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China's Search for an Economic Reform Strategy: Schools of Thought

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A Research Paper

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China's Search for an Economic Reform Strategy: Schools of Thought [Redacted]

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A Research Paper

This paper was prepared by [Redacted] Office of
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**China's Search for an
Economic Reform Strategy:
Schools of Thought**

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Summary

*Information available
as of 24 April 1987
was used in this report.*

When Mao died in 1976, China's economy was riddled with waste and low labor productivity. Inefficiencies caused by rigid economic planning had been exacerbated by Maoist policies that used political campaigns in futile efforts to achieve economic goals and that elevated ideological orthodoxy above objective economic criteria in decisionmaking.

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Two years later, China's new leaders convened the Third Plenum of the 11th Party Congress, which made economic modernization China's top priority. All believed economic reform was necessary to prevent China from falling further behind the industrialized nations, and all were united in viewing reform as a limited process involving decentralization of some decisionmaking authority and greater involvement of scientists and engineers in the operations of state enterprises. No one advocated allowing market forces to play a major role in China's economic development.

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Initial incentive-based agricultural reforms proved more successful than anyone imagined, however, and Deng Xiaoping, Zhao Ziyang, and other leaders began pressing for much wider use of market mechanisms in China's economy. As the scope of reform broadened, the consensus about economic policy quickly dissolved. A split emerged between those who supported comprehensive reforms and more "conservative" leaders who believed that reforms should remain narrowly focused.

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These two loose groups differ in how they view three core issues:

- ***The Locus of Economic Decision Making.*** Reformers see devolution of authority to factory managers and increased use of market mechanisms as the key to boosting efficiency and growth. Conservatives are more concerned about the wider fluctuations in prices and in growth rates this introduces, and believe that stable economic development can be achieved only by continuing to rely primarily on central planning.
- ***The Social Costs of Development.*** All leaders recognize the potentially destabilizing aspects of reform, but reformers are more willing to tolerate the greater income disparities and social tensions they see as the price of progress. As with economic performance, conservatives place a premium on stability.

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- *The Primacy of the Party.* All agree that the party must loosen its control over day-to-day economic decisions, but conservatives worry that, if this goes too far, party control over other areas will erode and give rise to demands for political liberalization. [Redacted]

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In high-level debates the reform view has generally prevailed, and, since the early 1980s, reformers have implemented elements of their program—including abolishing mandatory procurement quotas for grain; relaxing state price controls over vegetables, meat, and major consumer durables; and reducing the number of goods that are produced under the central plan to fewer than 60. For the future, they want to extend price reforms, allow state enterprises to experiment with issuing stocks and bonds, and establish labor, capital, and raw materials markets that will allocate a significant share of resources:

- In putting together a development strategy, reform leaders have relied on Chinese economists who increasingly have accepted Western economic theory as a guide. [Redacted] Chinese economists—particularly young scholars at Chinese universities and government think tanks—demonstrate increased understanding of market tools, frequently use concepts from Western economic theory to illustrate shortcomings in their planning system, and express a willingness to broaden market forces in China.

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- Chinese reformers apparently have been influenced, in part, by their exposure to the ideas of US officials and educators. US economic textbooks reportedly are popular in China, the official press often reports the views of US professors, and Beijing openly solicits advice from US experts. [Redacted]

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Conservatives, on the other hand, seem more sure of what they do not want than how they would spur growth while maintaining economic and social control. Generally, they believe that reform has gone far enough, and what is needed is greater attention to the problems that it has created, such as inflation, runaway outside-of-plan investment, and a big jump in China's foreign debt. Conservative solutions to these problems include tighter

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controls on how enterprises can spend their retained earnings and sharp limits on the ability of local authorities to import or borrow foreign funds independently of the central plan. [redacted]

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The debate over reform strategy may be approaching a critical juncture. In a speech in March 1987, Zhao Ziyang revealed that a major review of China's eight-year-old experiment with economic reform currently is under way. According to US Embassy sources, the purpose of the study is to develop a comprehensive, coordinated blueprint for further reforms that will be submitted to the 13th Party Congress in October. Reformers probably hope to use the study to reassure conservatives that new policies will be implemented prudently, while building a consensus over which steps to take next. Zhao's vigorous defense of price reform in recent speeches and [redacted] advocating further experiments with ownership reforms in state enterprises indicate that reformers expect difficulty resolving these sensitive policies. [redacted]

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Given what is at stake and the sharp differences in how Chinese leaders view the risks of further reforms, we believe that a consensus will remain elusive. Moreover, China remains a political system dominated by a paramount leader who sets the tone and resolves differences, and the views of that individual—whether Deng or a successor—will have much to say about reform strategy. In a period of leadership transition that will see significant turnover at the top of an aged leadership, we believe battles over economic reform strategy are likely to be lengthy and intense. [redacted]

