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The Engine of Growth and the Root of Inflation in the Chinese Economy

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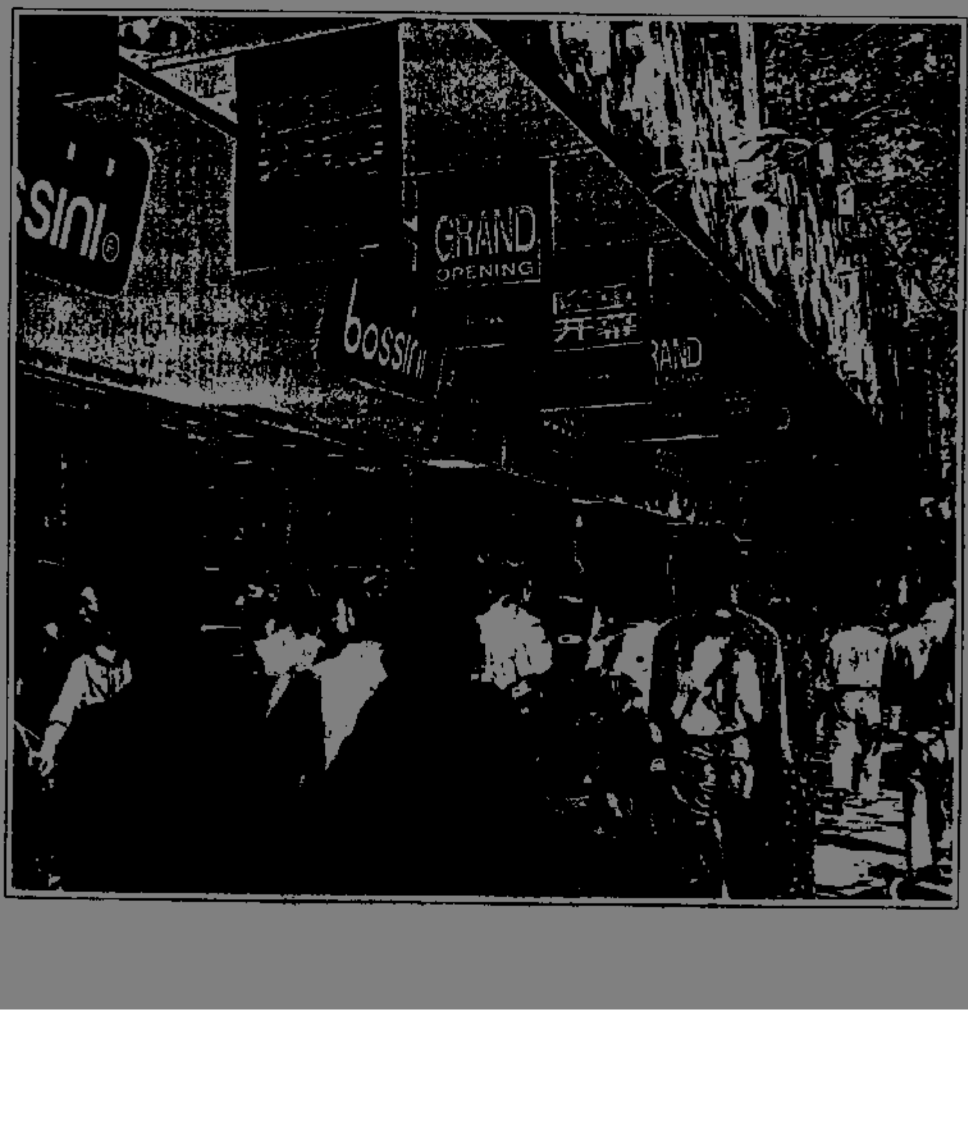

Two of the most outstanding features of the Chinese economy in 1993 were high growth and high inflation. This chapter reviews economic forces behind the high growth and high inflation, government policies towards them, and the responses to the policies by various economic players. China's recent economic growth has been the focus of world attention. Reports and analysis about recent economic events in China can be found in all major newspapers, journals and academic publications.[1] So, we will only summarize briefly the background of China's economic development and reform before 1993 and highlight the behaviour of major economic variables in 1993. Our major effort in this chapter is to provide a coherent explanation of the workings of the Chinese economy in 1993 under a "one economy-two systems" regime (the planning system of the state sector and the market-oriented system of the non-state sector). Although it is difficult to have a clear-cut perception and risky to give an interpretation of the complicated Chinese economy, we conclude with reasonable confidence that for the Chinese economy in 1993 the engine of growth was the non-state sector and the root of inflation was the state sector. The banking and financial sectors played the double role of facilitating both growth and inflation.

