposits are a small and decreasing fraction of total bank funds, the major increase coming from urban households. The absolute value of total bank funds corresponds to the value of broad money minus deposits. Thus Table 5 also reveals the major sources of the growth in M2 over the 1980s. While it is possible that rural savings were financing rural TVEs through the proliferation of non-state financial institutions, this would imply an even higher degree of monetisation of the Chinese economy. In this case, however, it is likely that the ratio of M2 to GNP reflects substantial forced savings of the urban population. What McKinnon (1994) regards as an efficient mobilisation of resources, in our view, bears an increasingly dangerous inflationary potential.¹⁹

In contrast to China there was no sector with abundant surplus labour in Central Eastern Europe during the 1980s. Indeed, the region's extensive growth potential had been exhausted by the late 1960s (Gomulka, 1986). An attempt to redress structural distortions and reduce forced savings by emphasising the production of consumer goods failed in Poland, Hungary, and Russia during the 1980s.²⁰ Hence the monetisation of public sector deficits resulting from subsidies to

¹⁹ McKinnon (1994) relates the high level of household savings to the positive interest rate policy pursued by Chinese monetary authorities. However, there is nothing in such a policy that would favour gradual reforms as such. Moreover, during the inflationary episode of 1987-1988, deposit rates turned highly negative leading to a fall in the ratio of M2 to GNP in 1989 (Table 6). This exemplifies the dangers of a monetary expansion that relies on the absorption of liquidity by domestic households.

²⁰ Naughton (1993) places great emphasis on the shift of production towards consumer goods in China during the 1980s and argues that this was achieved without a massive correction in the relative price vector.

Table 5 — Sources of State Bank Funds, in per cent of Total Liabilities, 1986-1991

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---------------------------------------|------|------|------|------|------|------|
| Total deposits | 66.0 | 66.0 | 64.7 | 66.5 | 69.2 | 72.1 |
| - Enterprises | 27.6 | 27.1 | 25.6 | 15.4 | 23.7 | 23.9 |
| - Individuals | 24.9 | 27.2 | 29.0 | 32.8 | 35.8 | 38.5 |
| - urban | 18.1 | 20.9 | 23.2 | 27.5 | 30.8 | 32.9 |
| - rural | 6.8 | 6.3 | 5.8 | 5.3 | 5.0 | 5.6 |
| - Other | 13.3 | 11.7 | 10.1 | 10.9 | 9.5 | 9.6 |
| Bonds | 0.3 | 0.5 | 0.6 | 0.5 | 0.5 | 0.7 |
| Funds from international institutions | 1.4 | 1.7 | 1.3 | 1.0 | 1.1 | 0.8 |
| Currency | 15.0 | 14.7 | 18.6 | 17.3 | 15.7 | 15.4 |
| Working fund ^a | 11.7 | 9.5 | 9.4 | 8.8 | 7.8 | 7.2 |

^a Allocations from the central government budget.

Source: Almanac of China's Finance and Banking (1992).

producers were not absorbed by an increasing demand for money as in China. The fundamental problem for the European CPEs was the sheer size of the industrial sector and the burden of subsidisation it imposed on all other sectors of the economy (Sachs and Woo, 1993). Hence, even the toleration of a parallel economy, such as in Hungary, could not solve the problem of persistent shortages, resulting from soft budget constraints for industrial SOEs (Kornai, 1986).

Second, it is true that China has avoided the "recession following stabilisation" (Gomulka, 1991). But it should be clear from the foregoing that this can hardly be attributed to its less austere macroeconomic stance. China did not avoid stabilisation at the start of reforms, it did not need it. Moreover, it is questionable whether the drastic government interventions into the capital market in 1988/89 were the cost-minimising solution to the build-up of an inflationary problem. Particularly the dynamic private and TVE sector was hit by the credit squeeze imposed through the state banking system and job and output losses were substantial (Li, 1991). By contrast, the temporary tightening of bank credit to SOEs did not alter their chronic investment hunger which has driven each inflationary episode in China's succession of macroeconomic cycles (Woo et al., 1993). Table 7 reveals that loans to industrial production enterprises took an increasing share of bank lending since 1986, with the exception of 1990. Loans to fixed assets²¹ which replaced central budget allocations since 1984

²¹ Loans for fixed capital investment, in contrast to revolving funds for working capital.