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Beijing's choice of a development strategy will have significant implications for US-Chinese economic relations. A reformist strategy involving price reform and less government control over access to foreign exchange would improve the investment climate for foreign firms. Moreover, the reformist program—including decentralizing trade authority—probably would spark faster growth in bilateral trade, with Chinese imports of US machinery, computers, consumer goods, and scientific equipment growing rapidly. Because of China's strong demand for these and other products, China probably would register balance of trade deficits—forcing Beijing to step up borrowing from US banks. Diminished central control over Chinese enterprises and greater incentives to sell abroad would sharply increase Chinese exports—particularly textiles, electronic components, and other light manufactures—and might disrupt US markets and cause increased trade frictions. [redacted]

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A conservative development strategy, on the other hand, probably would mean slower growth in bilateral trade and less willingness on Beijing's part to borrow money from US banks or allow US firms to set up operations in China. Tightened central restrictions over trade, however, would give Beijing greater control over the volume and mix of Chinese exports—thereby decreasing the probability that its exports would disrupt US markets. [redacted]

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Contents

	<i>Page</i>
Summary	iii
From Unity to Fragmentation	1
Who Are the Players?	1
At Stake: Privilege, Stability, and Control	1
Economic Control	2
Social Stability	2
Party Primacy	3
The "Mainstream" Reform Strategy	4
The Influence of Western Economic Thought	5
The Influence of the "Radical" Reformers	6
Reform Policies and the Conservative Agenda	7
The Scope of Market Forces	8
Rural Reforms	8
Industrial Reforms	8
Wage Policy	9
Price Reforms	9
Foreign Trade Reforms	9
Signposts	10
The US Stake	12

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China's Search for an Economic Reform Strategy: Schools of Thought

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From Unity to Fragmentation

When the Third Plenum of the 11th Party Congress, meeting in December 1978, made the landmark decision to reject Maoist notions of class struggle and devote full attention to economic development, Chinese leaders, as indicated by their public statements, viewed reform as a way to patch up the planned economy and reassert the role of rationality and expertise in economic decision making. Although senior officials were unclear over how extensive the reforms should be, no one advocated giving much scope to market forces.

We believe the success of initial economic reforms, however, convinced Deng Xiaoping and other senior leaders to implement a much more far-reaching reform program. In particular, raising state procurement prices and allowing rural households increased autonomy over production decisions proved more successful than Beijing had anticipated—from 1981 to 1984 grain production shot up at an average annual rate of almost 8 percent—apparently convincing some leaders that wider use of market mechanisms would stimulate rapid growth in other sectors. We believe that these leaders—at the same time—viewed difficulties with initial efforts to loosen state controls over enterprises as evidence that industrial efficiency could not be raised unless the whole urban economy was transformed through price, wage, financial, planning, and management reforms.

On the basis of public statements by Chinese leaders, we believe that, as the scope of economic reforms expanded, the consensus about economic policy quickly eroded among senior officials who previously had been united by their opposition to Maoist practices. A split emerged between those who supported comprehensive reform policies and party “conservatives” who believed reforms should be much narrower.

Who Are the Players?

Chinese leaders have denied the existence of “reformist” and “conservative” factions within the top ranks of the Chinese Communist Party. Although we agree that neither grouping constitutes a unified faction—members have their own interests and agendas and often line up differently on particular political issues—a large body of press reporting points to sharp disagreement between the two groups over the extent to which market forces should govern economic activity in China. Deng Xiaoping and other reform proponents—including Premier and Acting General Secretary Zhao Ziyang, Vice Premiers Wan Li and Tian Jiyun, Politburo member Hu Qili, and former General Secretary Hu Yaobang—support broadening the use of market mechanisms in China. Conservatives include diehard central planners and party ideologues—such as President Li Xiannian, Politburo Standing Committee member Chen Yun, National People's Congress Chairman Peng Zhen, Vice Premiers Yao Yilin and Li Peng, Politburo member Hu Qiaomu, and former Propaganda Department chief Deng Liqun—who believe that ideological orthodoxy and strong central controls over agriculture, industry, and foreign trade are necessary to maintain stability and party control.

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At Stake: Privilege, Stability, and Control

Chinese leaders realize that individual power and perks, the role of the Communist Party, and even China's security are at stake in the reform process. At a party conference in January 1986, Tian Jiyun admitted that economic reform involves a “readjustment of power and interest” in China. Throughout the economy, from the head of a ministry asked to relinquish control of its factories, to a party secretary in a small state enterprise asked to cede authority over personnel decisions to the factory manager, reforms are causing a fundamental shift in the locus of

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Chen Yun, Deng Xiaoping, Hu Yaobang, Li Xiannian, and Zhao Ziyang in 1981. These leaders launched China's economic reform program, but Chen and Li later opposed widening the scope of market-oriented reforms. [redacted]



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decisionmaking and, therefore, power. All senior officials realize that problems may emerge from reforms, but conservatives assess the risks of economic, social, and political instability arising from too great a reliance on market-oriented policies as being unacceptably high. [redacted]

spokesman on economic policy, warned that central planning was still the "essence of macroeconomic control." [redacted]