Background to 1993: Rise of Non-state Sector and Expansion of Markets

After 15 years of economic reform, the non-state sector, which includes private business, urban collectives, rural township and village enterprises and enterprises with foreign investment, became the major force of China's economic growth and development. The non-state sector's share of the gross value of industrial output increased from 20% in 1978 to 51% in 1992. In particular, the rural township and village enterprises produced about 38% of the gross value of industrial output. Its share of the commodity retail sales jumped from 9.5% in 1978 to about 70% in 1992. The non-state sector by 1993 was producing close to 70% of China's gross domestic product (GDP).[2]

The number of rural and urban individual businesses had been trivial before 1978, but it exceeded 15 million units by the end of 1992. In Guangdong province, the registered capital of the purely private business amounted to RMB 264.7 billion in 1991, surpassing the sum of the registered capital of the state-owned and collective enterprises. The share by purely private business of the gross value of Chinese industrial output had been less than 1% in 1978 but was 7% in 1992. The growth of the private businesses during the past 15 years has exceeded 50% a year. The number of enterprises with foreign investment increased from 1,392 in 1983 to 15,997 in 1988 and to 130,000 in 1992. In 1992, these latter enterprises produced about 9% of the gross value of industrial output and 25% of China's export. In 1992, the non-state sector employed about 57% of the non-agricultural labour force.

On the other hand, one-third of the state enterprises were acknowledging their losses, which amounted to about RMB 200 to 300 billion a year or about one-fourth of the central government's fiscal income, while another third of the state-owned enterprises were using bank loans to cover up their losses. During the past 15 years, the growth of output by the state-owned enterprises has been below 10% a year compared to above 20% a year for the non-state enterprises. Moreover, the relatively low growth of the state sector's output has been supported by massive investment. In 1992, the state sector received 67% of the total fixed capital investment in China and produced only about 30% of the GDP. Since 1978, the state sector's share of the gross value of industrial output has declined about two percentage points a year. In 1992 alone, it dropped four percentage points. The share of fixed capital investment by the state sector has declined much more slowly than that of its output. Hence, in terms of output-investment ratio, the performance of the state-owned enterprises has deteriorated significantly in recent years.

The economic reforms of the past 15 years have greatly weakened the old central planning system. The market has started to allocate a majority of economic resources. By 1992, based on output value, 80% of output was being traded according to free market prices (about 85% for agricultural products, 90% for industrial products and 70% for producer goods). Even the state-owned enterprises now had to buy about 85% of their supplies from the market and sell about 90% of their products to other market actors. A shrinking of the market would now inevitably lead to losses for any one of the Chinese enterprises.

Although the banking sector is still tightly controlled by the government, investment has been dramatically decentralized. The self-accumulated funds of the state-owned enterprises have provided more than half of their fixed capital investment while the state bank loans have satisfied only about a quarter of the total investment. Since 1992, the market for inter-bank lending has expanded very rapidly to about RMB 300 billion, a scale comparable to total state bank loans for fixed capital investment during the same period. The emerging non-bank financial institutions, such as the Trust and Investment Companies and the Urban and Rural Credit Cooperatives, have used the inter-bank lending markets to channel a large amount of funds from the state banking system to the non-state sector. Stocks, government bonds, foreign currencies, and commodity futures contracts are now traded on Shanghai Securities Exchange, Shenzhen Stock Exchange, Securities Trading Automated Quotation System (STAQ) in Beijing, and a number of foreign exchange swap markets and commodity futures markets in major Chinese cities. The property market has expanded rapidly driving up land prices in premier locations.

The rise of the non-state sector and the expansion of markets in China have dominated recent economic development and growth in China. The emerging market players and market institutions have been constantly clashing with the remaining central planning institutions and tradition. In 1993, the conflicts and interactions between the two different systems have escalated to a new high.

The Economy in 1993: High Growth and High Inflation

Deng Xiaoping's trip in early 1992 to southern China boosted China's real GDP growth to 13% for that year. This high growth continued in the first half of 1993 and slowed only a little after a brief austerity programme initiated in June. China's GDP grew by 14.1% during the first six months, fell to 12.1% in the third quarter because of the austerity measures, and ended with a respectful 13.4% for the year. The growth of the gross value of industrial output reached its peak of 30.3% in June and fell to 19.1% in September. The two years of continuous growth at above a 20% rate stopped briefly in September. But for the whole year, industrial value-added growth still achieved 21.1% (see Table 1).[3] The industrial value-added margin grew by 6.4% for the state sector, 28.6% for the collective sector, 41.3% for township and village enterprises, and 46.2% for the enterprises with foreign investment. Heavy industry grew faster than light industry (22.2% versus 19.9%) and contributed more to the total industrial value added (52.7% versus 47.3%).

The high growth was generated by a surge in investment as well as by strong consumption. During the first half of 1993, fixed capital investment amounted to RMB 354.2 billion, up 61% from the same period last year.