Table 6 — Monetary Aggregates and Selected Interest Rates in China, 1978-92

| | 1978 | 1980 | 1984 | 1985 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
|------------------------|------|------|------|------|-----------|-----------|------------|------------|------------|-------|
| M1/GDP | 16.2 | 25.7 | 35.2 | 35.2 | 40.4 | 39.1 | 36.7 | 39.6 | 45.5 | 48.0 |
| M2/GDP | 24.8 | 37.4 | 51.7 | 57.0 | 70.4 | 86.8 | 71.6 | 82.9 | 94.1 | 101.4 |
| Deposit rate (IFS) | | 5.40 | 5.70 | 7.20 | 7.20 | 8.64 | — | — | — | — |
| Demand deposits | | | | | 2.88-6.12 | 2.88-6.12 | 2.88-6.48 | 2.16-2.88 | 1.86-2.16 | |
| - Enterprises | | | | | 6.12-8.28 | 7.20-9.72 | 7.20-9.72 | 7.30-13.14 | 6.12-10.08 | |
| 1 year deposits | | | | | 1.8 | 2.88 | 2.88 | 2.88 | 2.16 | |
| - Enterprises | | | | | 5.04 | 8.64 | 8.64-11.34 | 8.64-11.34 | 7.56-8.64 | |
| Lending rate (IFS) | | 5.04 | 7.20 | 7.74 | 7.92 | 8.28 | 11.15 | | | |
| Working capital | | | | | 7.92 | 7.92 | 9.0 | 11.34-7.92 | 9.36-8.64 | |
| Fixed assets | | | | | 7.92-10.8 | 7.92-10.8 | 7.92-10.8 | 3.60-12.00 | 8.46-11.16 | |
| Memorandum | | | | | | | | | | |
| Retail price inflation | | | | | 7.3 | 18.5 | 17.8 | 2.1 | 2.9 | 5.4 |
| CPI | 0.07 | 7.5 | 2.8 | 11.9 | 8.8 | 20.7 | 16.3 | 1.3 | — | — |

Source: IFS (1993) and Almanac of China's Finance and Banking (1992).

have also increased. On the other hand, loans to TVEs and industrial firms under communal management have decreased in relative importance since 1986. This points at a persistent inefficiency in China's capital markets that is closely linked to the continuous role of the credit plan in macroeconomic management (Bowles and White, 1989; 1992).²² In 1994 inflation is back on the top of the policy agenda. At the same time, the spread of informal credit markets makes it increasingly difficult to control credit expansion via the central credit plan. Thus, in 1992 official credit growth exceeded the target of 20 per cent by only 1.7 per cent percentage points. Net domestic assets, however, rose by 32.7 per cent, reflecting

²² A detailed review of capital market reforms shall be given in the sequel to this paper in conjunction with the discussion of SOE adjustment.

growing credit creation outside the plan (Harrold and Lall, 1993). The stock of credit in non financial banking institutions (NFBIs) reached Y 140 billion at the end of 1992. At the same time currency holdings increased by 46 per cent in 1992, while M2 rose by only 31 per cent. Thus China's enterprises and consumers were swamped with liquidity. The task to achieve a soft landing in 1994 will put China's rudimentary monetary instruments to their toughest test as yet.

Table 7 — Directions of Bank Lending, per cent of Total Loans

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---------------------------------------|------|------|------|------|------|------|
| Industrial enterprises | 18.7 | 22.5 | 19.8 | 21.9 | 16.9 | 23.5 |
| Material supply and sales enterprises | 6.3 | 6.5 | 4.9 | 4.6 | 4.3 | 3.9 |
| Commercial enterprises | 40.7 | 38.8 | 38.8 | 38.5 | 38.0 | 37.1 |
| Construction enterprises | 4.8 | 6.1 | 4.7 | 4.8 | 4.4 | 3.9 |
| Urban collective enterprises | 10.3 | 7.0 | 6.0 | 5.6 | 5.4 | 5.2 |
| Private enterprises | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| Loans to fixed assets | 13.3 | 16.7 | 14.8 | 14.3 | 14.8 | 16.8 |
| Loans to agriculture | 7.5 | 9.0 | 7.7 | 7.2 | 6.8 | 6.7 |

Source: Almanac of China's Finance and Banking (1992).