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Economic Control. When reforms were launched, conservatives warned that Beijing could lose control of the economy if the central planning mechanism were weakened, and they argued that strict limits should therefore be placed on decentralization. Nonetheless, reformers were able to sharply curtail the scope of mandatory planning during the past eight years, in part by arguing that indirect economic levers—such as taxes and interest rates—could be used to regulate economic activity outside the plan. Conservatives felt vindicated when, in 1985, investment spending skyrocketed, inflation tripled, imports surged, and foreign exchange reserves fell precipitantly—and they strongly criticized reformers for excessively decentralizing economic decision making. In a sharply worded speech to the National Party Delegates Conference in September 1985, Chen Yun, the senior conservative

Social Stability. Hong Kong press reports and public comments by orthodox officials indicate that conservatives believe spillovers from economic reforms—such as growing income disparities, inflation, and corruption—will damage the party's image and, in a worst case, lead to widespread social unrest including massive demonstrations in Chinese cities. No senior officials support a return to strict Maoist egalitarianism, but conservatives believe that, by encouraging some people to "get rich before others," by publicizing the achievements of successful peasants and urban entrepreneurs, and by sanctioning purchases of consumer durables and fashionable clothing, market-oriented policies will create social polarization. Although reform-minded journalists have identified envy as China's top social problem, Deng Xiaoping and his

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Where the Leadership Agrees

On the basis of public statements by Chinese officials, we believe that there is broad agreement within the leadership over some aspects of China's development strategy. Most significant, all leaders view economic reform as necessary to make China a prosperous and powerful nation with worldwide influence. Reformers and conservatives also agree on broad guidelines for reforms of the planning system and on investment priorities:

- *The planning apparatus must be overhauled. The old system is too extensive and rigid, and some degree of decentralization is necessary.*
- *Output targets in the plan should be set low, and greater emphasis should be placed on meeting qualitative goals, such as improving product quality and boosting industrial efficiency. Economic decisions should be based on objective criteria, including cost-benefit analysis. Even mandatory planning must take supply and demand into consideration.*
- *Bureaucratic interference in economic activities should be reduced, and responsibility systems—such as granting factory managers increased decisionmaking authority but holding them accountable for profitability—should be set up in industry and agriculture.*

- *Productive capacity should be increased through technological transformation of existing factories, rather than building new factories or importing whole plants.*
- *Development of heavy industry, light industry, and agriculture should be balanced.*
- *Priority in investment spending must be given to developing energy, transportation, and communications facilities.*
- *Technical expertise must be respected and rewarded. Scientists and engineers should play a larger role in factory decision making, and the skills of factory managers should be enhanced through education.*
- *China should import technology and managerial skills from Western countries.*

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supporters believe that reforms will cause general living standards to rise fast enough to keep social tensions from boiling over. Conservatives also worry that loosened central controls and the emphasis on making money have opened the floodgates of fraud, bribery, smuggling, black-market trading of foreign currencies, and graft by local officials

Party Primacy. Conservatives fear that decentralization of economic decision making and increased exposure to Western ideas will give rise to demands for political liberalization that Beijing will have difficulty

suppressing. In a speech to the Party Central Advisory Commission in October 1984, Deng Xiaoping admitted that some officials who joined the party 50 years ago fear that economic reforms may erode party control and lead to the restoration of capitalism in China. Other critics worry over what role local party officials can play when the power to make economic decisions is transferred to peasants and factory managers.² All senior leaders are firmly committed to

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Chen Yun: China's Original Reformer



Last summer a US Embassy contact placed Chen Yun at the head of those in China who believe in the importance of improved state planning. In our view, the fact that in the late 1970s Chen was considered the leading proponent of an expanded role for the market indicates how sharply the development strategy debate has swung toward acceptance of market mechanisms. [redacted]

Although Chen is considered a leading conservative, all Chinese leaders frequently quote his remarks to support their own policies—indicating that, [redacted] he still has enormous personal prestige. Respect for Chen probably stems from his

longevity in the party—he has been a member of the Party Central Committee since 1931, longer than anyone else—and his role as China's chief economic troubleshooter over the past 40 years. When the Communists came to power in 1949, Chen ended the hyperinflation then plaguing China, restored production, and guided the transformation of the economy from private to public ownership. In 1958 Chen was one of the few leaders to oppose Mao's ill-conceived Great Leap Forward, and in 1961-62 he helped bring the economy back from the disaster it caused. After Mao died, he played a key role in reducing the inflation and large budget deficits caused by Hua Guofeng's overly ambitious development plans. [redacted]

At the Eighth Party Congress in September 1956, Chen proposed that the market could be an important supplement to central planning. Over 20 years later he described his views on the relationship between the market and the plan as being like that of a bird and a cage: if the cage is too restrictive, the bird will suffocate, but if the cage is too loose, the bird will fly away. In our view, the fact that his views are widely accepted by conservative leaders provides a degree of protection to Chinese economic theorists who—according to the metaphor—can argue over the size of the cage, and not whether the bird has a right to live. [redacted]

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maintaining one-party Communist rule, but reformers are more confident of their abilities to moderate demands for political reform, and therefore more willing to risk "ideological contamination" from contacts with the West. [redacted]