Table 1. Main Indicators of the Chinese Economy in 1993
(Percentage change unless otherwise indicated)

	1992	First Half 1993	1993
Real GDP	13.0	13.9	13.4
Industrial output (constant prices)	25.6	25.1	21.1
State-owned enterprises	12.4		6.4
Collectively owned enterprises	39.3		28.6
Rural township enterprises			41.3
Enterprises with foreign investment			46.2
Investment in fixed capital (current prices)	36.8	61.0	50.6
State-owned enterprises	45.3	70.7	58.7
Collectively owned enterprises	94.8	104.6	53.9
Urban/rural residents	3.3	6.1	15.8
Real income of urban residents	9.0		10.2
Real income of rural residents	3.2		3.2
Retail price index	6.6	13.9	13.0
Cost of living index for 35 major cities	13.3	21.6	19.6
Price index for industrial products			24.0
Currency in circulation (M0)	36	54	25.3
Broad money (M2)	31	26	24.0
Total bank loans	19.8		22.4
Trade balance	US$4.4 billion	–US$3.5 billion	–US$12.2 billion
Import			
Growth			29.0%
Volume	US$80.6 billion	US$40.7 billion	US$104.0 billion
Export			
Growth			8.0%
Volume	US$85.0 billion	US$37.2 billion	US$91.8 billion
Foreign investment (contractual value)			
Growth	255.0%		76.7%
Volume	US$69.4 billion		US$122.7 billion
Foreign investment (realized value)			
Growth	66.2%		91.5%
Volume	US$19.2 billion		US$36.8 billion

Source: State Statistical Bureau, *People's Daily*, 1 March 1994.
Note: Industrial output growth is calculated according to value added for 1993 and according to growth output value for 1992 and the first half of 1993.

Across ownership categories, the growth of investment was 70.7% for the state sector, 104.6% for the collective sector, and 6.1% for the urban and rural individual units. After the austerity programme was initiated in June, investment by the state sector slowed a little to 61.7% in the third quarter, of which 56.5% in September. Due to a significant decline in the last quarter, investment in fixed capital for the year was RMB 1,182.9 billion, up 50.6% over 1992. Of this total investment, the state sector, collective sector and individuals have shared respectively 70.0%, 18.0% and 12%. The growth of investment for the three groups was respectively 57.8%, 53.9%, and 15.8% in 1993 (see Table 1).

The growth in retail sales was 28.4% in the first two quarters; it fell to 23.3% in the third quarter and achieved 26.1% for the year. About two-thirds of newly increased sales were concentrated in the coastal provinces. During the first three quarters, the agricultural producer's goods grew by only 2.7%, which implied a negative real rate after subtracting inflation. The non-household (work units) consumption far exceeded the household consumption in the first two quarters; this consumption fell below its previous level in August and September but ended about four percentage points higher for the whole year.

The high growth was accompanied by high inflation and a worsening of trade balance. The prices for agricultural and industrial raw materials jumped 52.9% in June and fell 45% in July and 42% in August. In September, the price index grew 14% for retail sales, 15.7% for living costs nationally and 20.7% for the 35 major cities. At the end of 1993, the retail price had increased by 13%; the cost of living index had risen 14.7% for the nation and 19.6% for the 35 major cities; the price index for industrial products had jumped 24%. Imports of US$104 billion (up 29%) exceeded exports of 91.8 billion (up 8%) by a trade deficit of 12.2 billion, which may have moderated domestic inflation. The increase in imports was accompanied by a strong inflow of foreign capital. The contracted value of foreign investment increased from US$69.4 billion in 1992 to US$122.7 billion in 1993. The realized value of foreign investment also jumped from US$19.2 billion in 1992 to US$36.8 billion in 1993.

The inflation was fueled by rapid monetary expansion. In addition to the 36% increase of currency in circulation (M0) in the previous year, the growth of M0 peaked at 54.0% in June and fell to only 42.6% in September after the implementation of the austerity programme. At the end of the year, the growth of M0 reached 35.3% (see Table 1 for the growth of M2 and total bank loans). In addition, the central government's budget deficit was RMB 20.5 billion if presented according to the old Chinese accounting system which counts government bonds (about RMB 30 billion) as revenue. Subsidies to loss-making state-owned enterprises and the doubling of wages of government employees contributed significantly to the deficit.

Economic growth in 1993 was uneven across regions. During the first ten months, the growth of the industrial output for seven coastal provinces (Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan) achieved 32% compared with only 13.9% for other provinces and contributed to 64.5% of the increase in the national total. During the first six months, the growth of fixed capital investment in coastal provinces was 81.2%, or about 30 percentage points more than the western provinces. In Guangdong province, investments increased 100.2% during the first four months.

A description of high growth is not totally true; it does not apply well to the agricultural sector. The agricultural output grew by only 4%. Grain production maintained about the same level as in 1992 although the cultivated land declined about 11 million *mu*. Cotton production fell by 376,000 tonnes, down 16.6%, with a dramatic shrinking of cotton growing areas left fallow by about 20 million *mu*. But, meat and fish production, mostly free from government control, grew respectively by 10.2% and 14.6%. On the other hand, significant price increases for agricultural tools and production materials slowed farmers' real income growth to about 3.2%. A sudden jump in farm product prices at the end of the year, which was largely caused by problems in the grain wholesale process, put some inflationary pressure on farm products.