In EMEs the causes of the output collapse at the start of transformation are still widely debated. Much of the evidence points against a Keynesian demand-led explanation of the transformation crisis (Raiser 1993b; Schmieding, 1993). Inflation in 1994 is falling in Poland and in the Czech Republic which implemented so-called Big Bang stabilisation and liberalisation programmes at the start of the 1990s, and output is recovering. In Russia, economic decline continues unabated and the lack of stabilisation efforts has led to hyperinflation. A less drastic stabilisation effort in EMEs in our view would not have avoided the recession, but would have forced restructuring to take place under much more unstable macroeconomic conditions.

Third, the consistency and transferrability of China's gradual price liberalisation may similarly be doubted. It is very dubitable whether the dual track pricing system significantly contributed to lower inflation in China, as recently argued by McKinnon (1994). Indeed, Yi (1990) argues that inflation in China during 1987-89 was a direct result of inconsistent price reforms. Particularly in

agriculture, state procurement prices had to be adjusted upwards in order to provide sufficient incentives for the fulfilment of planned delivery quotas (see also Secular, 1990). But because higher food prices would have reduced real wages of urban consumers, subsidies to SOEs were simultaneously increased. The share of government expenditures going to the financing of SOEs losses quadrupled from 5 per cent in 1978 to 20 per cent in 1989, representing 3.8 per cent of GDP. The rigidity of relative prices meant that price adjustments had to proceed via inflation.²³ The structural problem of distorted relative prices remained until very recently. Moreover, the oft-voiced contention that dual track pricing introduced market incentives to SOEs at the margin (e.g. Naughton, 1993) is much less relevant when it becomes clear that these incentives applied primarily on the revenue but not on the cost side. Hence, until very recently, there was evidence of SOEs buying inputs at low planned prices and reselling them at the much higher market prices (Far Eastern Economic Review, February 17, 1994; see also Hussain, 1990). Under such conditions, it would seem that political connections determining access to subsidised inputs would have a substantial influence over enterprise performance that may still outweigh technical and allocative efficiency considerations. Failure to minimise costs according to market signals is a clear symptom of prevailing soft budget constraints for SOEs. As we have shown on a previous occasion for a sample of developing countries, this again tends to increase inflation (Raiser, 1994). The challenge for Chinese policy makers will be to resist the temptation of replacing price subsidies with direct monetary transfers as liberalisation proceeds.

In the case of Central Eastern Europe, the successful stabilisations in the Czech Republic and to a lesser extent in Poland manifestly contradict McKinnon's (1994) contention that in transition economies with segmented capital markets and soft budget constraints for SOEs, price liberalisation should not be implemented at once. Rather than divising several tier delivery and price quotas which are notoriously difficult to enforce (particularly under the political circumstances in EMEs), governments in Central Eastern Europe should concentrate on those institutional regulations by which SOEs' budget constraints can be effectively hardened. This requires a credible stabilisation package

²³ Commander and Coricelli (1991) provide a model with planned and market determined prices, where inflation is caused by the subsidisation of producers subject to price controls. Macroeconomic stability is a function of the ability of planners to adjust planned prices more rapidly than free market prices and of the absolute share of prices determined by free markets. In line with their prediction subsidies in China have risen dramatically after the mid-1980s and have forced a new wave of price liberalisations in the early 1990s.

alongside temporarily limited interventions in factor markets, such as an incomes policy and credit ceilings for loans to SOEs (Raiser and Nunnenkamp, 1993).

Fourth, there is rising evidence from Central Eastern Europe that SOEs can be successfully restructured before privatisation (Pinto et al., 1993; Buch et al., 1994). However, this evidence emanates from precisely those EMEs that stabilised and liberalised their economies early on in the transformation process. Moreover, the preceding discussion has highlighted the deficiency of incentive structures under conditions of high inflation or partial liberalisation. The evidence for structural adjustment in Chinese SOEs is thus far from clear cut. Chen et al. (1988) were the first to find impressive total factor productivity (TFP) growth for Chinese state industry of 5.4 per cent per annum for 1980-1988. Their approach suffered from the exclusion of material inputs in the estimation of the production function. The correction of this shortcoming by Jefferson et al. (1992) reduced TFP growth to 2.4 per cent per annum. Recent sample surveys of SOEs have yielded conflicting results. Groves et al. (1993) find TFP growth of 4.5 per cent for 769 firms and, crucially, a significant positive effect of enterprise reforms on productivity growth. Woo et al. (1993) criticise the method of deflation employed by all three studies and argue that non-productive inputs should be included in the estimation of TFP. In their sample of 200 large and medium SOEs, TFP growth is stagnant at best and negative at worst. In any case, there are large differences in technical, scale, and allocative efficiency between firms within the public sector (Jefferson, 1990; Kalirajan and Yong, 1993) and state sector performance between different regions in China (Perkins et al., 1993). Whatever the impact of China's enterprise reforms on the productive efficiency of the SOE sector as a whole, the true challenge for policy makers in transition economies is what to do with those firms that continue to produce unprofitably.²⁴ The rising share of subsidies in government expenditures and the continuing misallocation of capital by China's banking system are an indication that this challenge may be growing. In this respect, Woo et al. (1993) report the worrying result that in their sample, a rising