The "Mainstream" Reform Strategy

Since the early 1980s, reformers have implemented an increasing amount of their program—and the "mainstream" position in the debate over reform strategy consequently has shifted in an increasingly market-oriented direction. In our view, reformers have had

success implementing their policies because of political victories³ and rapid gains in production. Beijing's most notable success was increasing grain production—which made China a net grain exporter in 1985 for the first time in 25 years. Moreover, gross national product grew at an average annual rate of about 9 percent in real terms between 1978 and 1986, according to official statistics.⁴ Although reforms have also



⁴ Some long-stagnant sectors also have shown significant gains. For instance, production of rolled steel and coal grew at average annual rates of 9 and 7 percent, respectively, between 1981 and 1986. [redacted]

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Beijing's Nightmare of Solidarity-Style Labor Unrest

Beijing had just launched its reform program when the Polish Solidarity trade union movement arose in full force. A variety of information, including that from Hong Kong journals and speeches by Chinese intellectuals, indicated Beijing was deeply troubled by the specter of widespread labor unrest being sparked by attempts at reform in a socialist state. At the time, many leaders viewed Solidarity as an example of what can happen if the party loses touch with the people and fails to satisfy their desire for progress. The episode apparently also reinforced the fears of some conservatives who believed that extreme caution should be exercised in implementing economic reforms. [redacted]

Although overt signs of worker unrest have been relatively rare in China since Beijing began implementing reforms, there have been a few notable exceptions. Most recently, a Hong Kong newspaper reported that 20,000 workers at a tractor factory in Henan Province went on strike for two days last December, protesting low wages. [redacted]

Despite the relatively small number of incidents that have been reported, we believe Chinese leaders fear widespread labor unrest and the cycle of declining labor productivity and falling standards of living that would accompany it. For example, a Hong Kong journal reported that Deng Xiaoping reacted harshly to protests by university students in December because he was extremely worried that workers would join the students. [redacted]

sparked inflation and budget and trade deficits, Deng and his supporters continue to view these problems as secondary when compared with the overall increase in China's standard of living. [redacted]

On the basis of important speeches by reform leaders—particularly Zhao Ziyang's annual reports to the National People's Congress and his speech to a party conference in September 1985—we believe that mainstream reformers want to establish an economy in

which the market plays a large, but not dominant, role. In the countryside, peasants would have wide latitude to plant crops or start local industries—but important inputs, such as fertilizer and diesel fuel, would continue to be distributed through state supply channels. The production and distribution of key industrial products would be controlled by the state, but managers of state enterprises would make all operational decisions, including appointing subordinates and hiring and firing workers, purchasing raw materials, and directly marketing a significant share of output. Some firms producing exports would be allowed to contact foreign purchasers directly. Unprofitable enterprises would be shut down, and laid-off workers could seek employment with other enterprises or join the service sector—and would be protected by unemployment insurance until they found a new job. Overall market activity would be controlled by China's central bank through adjustments in credit availability, and by changes in taxes.

The Influence of Western Economic Thought

We believe that a driving force in the reform program has been the significant inroads that Western economic thought has made over Marxist theory in the minds of China's economists, as has been evident in their conversations with US officials and in Chinese press reports. For instance, the director of the Comprehensive Planning Department of China's central bank told US officials that policymakers in the bank hope eventually to control China's money supply using the same tools—open market operations, discount rate adjustments, and changes in reserve requirements—that the US Federal Reserve Board uses. And the director of the Institute for Planned Economy in China's conservative State Planning Commission reported that he favors gradually eliminating price controls over key products such as coal. [redacted]

On the basis of conversations between US and Chinese officials, we believe that increased familiarity with Western economic concepts is not limited to one group of scholars or bureaucrats. Growing economic sophistication is evident from conversations with economists in China's central ministries and organizations,

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particularly the State Commission to Restructure the Economic System—a State Council think tank for reform policies—and the Economics Institute of the Chinese Academy of Social Sciences. [redacted]

[redacted] the evolution in economic thought in China has been caused, in part, by exposure to the views of US officials and educators. According to a knowledgeable Chinese economist, an introductory economics textbook by a well-known US professor is more popular in China than Marxist writings.⁵ The Chinese press reports the views of US professors on China's reform program, and Beijing openly solicits advice from US experts. China's central bank, for instance, invited a delegation of US financial experts—including the chairman of the New York Stock Exchange—to Beijing last fall to discuss how to run securities markets. At annual meetings of the US-China Joint Economic Committee and the Joint Committee on Commerce and Trade,

[redacted]

US economists of ethnic Chinese origin have strongly influenced the thinking of Chinese leaders—and the Chinese press has reported meetings between those economists and China's top reform leaders. [redacted]

The Influence of the "Radical" Reformers

A few Chinese economists have argued that Beijing should renounce central planning and adopt a market economy:

- Li Yining, an economics professor at Beijing University, told a US Embassy officer that the best way to improve China's industrial efficiency would be for the government to cede ownership of state enterprises to workers and managers. Li believes that over the next 15 years Beijing should transform China's state-owned enterprises into firms run by boards of directors whose composition would be determined by stock ownership. Shares in what are now state enterprises would be sold to workers and

⁵ Only a handful of Chinese students have learned economics in the West. According to the Chinese press, about 150 Chinese scholars were studying economics in the United States last year. [redacted]

managers, with the government retaining a controlling—though not necessarily a majority—interest. The economic planning apparatus correspondingly would be dismantled, and enterprises would compete in a market environment.