Debate about Overheating

Like in 1992, high growth and high inflation characterized the Chinese economy in 1993. Growth was welcome but not inflation. Theoretically, very few economists and government officials in China could be convinced that high growth had to be accompanied by high inflation. But, empirically, high growth had gone hand-in-hand with high inflation during China's 15 years of reform. When growth and inflation were bundled together, opinions differed sharply on how to deal with the problem. By mid-year, high growth had been accompanied by a sharp rise of steel prices, the stagnant growth of the volume of transportation, the worsening of the trade deficit, a rapid drop of the price of the *renminbi* in the foreign exchange swap markets, accelerating investment (especially in securities and in property) and chaotic financial dealings. Economists, government officials and foreign experts from the World Bank concluded in June that the Chinese economy was seriously overheated, and an austerity programme had to be resolutely implemented. On the other hand, some influential liberal Chinese economists argued fiercely against strong austerity programmes and even denied any serious problems of an over-heating of the economy. They emphasized that most part of the Chinese economy had been growing healthily and that only a few regions and sectors may have over-invested. They pointed out that the rising prices of steel and the associated jump in steel import were evidence of functioning market forces. They argued that the bottlenecks in transportation and in the communication sectors were also attracting more and more foreign investment and that the huge increase of foreign direct investment would be able to support the high growth of the domestic economy. They blamed the financial chaos on the outdated state banking system and the slow pace of reform in securities and property markets. They also warned of the negative effects of strong austerity measures on the economy and its transition towards a market system.

Both sides had their good points, and both won the debate to some extent. The government implemented a brief but strong retrenchment programme during the third quarter. The government's official newspaper, the *People's Daily*, published on 29 November a lengthy research report by a senior World Bank economist on the initial positive results of the retrenchment programme and the danger of any early relaxation of the austerity measures. At the same time, the government announced a comprehensive reform package for 1994 and softened many austerity measures after Deng Xiaoping was reported to have made his latest call for fast growth. This debate about over-heating has continued into 1994 without any clear-cut resolution.

Financial Chaos

During the debate on over-heating, the government and many foreign experts, including economists from the World Bank, were particularly concerned about the chaos in the financial sector. It was widely reported that a huge amount of money had been diverted away from the state banking system and was circulating in the property markets, the securities markets, the non-state sector, and even overseas behind the veil of legitimate business activities of Chinese firms. There was a consensus that the financial chaos facilitated corruption and the loss of state property. It was suggested by many economists and government officials that the lack of control over the chaotic financial sector might threaten economic and political stability and hinder any further reform towards a market economy.

The loosening of the financial flows across regions and sectors had been facilitated mainly by the rapidly growing inter-bank lending market. This market had developed originally for short-term lending among the state banks to solve the banks' liquidity problems. However, the inter-bank loans were now used as investment funds. Many non-bank financial institutions and even some enterprises were able to participate in one way or another in the inter-bank lending market. As a result, financial resources were being diverted from the state banking system to the extremely dynamic non-state sector in the southeast coastal regions, breaking the monopoly of bank loans by the state sector and supporting faster growth in those regions. By the end of June, inter-bank lending had risen to about RMB 200 billion, close to about 15% of the total state bank loans at that time.

The inter-bank lending market had responded to strong demand for funds by the non-state sector of the coastal provinces. The interest rate in the inter-bank market of Hainan and Guangdong had been about 30% or above in June while it had achieved only about 20% in the interior provinces. Apparently, enterprises in the coastal provinces were able to bear higher interest rates than those in the interior.

In 1993, direct fund-raising by enterprises through joint-stock companies and enterprise bonds was another major channel for diverting funds from the state banking system to the non-state sector. Attracted by high returns, individuals and the state-owned enterprises were withdrawing their deposits from state banks and investing directly in many new joint-stock companies or buying their bonds. The Great Wall Corporation scandal was one of the most publicized cases. This private corporation had offered 24% returns to about 100,000 investors who had purchased its one billion bonds. The corporation went bankrupt when the government started an investigation of its possible corrupt dealings. One vice-minister was arrested, and 120 government officials were involved in this case. While many private enterprises did go bankrupt, a significant number of them succeeded as the increasing share of output produced by the private sector showed. Like the inter-bank lending, direct fund-raising by the private enterprises weakened the monopoly of the state-owned enterprises on financial resources.

It was suggested that the diversion of financial resources away from the state banks worsened the structural imbalance of the economy. The "bubble economy" of speculative property and securities markets tied up too much funds which could have been used to improve the bottleneck sectors of transportation, communications, energy and the production of raw materials. This proposition was supported by the observed high demand pressures in these bottleneck sectors. However, it should be noted that the bottleneck sectors have always been the "key" sectors heavily supported by the State. Why have they always been the "bottleneck"? In addition, foreign investors have been anxious to enter these sectors. A "super highway" from Guangzhou to Hong Kong has been under construction by Hong Kong entrepreneur Gordon Wu and his Hopewell Holdings and will be completed by June 1994 if on schedule. Another Hong Kong based company, China Strategic Investment Ltd., formed a joint-venture with Hangzhou government to build a highway.

The other side of the structural imbalance was the boom in the property market, which was no doubt caused by the high speculative returns. As China has been marching towards a market economic system, it was good news to see a rapid development of the property market. If the properties were being bought by private individuals and enterprises, high price (or high demand) would not be object of concern. Price (or demand) is constrained by private wealth. However, China's property market by 1993 was still tightly controlled by the government. A large amount of land was being contracted out for development purposes through government agencies at below the free market prices. Many participants in property transactions were state-owned companies using funds borrowed from the state banks. The heavy involvement of government agencies and the diversion of state-owned funds greatly distorted the normal functioning of China's property market.