²⁴ Gomulka (1993) shows that over half of all outstanding liabilities from Polish SOEs were concentrated in a financial "black hole" comprising less than 10 per cent of all firms. But the sheer size of their obligations continues to destabilise Poland's entire financial system. According to press reports around 50 per cent of China's SOEs are currently loss making (FAZ, 19.04.1994).

share of enterprise revenues were used for non-productive investments and rising worker remunerations.²⁵

Enterprise adjustment in the transition to a market economy requires the implementation of the "stick" of financial discipline alongside the "carrot" of profit incentives (Kornai, 1993; Raiser and Nunnenkamp, 1993). While we concede that privatisation is not a condition sine qua non for increasing enterprise efficiency, restructuring SOEs is itself reliant on a number of preceding or complementary reforms. Advocates of the Chinese approach to enterprise reform not only have to produce evidence that it did lead to significant behavioural changes in SOEs but also that the zeal to privatise early in Central Eastern Europe was in fact counterproductive. But here the evidence is clear cut: privatised firms displayed significantly larger adjustment efforts than non-privatised firms (Buch et al., 1994). If there were problems of adjustment inertia connected to privatisation, they were related to its delay and the resulting insecurity for enterprise managers (Schmieding, 1993).

3.2 Gradualism Versus Shock: The Intensity of Reforms

Advocates of a shock approach to economic reforms argue that there may be a threshold level below which reforms would remain ineffective. This may apply to a single reform measure, such as price liberalisation, but it may also implicate all reform measures at the same time. The major argument for a Big Bang in EMEs consequently derived from the recognition that to achieve a decisive adjustment of economic behaviour, a critical mass of reforms was needed (Williamson, J., 1992; Hiemenz, Funke, 1993). Partial reforms would suffer from a credibility defect and could lead to perverse reactions, if reform measures were perceived to be reversible (Funke and Nunnenkamp, 1992).

Conversely, gradualists can point at two major arguments, why there may be "diseconomies of scale" in increasing reform intensity (Jefferson and Rawski, 1992). The first relates back to the administrative limitations of reformist governments. We have argued above that concentrating reforms on one particularly sector or area requires that such a prospectively "easy" reform area be available. In the absence of such substitutability there is no reason why reforming everything at a moderate pace would require less governmental human capital than a radical shift of course in all aspects of economic policy. The question then reduces to an empirical point about the political acceptability

²⁵ An interesting parallel may be found in Russia (DIW et al., 1993) pointing at the macroeconomic consequences of keeping SOEs afloat on a large scale.

of radical reforms. This, however, makes the applicability of the gradualist reform agenda highly contingent on prevailing socio-political circumstances. It is our argument that the Chinese government treaded cautiously precisely because a more radical course was unacceptable for Communist Party ideology not because it was aware that a higher reform intensity would have exhausted its administrative capabilities.

The second argument pointing at potential diseconomies of reform intensity stresses a rise in transactions cost due to the dismantling of economic institutions by a radical reform agenda (Schmieding, 1993). The transition from socialism involves the replacement of negotiable input quotas and planned output requirements by indirect market signals. The informational content of relative prices has to be learned to the extent that economic actors were used to a hierarchical coordination of economic activities in which scarcities were determined by decree. As a result, a radical transition may have to proceed under a higher degree of initial uncertainty.²⁶ At the same time, behavioural adjustments take time and the premature wholesale abolishment of the coordination mechanism prevalent under central planning may generate perverse responses if a new incentive structure is not yet in place (see also McKinnon, 1994). For the Chinese case, such an analysis provides an *ex post* justification for gradual price liberalisation, the gradual replacement of budgetary investment grants with loans from the banking system, and the incremental loosening of labour market controls on a regional and enterprise basis.