- Wang Jue, a senior economist at the Chinese Communist Party's Central Party School, told a US Embassy officer that he teaches market concepts to high-level party officials attending the school. Among other things, Wang apparently presents the idea that the central plan should be sharply curtailed and that prices, wages, and rents should be market determined.

Even these progressive economists, however, believe that some type of government planning is necessary—for instance, to determine which industries to encourage—and believe that the state should directly run important sectors, such as banking, transportation, and communications. [redacted]

According to the US Embassy in Beijing, these progressive ideas have received a hearing from reform leaders. Li Yining, for instance, told a US Embassy officer that he has briefed Zhao Ziyang on his reform proposals. Limited evidence suggests that Zhao may have been influenced by the ideas of China's most progressive economists. A contact of the US Embassy, for example, reported that Zhao is the chief sponsor of experiments with multiple ownership forms in state enterprises. Nevertheless, in conversations with US officials, including Secretary of State Shultz in March 1987, Zhao has maintained that the economy will remain predominantly publicly owned and that China will not adopt the US free market model.

[redacted]

The fact that radical proposals by some economists received an open airing in the Chinese media last year indicates that reform leaders—if not necessarily accepting these ideas—believe that China's most market-oriented economists have an important role in the

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Zhao Ziyang: Innovator and Patron of China's Reform Economists



Zhao has also been one of the chief advocates of practical and theoretical exploration of new reforms. In his speech to the National People's Congress in March 1986, he complained that economic theory in China lagged reforms, and encouraged economists to "boldly explore" new ideas. This exhortation signaled the start of an increasingly open debate in 1986 in the Chinese press over the relevance of Western economic thought in China's reform process. According to US Embassy contacts, Zhao listens to the views of China's most progressive economists and has protected them from party ideologues who in the past have tried to prevent them from conducting research on non-Marxist theories. [redacted]

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Zhao Ziyang, as Premier of China's State Council since 1980, has been the leader most directly responsible for designing and implementing economic reforms. A senior Chinese economist told the US Embassy in March that—even with his added responsibilities as Acting General Secretary—Zhao continues to guide the reform program. [redacted]

We believe that Zhao has gone further than any other senior leader in advocating the use of market forces to drive China's development program. According to the Chinese press, when Zhao—on a visit to Romania last summer—was reminded of Chen Yun's birdcage metaphor, he replied that "a really good bird keeper can let a bird out and summon it back as soon as he calls . . . we are trying to learn just that trick." In our view, Zhao's remark was a clear, and calculated, rebuke to Chen's advocacy of the primacy of the planned economy. [redacted]

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In our view, Zhao is one of the strongest supporters within the Chinese leadership of the use of economic incentives. As party secretary in Sichuan Province in the late 1970s, he was one of the first leaders to promote rural reforms linking peasant income with individual production. And, as Premier, he has consistently argued that monetary and fiscal tools should replace administrative means to regulate the economy. [redacted]

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debate over development strategy. Li Yining's proposal to transform state enterprises into joint stock operations was reported in Beijing's party daily as well as in its leading English-language journal. And, according to the US Consulate in Shanghai, Zhao Ziyang recently prevented conservatives from closing a newspaper—the Shanghai *World Economic Herald*—that published bold commentaries last year advocating, among other things, that the state plan be tailored to meet the needs of a market economy. [redacted]

Reform Policies and the Conservative Agenda

In our view, conservatives have a much clearer idea of what they do not like than of what they would do if they had the chance to implement their own program. Nevertheless, statements by conservative leaders indicate how their development strategy differs from recently implemented reforms (which are enumerated below in italics). [redacted]

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***The Scope of Market Forces.** Because of regulations promulgated in 1984 that allow enterprises to sell over quota production at market prices, about 50 percent of steel, 60 percent of coal, and 84 percent of cement are distributed outside the central plan. Moreover, production of fewer than 60 goods is now controlled through the plan. Last year, reformers called for the establishment of labor, capital, and raw materials markets, and Beijing set up experimental interbank loan markets, steel markets, and rudimentary bond markets in several Chinese cities.* [redacted]

Party conservatives believe that the market has a small, but important, role in the economy. This view was reiterated in March, when Li Xiannian told Secretary Shultz that “the private economy can exist, but only as an auxiliary.” In practice, conservatives believe that market forces should govern production of subsidiary agricultural products, handicrafts, output of small workshops, and minor consumer items. In past speeches, Chen Yun argued that about one-fourth of all retail sales should be permitted to occur completely outside government channels. [redacted]