Austerity Programme

When Vice-Premier Zhu Rongji announced his 16-point austerity programme in July 1993, he stated clearly that it would be different from the

1988–1989 retrenchment programme. He emphasized that, instead of a dramatic cut in overall credit, his macroeconomic adjustment would clean up financial chaos by recalling questionable loans for speculative property and security transactions but would ensure loans to the national key projects.[4]

The 16-point directive issued by Zhu was a temporary measure to stabilize the economy so that a comprehensive reform of the enterprise system, the banking and financial sector, and the fiscal system could be implemented in 1994. However, by the middle of October, only one-third of the questionable inter-bank loans (about RMB 70 billion) had been recalled. It had been so difficult for the central government to trace the other two-thirds (about RMB 140 billion) that no one from the government openly discussed the progress of the operation after October 1993. Moreover, during the fourth quarter, the central bank apparently relaxed credits to key state-owned enterprises and national key projects in response to a severe shortage of working capital.

Our explanation for this inconsistent behaviour on the part of China's central bank is very simple. The individuals and enterprises who had been able to get loans from the state banks to buy property and securities were probably the most powerful (or corrupt) groups in China. They had connections throughout the central and local government agencies, the state banks, and even with overseas investors. Hence, it was very difficult to recall their loans. Moreover, a withdrawal during the austerity period of funds sunk in the property market would have brought serious losses to the investors as well the banks if the projects had failed. On the other hand, the state-owned enterprises had been required to deposit their funds at state banks. Hence, it was easy for the state banks to seize the working capital funds of the state-owned enterprises as an indirect way to fulfill the quota implied by the recalling of questionable loans set by the central authority. However, the drop in bank deposits held by the state-owned enterprises immediately created inter-firm debts (or triangular debts) and directly threatened the normal production activities of the state-owned enterprises. It turned out that even Capital Steel, one of the most resourceful state-owned enterprises in China, had payment problems after the austerity programme started. At least in the state sector, the central government seemed forced to short-circuit its retrenchment policy by extending new loans to relieve triangular debts.

Outside of the state sector, most of the questionable loans are probably still being circulated against the will of the central authority.

Engine of Growth and Root of Inflation

From our previous research on the recent developments in the Chinese economy, we draw two important conclusions: first, the engine of China's recent economic growth has been the non-state enterprises; secondly, the failing state sector has been the root cause of China's macroeconomic instability.[5] These two powerful underlying economic forces, which have been unleashed by 15 years of market-oriented reforms, have once again dictated the dramatic change in the economic variables and in government economic policies during 1993. In 1993, the state sector absorbed 70% of China's investment in fixed capital but produced only about 30% of GDP (value-added of all outputs). There may be important biases (over- or under-estimation) in these two statistics, but it is doubtful whether the statistical biases would affect the basic conclusion that the state sector was grossly inefficient in comparison to the non-state sector in terms of output-investment ratio.

Comparative growth in the two sectors was even more disappointing. As shown in table 1, in 1993, the growth in value-added of state industry's production was less than one-fourth the value-added of the collective industry, one-sixth of the rural collective industry, and one-seventh of the foreign joint-venture enterprises. Hence, in 1993, as in previous years, the engine of growth was the non-state enterprises. The rise of the non-state sector has created the Chinese economic miracle (close to 10% of the annual growth of GDP for more than a decade) and has saved the Chinese economy from serious macroeconomic instability by providing a steady and increasing supply of commodities and services. Without this significant increase in supply from the non-state sector, the expansion of aggregate demand supported by credit creation in the state sector would have led to serious inflation much earlier and for a much longer period. The increasing volume of real activities in the non-state sector also absorbed a large amount of money for transaction purposes, thus contributing to the reduction of inflationary pressures.

Unfortunately, even with the favourable supply conditions provided by the non-state sector, China's central bank and the central government were not able to limit the expanding allocation of loans, especially policy loans. Policy loans are extended not on the basis of profitability and risk but on the basis of the preferential policies or the *ad hoc* priority set by the government for some economic and political reasons. Policy loans have been allotted to loss-making state enterprises, to the highly regulated energy, transport, and communication sectors, to the state-managed farm procurement system, and to corrupt state officials and their friends.

Without policy loans, the state sector would have shrunk quickly. Had this policy line been followed, there would have been little impact on the economy as the strong growth of the non-state sector would have filled the supply gap left by the bankrupt state enterprises. The government did not take the opportunity offered by a growing non-state sector to get rid of the inefficient state enterprises. Instead, it subsidized the state sector with policy loans. The damage to the economy would have been much less had the government instead used budgetary measures to support the state sector. The result would have been a higher government deficit and a larger government borrowing through bond issuing but a lower inflation. The use of policy loans to subsidize the state sector not only covered up the true losses of the state sector but also led to excessive credit expansion. Because of the unique features of China's credit creation process, the expansion of policy loans is roughly equivalent to an injection of high-powered money (reserve at the central bank) into the economy. In the case of China, one *renminbi* in new policy loan creates through the banking system about RMB 3 in new deposits which may be lent to priority or non-priority sectors. In 1993, when any state bank ran out of deposits to lend to government priority projects, it asked the central bank for more credit in order to fulfil the obligations of policy lending. The excessive expansion of policy loans forced an explosion of central bank credit to the state banks. Inflation resulted. Real interest on state bank loans and deposits turned negative. Individuals rushed to banks and withdrew deposits to buy gold, foreign currencies, stocks and durable goods. Firms, state- and non state-owned, rushed in to get loans to invest in stocks, real estate and new development projects. Chaos in the financial sector resulted, especially in the inter-bank lending market.