The force of institutional arguments against the combination of liberalisation, stabilisation, and privatisation in the typical blueprints for Big Bang reforms in EMEs cannot be denied. Indeed, a major reason for the transformation crisis in Central Eastern Europe may be found in the institutional void resulting from the disintegration of the traditional institutional infrastructure and the slow emergence of new market based institutions (Raiser and Nunnenkamp, 1993). However, to state that China successfully steered around the institutional void characteristic of the first phase of transition in Central Eastern Europe is not equivalent to proving a causal connection to its gradual reform strategy. On the one hand, there was less need in China to confront managers of SOEs, state banks, or local officials with full market signals, as they could still be partly

²⁶ Vitali Naishul (1993) has argued along such lines that radical price liberalisation disrupts inherited contractual obligations. Safeguarding the constitutional liberal principle of firmness of contract is viewed as a function of the price mechanism that supersedes its role in signalling relative scarcities in the initial stages of transition.

monitored with bureaucratic commands. The political continuity of the Chinese government allowed the reformers to expose economic actors to competition outside the plan, while maintaining planning discipline within the public sector. There is, however, increasing evidence that central government intervention in China is becoming ineffective (*Far Eastern Economic Review*, 17 February, 1994). In EMEs, on the other hand, by the 1980s traditional hierarchical coordination had been replaced by bargaining in a bureaucratic market (Kornai, 1984; Naishul, 1993). Thus, Hungary which essentially tried to implement a gradual reform strategy (Szekhely and Newberry, 1993) was not spared by the recession. Apart from the structural differences discussed above, a reason for Hungary's disappointing performance up to date may lie precisely with the lack of credibility of its partial reforms (Estrin et al., 1992; Sachs and Woo, 1993). Finally, "growing out of the plan" (Naughton, 1993) was naturally easier in China as it had never permeated such an extensive share of the national economy.²⁷ It is a matter of speculation in this respect whether a government equipped with the authority of the Chinese Communist Party could not have chosen a higher reform intensity without risking a disruption of customary rights and hierarchical coordination.²⁸ While *ex post* we must concede that the Chinese reform path prevented an institutional disruption, we conclude that such an option was unavailable in Central Eastern Europe. The credibility of the Chinese leadership was an asset that the reformers in EMEs had yet to earn themselves - with radical reforms.

CONCLUDING REMARKS:

The preceding discussion is not intended to downplay China's remarkable reform achievements up to date. Returning to our initial three question, however, we conclude that China's outstanding economic performance may be largely attributed to fortuitous initial circumstances. This implies that factors outside the control of governments also account to a significant extent for the initial recession in the wake of economic transformation in Central Eastern Europe. Our discussion does not allow the conclusion that China's economic policies were the mother of its successful growth performance. As a midwife, they may

²⁷ Sachs and Woo (1993, p.11) quote estimates according to which around 25 million commodities entered the Soviet economic plans against only 1200 in China.

²⁸ It seems that Vietnam provides a case where political continuity combined with a shock reform programme to yield an impressive example of transition without crisis. See Diehl (1993) for an overview of Vietnamese reforms.

be credited for having allowed the development of market based activities in a growing share of the economy without disrupting traditional coordination mechanisms. The at times crude interventions into the allocation of resources have so far achieved the aim of restoring stability. But as their continuous effectiveness comes under suspicion, China's policy makers may have to learn from their counterparts in EMEs that changes in the behaviour of economic actors within the public sector may require more than changes at the margin.

Taking a medium term perspective, the contrast between success and gloom characteristic of present comparative studies may turn out to be inappropriate. Central Eastern Europe has embarked on a process of vigorous structural change. Its highly educated labour force and the proximity to Western European markets provide for an inherent dynamic that may generate fast growth in the region on the way to the next millennium (PlanEcon, 1993). Moreover, the democratic revolutions that served to unsettle the economic institutions of central planning and thereby confronted economic reformers with the institutional disintegration discussed above may turn out to be the biggest asset for EMEs as they develop into mature market economies. Without the rigidities of an authoritarian and still essentially bureaucratic state, EMEs may display a higher degree of institutional flexibility and adapt to the changing requirements of a global division of labour more smoothly. China's reforms have delivered the goods so far. The challenge for Chinese policy makers will be to turn gradual reforms into a self-sustained market driven growth process.

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