According to conservatives, mandatory state plans should govern the production of important agricultural, industrial, and consumer goods—such as grain, steel, and cloth. They believe, however, that a large number of other goods can be produced under “guidance” plans set by the state but flexible enough to enable enterprises to adjust to changing market conditions. For instance, many enterprises in light industry could purchase raw materials and market some of their output themselves—and Beijing would use a combination of administrative restrictions and changes in tax and credit policies to regulate their activity. [redacted]

***Rural Reforms.** In 1985, Beijing eliminated grain procurement quotas. Peasants now sign grain contracts with state supply units and have autonomy to sell the remaining output on the free market. They have increased flexibility to raise cash crops and livestock or to leave farming for rural industries. In a speech to China’s Rural Work Conference in November 1986, Tian Jiyun called for broadening market forces in the countryside to commercialize Chinese agriculture.* [redacted]

Conservatives support rural reforms that have given peasants increased autonomy over production decisions, but believe that administrative measures—such as restrictions on how much farmland can be transferred to other uses—should be employed to ensure production of an adequate grain supply. In a speech at the party plenum in October 1984, Chen Yun touted policies allowing peasants who have fulfilled their delivery obligations to the state to sell excess grain on rural free markets. And at a party conference in September 1985, Chen praised the “household responsibility system” for increasing agricultural production and raising rural standards of living.⁶ [redacted]

Conservatives, however, oppose policies that in the past two years have encouraged peasants to leave their land and start rural businesses and that have increased incentives for raising cash crops and livestock.⁷ In his 1985 speech, Chen complained that peasants are no longer interested in growing grain because they can earn more in rural industry, and he warned that a drop in grain production would lead to social disorder. Since then, conservatives have repeatedly urged peasants not to neglect grain production. Open criticism of reformers’ agricultural policies by delegates to this year’s session of China’s National People’s Congress indicates that there is still a sharp dispute within the leadership over how much autonomy peasants should be given in determining the mix of rural production. [redacted]

***Industrial Reforms.** To enhance the prerogatives of factory managers, and the penalties for poor decisions, Beijing issued regulations last fall that allow state enterprises to hire new employees under renewable contracts—rather than for life, as was the policy*

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in the past—and approved an experimental bankruptcy law that provides guidelines for shutting down inefficient state enterprises. Beijing also experimented with new ownership forms in industry by leasing small state factories to individuals and allowing other enterprises to issue shares to their workers. []

According to conservatives, training factory directors in modern management techniques and promoting younger, better educated technocrats—not implementing sweeping industrial reforms—are the keys to boosting efficiency in state enterprises. They agree, however, that enterprises and local governments should be given increased decisionmaking authority. Enterprises producing under the state plan, for example, should be granted the right to make day-to-day production decisions, but with factory managers and party committees working closely to arrive at these decisions. They support factory discretion on spending retained earnings, but with strict guidelines to prevent outside-of-plan spending from disrupting the state's priority construction projects.⁸ They do not object to new ownership forms in small state enterprises, but they believe that all medium and large enterprises should be state owned, and they object to sales of stock by these enterprises. []

Wage Policy. *In 1986, Beijing continued to urge factory managers to set wages and bonuses according to productivity, and allowed some enterprises to base their total wage bill on factory profitability.* []

Orthodox officials acknowledge that material incentives can play a role in China's economic development. In his October 1984 speech, Chen Yun blasted "big pot" egalitarianism under which workers' wages are unrelated to individual productivity. And, in the past, Chen has supported the use of piece rate wages for coal miners. But conservatives are concerned that material rewards could create excessively wide income disparities and they believe that equal weight should be placed on altruistic incentives. In March,

⁸ Outside-of-plan investment by state enterprises made up almost 20 percent of the total investment spending by state enterprises in 1986. According to the Chinese press, this outside-of-plan investment often pulled resources away from key projects. []

while defending the use of wage differentials, Li Peng argued that workers must be motivated by "socialist ethics"—their love for China and respect for party ideals. []

Price Reforms. *Beijing eased controls on the prices of vegetables and meat in 1985, and freed prices of major consumer goods—such as bicycles and refrigerators—last fall. The mayor of Guangzhou told the US Consul General in January that Beijing had planned to allow the prices of key raw materials—such as coal, oil, and steel—to float within a broad range this year, but has temporarily shelved those plans because of concerns about the potential inflationary impact.* []

Conservatives realize that China's distorted price system needs reforming, but they generally favor centrally regulated price adjustments rather than relaxation of state price controls. In their view, prices of sideline agricultural products and handicrafts may vary according to supply and demand, price differentials should be widened to reflect differences in the quality of similar goods, and price ratios should be readjusted periodically to encourage production of scarce goods. []

Foreign Trade Reforms. *Last year, Beijing continued to experiment with policies that bring Chinese enterprises, banks, and trade bureaus into closer contact with the West; according to the US Consulate in Hong Kong, for example, over 100 factories received authority to export their products independently of the state trading apparatus. Also last year, Beijing granted provincial units increased autonomy to raise funds abroad—for example, by issuing foreign-currency-denominated bonds—and allowed the Shenzhen Special Economic Zone (SEZ)⁹ to operate a*