However, the chaos also weakened the protected privileges enjoyed by state-owned enterprises in getting loans from state banks. Increasingly, the non-state sector was able to secure loans directly or indirectly from the state banking system, thanks to the newly developed profit incentives affecting the state banks and the emerging inter-bank lending market. These "diverted" loans facilitated the rapid growth of the non-state sector. This had a positive result as the rising output of the non-state sector helped fill the supply gap left by the shrinking share of the state sector and reduced some of the inflation pressure in the consumer goods market. On the other hand, the loose credit environment (a negative real interest rate on state banks' loans and deposits) led to a rise in capital-labour ratio in the firms and a decline in capital productivity in both the state and non-state enterprises. Hence, the Chinese enterprises, state or non-state, competed to take advantage of "cheap" domestic capital while foreign investors rushed in trying to benefit from the cheap labour in China.

To outside observers, such as the analysts at the World Bank, it was clear that in 1993 the Chinese economy was overheating. But, the insiders — Chinese economists, policy makers and government officials — debated fiercely over whether or not the economy was overheating. For a while, the debate disappeared from the public arena after Zhu Rongji had declared an emergency retrenchment programme in July; it resurfaced again in November before a new comprehensive reform plan was to be launched by the third plenum of the Party's Fourteenth Central Committee. With inflation running into double digits and steel prices jumping above the world market prices, why were so many veteran economists and officials still not accepting that the Chinese economy was overheating? Our conclusion is that they were concerned about the impact of a harsh austerity programme on the more dynamic and market-oriented non-state sector of the Chinese economy. The non-state sector would have been hit the hardest by an effectively implemented austerity programme.

However, as usual, the most effective plea for an end to the austerity programme came from the protected state-owned enterprise sector. The state-owned enterprises were less able to bear the burden of the belt-tightening retrenchment. This was indeed reflected in the serious problems which developed in the second half of the year, such as the shortage of operational funds and the widening phenomenon of triangular debts.

Most Chinese economists and officials have recognized that it is difficult, if not impossible, to bail out the deficit-prone state-owned enterprises. Sooner or later, the government will have to rely on the non-state sector for tax revenues and economic prosperity. However, state ownership is still insisted upon officially. The shift to private ownership is still out of the question according to the stated government policies (notwithstanding unofficial practices), although the commercialization of ownership rights is encouraged officially. The barrier to a complete free market system still lies with ideology and entrenched interests.

New Reforms and Prospects for the Future

The economic reality and the economic thinking discussed in the above sections are reflected in the new comprehensive reform policy, which turns out to be the core of Vice-Premier Zhu Rongji's reform plan. As the driving force behind fiscal reform, Zhu attempted to broaden the tax base of the central government to procure for itself a greater share of the benefits stemming from the rapid economic growth. The broadening of the tax base was a good idea provided the decision took a low rate as one of its integral principles. However, the principle of low rates was overlooked when the central government tried to shift tax collection from a contract-based system to a system based on tax sharing. Under the previous contract system, the nominal tax rate had not been binding; rather, it had been used, together with past profit and tax data, to draw a contract between the enterprise and the government or between the local and the central governments. According to the spirit of the tax contract system, the enterprise would deliver a certain amount of profits to the government as a contracted tax but would keep most of the increased profits for itself. The tax contract system had given the enterprises and the local governments strong incentives to maximize profits, and it had guaranteed a stable amount of tax revenues to the central government.

However, the major problem with the tax contract system was that the actual tax rate (total tax revenues divided by total profits) had been declining, while the nominal tax rates had not changed and had remained much higher than the actual rates. For example, the nominal profit tax rate for the state-owned enterprises had been 55%, but the actual tax rate under the contract system had for many enterprises been much lower than 55% and probably lower than the new profit tax rate of 33% because of many exemptions and negotiated arrangements. Hence, in the new system, although the nominal tax rates may go down, the enterprises may end up paying taxes at higher actual rates. The local governments may also get a smaller share of tax revenues under the new system. Another example of the central government seemingly using excessively high tax rates to intervene in the economy is the newly created value-added tax on property development. The tax rate reaches a prohibitive 60% for large gains. The increase in the effective tax rates, if implemented, will have negative incentive effects on both domestic and foreign investors.

Another central issue in the fiscal reform plan is the attempt to settle the sharing of tax revenues between the central and the local governments. In the previous tax system, the central government had had no need for an independent tax collection system. It had relied on the local governments to collect tax revenues. According to the new fiscal reform plan, this will change. A new tax collection network will be established and collect for the central government the tariffs, the consumption tax, the income tax from the state enterprises and the turnover tax at railway depots, banks and insurance companies. The local governments will then collect for themselves the business tax, the income tax from local enterprises and the individual income tax. The central and local governments will also share revenues from the value-added tax (VAT), the securities trading tax and the natural resources tax.

The fiscal reform involves conflicts of interest between the central and the local governments. With such conflicts, can the fiscal reform be implemented effectively? Is the current fiscal reform plan the best strategy for the central government to raise its share of tax revenues? Our brief answer to these questions is that the current fiscal reform plan can be implemented, but it is doubtful whether it will raise the central government's share of tax revenues significantly.

The fiscal reform plan gives the local governments the potentially important local enterprise income tax and the individual income tax. Also, the central government has agreed to make a refund to the localities if their tax revenues fall below their 1993 levels. On the other hand, the central government will keep the income tax from the state-owned enterprises, which is declining. Hence, the situation that had existed in the past will continue whereby the central government will have to look after the state-owned enterprises, exact a levy on their profits and shoulder their losses while the localities will do the same for local enterprises. This arrangement is easy to accept, but it does not eliminate the root problem of the fiscal decline at the centre — the deteriorating performance of the state sector.

This latter point relates to another item in the recent reform plan, the enterprise reform plan. Since the central government still wants to rely on the state sector for a major part of its revenues, it plans to transform the state-owned enterprises into modern corporations with state ownership remaining dominant. The government knows well that the state sector is not very efficient. However, for historical and political reasons, the government regards the state ownership of key industries as an important foundation of its authority. Hence, on the one hand, the government does not want to sacrifice the state-owned enterprises by cutting off their subsidies. On the other hand, the government wants to reform the state enterprises by giving them more autonomy. But, past experience has shown that giving more resources and more power to the state-owned enterprises does not lead to higher profits. Instead, the agents who control the state assets are expected to continue pursuing their own interest at the costs of the State.

In our opinion, the central government should turn to the private sector for its economic and political interests. It should shift its tax base (with low rates) to the private or non-state sector. In exchange, the central government should protect their private property rights, encourage them to grow large and establish unified and nation-wide markets. With the extraordinary growth of the private and non-state sectors, the central government could be assured of rising revenues by protecting their private property rights and maintaining a competitive environment. In effect, the private sector needs urgent help now from a strong central authority to deal with widespread corruption at the local level.

In the monetary sector, the objective of the financial reform was to commercialize some of the state banks, standardize the structure and function of the central bank, leave difficult and unprofitable lending to the policy banks and unify the foreign exchange rates into government-managed "market rates." These reform measures look like solid steps towards a market system. However, we may doubt whether the new financial reform plan when implemented will really be a step forward or backward. The major borrowers of the state banks are the state-owned enterprises. Most of the policy loans also go to the state enterprises. The root of the problems with the policy loans, the state banks, and even the central bank, is the state-owned enterprises. Hence, we see little chance of success for the banking reform if the state-owned enterprises are not properly dealt with. Moreover, if the new policy banks can effectively acquire funds from the central bank and effectively allocate them to the state enterprises, the new banking system may do more harm to the economy than the current system. As discussed in the previous sections, under the current banking system, some of funds targeted at the priority sector (mostly state industries) were diverted to more efficient non-priority (non-state) industries and generated more output. In the new system based on policy banks, the diversion becomes difficult. There is a possibility that the policy banks will monopolize a larger share of total funds in the economy for the less efficient priority sectors. That should do little to help growth and contain inflation.

There are three core elements to the plan for the unification of foreign exchange rates. First, a unified nation-wide interbank market rate for foreign exchange will replace the previous difference between the swap market rates of various regions and the official rate. Secondly, unlike on the swap markets, which had enterprises and even individuals as market participants, only state banks and a few foreign banks can participate in the interbank market for the foreign exchange. Thirdly, domestic enterprises can no longer hold foreign exchange accounts; they have to sell their foreign exchange earnings to the state banks and buy foreign currencies from the state banks when needed. Supposedly, the move should help to make the *renminbi* more convertible. That will come true if the new interbank market rates for foreign exchange reflect real market demand and supply and the control on selling and buying foreign currencies by the state banks is not too rigid. Under the new foreign exchange system, the government has too much influence on the rates and the accessibility to foreign exchange through its control of the state banks. If the government makes mistakes about the rates and limits the accessibility to foreign exchange intentionally or unintentionally, the *renminbi* could become much less convertible as a result.

In the previously decentralized foreign exchange system, the *renminbi* was convertible for participants at the many swap markets in the major Chinese cities. Moreover, the enterprises possessing a foreign exchange account or using the Hong Kong currency did not have any foreign exchange risk. They earned foreign exchange and used it to buy materials, products and services. It cannot be overemphasized enough that the previously decentralized system with its foreign exchange retention and the swap market as the major instrument had contributed decisively to the rapid development of foreign trade and investment in China, especially in the southeast provinces.