⁹ In 1980, Beijing set up four special economic zones in Shenzhen, Zhuhai, Shantou, and Xiamen to encourage investment in China. Foreign firms that establish joint ventures in the zones are offered favorable tax rates, lower tariffs on factory imports, and autonomy over most day-to-day operations—including hiring local workers. []

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limited foreign exchange market. In October, new regulations were established offering foreign firms increased inducements to invest in China—such as the right to hire and fire workers, and tax breaks if profits are reinvested in the joint venture. [redacted]

Although cautious about opening to the West, conservatives believe that China can benefit from trade with capitalist countries if the central government—not local authorities—retains complete control over China's interaction with foreign corporations and banks. For example, they support expansion of Chinese exports as long as competition for foreign sales by Chinese enterprises does not lead to competitive price cutting. Chen Yun, Li Peng, and other orthodox officials have touted the benefits of imported Western equipment, technology, and managerial expertise—but they believe that borrowing money from foreign countries is a poor method of funding economic development. These reservations are based on ideological and practical concerns. Chinese press reports indicate conservatives believe that capitalists are out to make the most money possible from China and that borrowing should not exceed Beijing's ability to repay the loans. In particular, they oppose extending borrowing authority to local officials. Li Peng reiterated the conservative apprehension about foreign debt when he told Secretary Shultz in March that China "would not become another Brazil." [redacted]

Conservatives also have been sharply critical of the SEZs. According to press [redacted] reports, orthodox officials believe that the SEZs have not attracted the type of Western investment or earned as much foreign exchange as reformers promised. A key conservative criticism has been that provincial governments have used scarce investment funds to set up redundant processing industries in the SEZs to earn foreign exchange and take advantage of the zones' less restrictive import policies. In 1985, Yao Yilin reportedly argued that "blood transfusions" of funds from provincial governments to the SEZs must end. [redacted]

In our view, orthodox officials have not openly attacked the policy of allowing foreign joint ventures in China because they recognize there are certain

areas—such as offshore oil exploration—where Western expertise and financing are necessary. Li Peng and other conservatives, however, have criticized the preponderance of foreign investment going into hotels and restaurants instead of high-tech enterprises. And Hu Qiaomu has criticized restrictions on party work in joint ventures in the SEZs, implying that without party control Chinese workers may be exploited by foreign businessmen. [redacted]

Signposts

The debate over China's reform strategy took a conservative turn in the wake of senior-level jockeying for position following Hu Yaobang's ouster as Party General Secretary in January.¹⁰ Delegates to a National People's Congress Standing Committee session, meeting at about the same time, reportedly emphasized the importance of mandatory state planning, criticized the lack of sufficient attention to grain production, and called for greater "coordination" among trade departments. The Chinese media have featured senior conservatives, such as Li Peng, asserting the role of the party in economic decision making and advocating "plain living and arduous struggle" by workers to build a modern China. In January some progressive economists broke off contact with US Embassy officers whom they openly met with last fall.

[redacted]

Zhao Ziyang has attempted to rebuild momentum for reform by vigorously defending reformist policies in speeches this spring. In his annual work report to the full session of the National People's Congress in March, Zhao gave a spirited defense of the need for new price reforms, and advocated measures that would further decentralize economic decision making. For instance, he called for wider use of public bidding on state construction projects and ordered planners to shift more rolled steel from the central plan to the free market. [redacted]

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We believe the debate over reform strategy may be approaching a critical juncture. In his March speech, Zhao also revealed that a major review of China's reform program is under way. A senior Chinese economist told the US Embassy in Beijing that Zhao tasked participants in the study to construct a comprehensive, coordinated reform blueprint. [redacted]

[redacted] the blueprint will be submitted to the 13th Party Congress that is scheduled to convene in October. In our judgment, reformers probably will use the study—which almost certainly will endorse past policies while reassuring conservatives of more prudent implementation of new measures—to try to build consensus for more extensive reforms. [redacted]

Given what is at stake and the sharp differences in how Chinese leaders view the risks of market-oriented reforms, a consensus over reform probably will remain elusive. Moreover, the ease with which Hu Yaobang was sacked—even though his supporters dominated important positions throughout the party hierarchy—underscores a basic truth of China's system: despite efforts since Mao's time to institutionalize power arrangements in party and government positions, China remains a system in which one person is recognized as the paramount leader—and that person can exert strong influence over policy. In a period of leadership transition that will see significant turnover at the top of an aged leadership, battles over economic reform strategy are likely to be lengthy and intense. [redacted]

We believe an important indicator of the state of the debate over development strategy in China is Beijing's willingness to tackle price and ownership reforms. Price reform is an integral part of the mainstream reform program—inability to implement it will stall other reforms. For example, Beijing continues to subsidize enterprise losses; in part, because the irrational price system makes it difficult to determine whether firms are losing money because of poor management or low state-set prices. But, without the

threat of bankruptcy, enterprises are not very responsive to economic levers. Higher interest rates, for instance, will not deter borrowing as long as the state bails out enterprises that cannot repay their debts:

- A State Council circular issued in January stated that Beijing would not free prices of any additional products this year. Early in 1986, Beijing also ruled out price reform for the year, and then went ahead with new reforms late last summer. Chinese economists have explained to US Embassy officers that Beijing is postponing price reforms this year—not because of opposition from conservatives but because of concerns that excessive demand would push prices up if state price controls were removed. According to other US Embassy and Consulate reporting, Beijing has tightened credit and restricted investment expenditures to reduce inflationary pressures. In our view, these measures should begin to work by midyear. Therefore, if Beijing does not ease price controls by the end of the year, we believe that will indicate that conservatives have enough influence to delay key reforms. [redacted]

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Reformers continue to call for experiments with leasing and issuing shares by small state enterprises, but a contact of the US Embassy in Beijing reported sharp debate over whether medium and large state enterprises should be allowed to sell stocks to their workers. We believe a key test of reformers' political strength will be whether they are able to conduct experiments with stock sales by large state enterprises. Significant broadening of such ideologically sensitive experiments—although probably unlikely in the short run—would indicate that the ideas of China's most progressive economists are making inroads in the thinking of reform leaders:

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- In our view, Beijing probably will continue with limited, tightly controlled experiments with stock sales in 1987. The State Council issued regulations

Deng Xiaoping: Arbitrator and Pragmatic Reformer



Deng Xiaoping—China's paramount leader since the Gang of Four was deposed—has played a key role in convincing party members that the risks of reform are tolerable and in resolving top-level disputes between reformers and conservatives. A Hong Kong journal described Deng's role at the Third Plenum of the 12th Party Congress in October 1984 as an unbiased arbitrator who listened to both sides and decided in favor of further reform while trying to keep policy differences from creating animosity between the two groups. []

By his own admission, Deng is a layman in the field of economics and is not involved in day-to-day policy-making. In fact, he claimed that he did not write or revise a single word in the landmark "Decision on Reform of the Economic Structure"—approved at

the October 1984 Plenum—which extended economic reforms to the urban sector. He has been, however, the key champion of two politically sensitive economic reforms—the opening to the West and the use of material incentives. []

Deng publicly has blamed China's backwardness on its past closed-door policies, and, according to Hong Kong media accounts, was the first leader to propose establishing China's Special Economic Zones and the 14 "open cities" that are allowed to offer special tax and tariff incentives to foreign investors. Deng believes that foreign investment is indispensable to China's modernization, but has reassured party members that, no matter how much foreign capital flows into China, public ownership will dominate and China will retain its socialist system. Deng continues to lend personal support to increased contact with the West, for instance, by meeting last fall with the chairman of the New York Stock Exchange, who was visiting China at the invitation of China's central bank. []

According to Deng, egalitarianism leads to "national pauperism" because it erodes incentives to work. He rejects the ideological concerns of senior officials who fear that wider income disparities will cause class polarization, arguing that the criteria for judging whether a policy is sound is whether it increases China's prosperity. Despite his pragmatism, however, he remains firmly committed to party control. []

in April prohibiting state-owned factories from issuing shares to the general public and restricting stock sales to a small number of enterprises. But, in the same week, Beijing also allowed Tianjin—a major industrial city—to open a small-scale securities market. []

slower growth in bilateral trade and less willingness on Beijing's part to borrow from US banks or allow US firms to set up operations in China. Strong central administration of trade, however, would allow Beijing to control the volume and mix of goods exported—thereby decreasing the chance that Chinese exports would disrupt US markets. []

The US Stake

We believe the outcome of the debate over China's reform strategy will set the parameters on US-Chinese economic relations in the next decade. A more conservative approach probably would mean

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A reformist strategy probably would increase the opportunity for US firms to profit from China's modernization. For example, by reforming the price system so prices reflect relative scarcities in China—and bear closer resemblance to world prices—and by easing state controls over access to foreign exchange, Beijing would significantly improve the climate for US investors. [redacted]

In our view, US firms also would benefit if Beijing expanded financial policies it has experimented with in the past few years. For instance, China has allowed a few foreign banks to set up branches in the Special Economic Zones. As Beijing improves its ability to control the economy with central bank monetary tools, and as it gains experience in regulating these foreign branches, we expect Beijing to allow more foreign banks in China. In addition, since 1984 China has issued over \$2 billion in foreign-currency-denominated bonds in Japan, Hong Kong, and West Germany. According to the US Embassy in Beijing, Chinese officials are now considering issuing bonds in the United States. [redacted]

We believe implementation of the reformist strategy also would mean faster growth in bilateral trade. In particular, Chinese imports of US capital equipment, scientific instruments, data processing machines, and high-tech products would probably grow rapidly. Given the strong demand for machinery, consumer goods, and raw materials in China, decentralizing trade authority probably would cause China to experience a series of balance-of-trade deficits—therefore, China probably would need to step up its borrowing from US banks. Moreover, with decreased central control over Chinese enterprises, and greater incentives to sell goods abroad, exports of particular Chinese commodities could expand rapidly—disrupting US markets and causing increased trade frictions.¹¹

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