One additional issue needs a brief discussion. What is going to be the impact on the economy of Deng Xiaoping's death? We have no doubt that the open-door policy promoted by Deng will continue and that market forces will dominate. The economic angle of the debates over the choice of the future leaders implies a decision on how much support the government should give to the state sector and how much freedom over economic policy the central government should give to the localities. Deng Xiaoping's strategy of political centralization and economic decentralization encouraged the development of the non-state sector and the expansion of local economic power; as a result, the strategy turned China decisively towards a market economy. But, as a by-product of Deng's reform, the central government saw its control of the economy greatly weakened. Hence, there are concerns that after Deng the conflicts between the central and the local political entities may endanger China's future stability or even lead to the disintegration of China like what happened in former Soviet Union.

We disagree. Deng Xiaoping did not loosen the political control of the localities at any time. No one at the centre did so either. In politics, the centre still maintains its tight control of the military and, thus, has almost absolute power over the local administrations. The conflicts between the central and local governments focus on economic policies. More accurately, the conflicts are reflections of struggles between two (or more?) lines of thought within the center. As soon as the next leading political group consolidate its power after Deng's departure, the central-local conflicts will be much easier to resolve. China's one-party system inevitably produces factions within the elite. At present, most Party leaders favour a market economy and a private sector because of the sharp contrast they have experienced since 1949 from the effects of an economy based on either a market or a planned system. The differences among Party leaders now centre on the steps needed to proceed from the currently half-reformed system to a market system. A significant portion of the current leadership have in mind the models of Japan, Singapore or Korea which emphasize the positive role of state intervention in the economy.

The preference of the current leadership has been well received by many well educated and highly intelligent young policy makers and advisers. The younger generation amongst China's elite has contributed significantly during the past 15 years to China's march towards a market economy. Many of them are experienced, self-confident, and anxious to lead China towards a socialist market economy according to their plan. This is in sharp contrast to the policy makers and advisers during the early years of reform, who were less experienced though eager to investigate, less confident though willing to learn; they were eager to push the central government to legitimize the good local initiatives they had studied; they were less anxious to propose new plans. The official blessing given to the Japanese, Singaporean and Korean models gives the present young elite a chance to show their ability to guide the economy.

Conclusion

Now China has produced a comprehensive reform blueprint and is about to implement it, with the help of the World Bank, foreign experts and newly emerging professional Chinese economists with Western or Chinese education. Will the comprehensive reform plan succeed? It is still too early to tell. Our concern at present is that the new reform measures announced so far seem to overlook what are, for the Chinese economy, the engine of growth and the root of inflation. In 1993, China had high inflation as well as a respectable real growth. However, if the government's new policy threatens the healthy growth of the non-state sector, in the worst case scenario, China's engine of growth could be shut down. Stagflation (inflation plus slow or negative growth) might result in the near future. However, we are cautiously optimistic about the future because of our trust in the non-state sector.

The most recent statistics show that, in the first two months of 1994, the gross industrial output grew by 49% in rural township and village enterprises, by 76.4% in private enterprises and joint-ventures with foreign investment, and by only 1.2% in the state-owned enterprises. Since more than two-thirds of China's growth comes from the non-state sector, we believe the economy will continue to grow at about 10% to 11%, barring any serious disturbances to the non-state sector. As happened in the past 15 years, government economic policies tend to change with China's economic reality. Hopefully, future economic events in China will reveal more and more clearly what the engine of growth and the root of inflation are and also what the good economic policies should be.

Notes

1. For a detailed and up-to-date review of the economy and politics in China, see the quarterly publication *Country Report: China and Mongolia* by the Economist Intelligence Unit. For more comprehensive review of recent economic reforms and macroeconomic conditions, see Michael W. Bell, Hoe He Khor, and Kalpana Kochhar, *China at the Threshold of a Market Economy*, Occasional Paper 107, International Monetary Fund, September 1993; *China: Reform and the Role of the Plan in the 1990s*, A World Bank Country Study, 1992; Peter Harrold and Rajiv Lall, *China: Reform and Development in 1992–93*, World Bank Discussion Papers 215, 1993.
2. Most of the statistics used here, unless otherwise indicated, were calculated from various volumes of the official *Statistical Yearbook of China*. But, we also employed a few statistics, which were derived and widely used by Chinese economists and officials but could not be calculated from the published statistical materials. For example, a well-known government

economist, Wu Jingliang, has claimed that the non-state sector is producing about 70% of China's GDP.

3. Starting in 1993, the State Statistical Bureau has been publishing value added measures of industrial output instead of the gross value of industrial output. This change is part of the transition of China's national accounting system from the old Soviet-style System of Material Product Balances to the new System of National Accounts following international standards.
4. See the chapter on financial reform in this book for a more detailed discussion of the sixteen-point austerity programme.
5. See Inderjit Singh, Dilip Ratha and Geng Xiao, *Non-State Enterprises as an Engine of Growth*, working paper, the World Bank and the University of Hong Kong, 1994 and Geng Xiao and Xu Mei-Zheng, *Policy Directed Lending and Economic Transition in China*, working paper, the World Bank and the University of Hong Kong, 1993.