

Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

30 September 1987

China's 13th Party Congress: Economic Issues [redacted]

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Summary

China's economic performance for the first half of 1987 has intensified debate about reform in advance of the forthcoming 13th Party Congress. Conservative critics have sounded the alarm at inflation, excessive increases in wages and investment, and growing budget deficits, while reform leaders have touted eight years of rapid economic growth and improved living standards. We believe the two sides have reached an uneasy standoff, with agreement on steps designed to improve enterprise efficiency. But the rift in the Chinese leadership over the extent and pace of market-oriented reforms threatens to turn the key policy issuance of the Congress into a vague and guarded endorsement of the role of market forces--and the disagreement seems certain to persist after the Congress concludes. [redacted]

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This memorandum was prepared by [redacted] Office of East Asian Analysis. It is the sixth in a series of typescripts examining issues, personalities and factors bearing on this fall's Congress. Information available as of 23 September 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economic Assessments Branch, China Division, OEA, [redacted]

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Economics in the Spotlight

According to accounts in the Hong Kong media, China's economic performance in the first half of 1987 was debated with special intensity in meetings leading up to the 13th Party Congress, scheduled to convene on 25 October. The Chinese press has highlighted sharply divergent signals on economic policy, which we believe reflect deep divisions among China's senior leaders over the extent and pace of market-oriented reforms. In late August, for example, Beijing announced a temporary freeze on previously decontrolled prices and tighter restrictions on how state enterprises can use their retained earnings. But, at the same time, party journals and reform leaders have touted the gains from reforms and affirmed that the implementation of new measures will be accelerated after the Congress. [redacted]

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To be sure, China's uneven economic performance in the first half of 1987 has given ammunition to both the reform and conservative camps. Spurred by a 20-percent surge in investment spending, for example, industrial output has increased at a 15-percent annual rate. But the Chinese press has noted that product quality is poor and inventories of unsalable goods are growing. Competition for raw materials for industry, and growing demand for consumer goods, have outstripped supplies, pushing prices up by an 8-percent annual rate in June--high by China's standards. [redacted]

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Economic performance in the countryside has, to some degree, bolstered reformers' arguments, because the output of nonstaples and rural industries have increased rapidly this year. But production of grain--a politically critical staple--has stagnated, and will fall far short of its 3.5-percent growth target, according to a senior Chinese economist. News on the foreign trade front is equally mixed, for Beijing has continued last year's effort to trim the foreign trade deficit, slashing it by almost 70 percent in the first half of 1987. But although central government holdings of foreign exchange increased modestly to more than \$3 billion by midyear 1987, they remain well below the \$12 billion level Beijing recorded several years ago. [redacted]

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To complicate matters, increased investment and wage payments are contributing to the declining profitability of state enterprises, and therefore to budget worries. Chinese statistics show enterprise losses rising at about a 25-percent annual rate, and more than one-fifth of state-owned industrial enterprises have recorded deficits this year. China's central bank has tried to rein in enterprise spending by raising interest rates, but the move has not deterred borrowing because enterprise managers are convinced the state will bail them out if they cannot repay the loans. [redacted]

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The Conservative Critique

Conservatives have cited China's inflation, excessive investment, budget deficits, and foreign exchange shortfalls to criticize reformers for economic mismanagement. They argue that market-oriented reforms, which have reduced the scope of administrative controls and mandatory planning, are the cause of the economic dislocations. They are probably particularly alarmed by State Statistical Bureau figures showing that China's inflation rate has increased each month since April. Conservatives

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may argue that social stability is jeopardized because the living standards of as many as one-fifth of urban workers have fallen this year because their wage gains have not kept pace with inflation. [REDACTED]

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Conservatives are correct in believing that by relaxing central controls Beijing has increased inflationary pressures. Since the early 1980s, Beijing has broadened enterprise autonomy--particularly by allowing state factories to retain a larger share of their revenues and permitting them to sell overquota production of industrial goods at "negotiated," above plan, prices. However, it has not implemented effective measures to make enterprise managers accountable if funds are used inefficiently. [REDACTED]

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A source of **Asiaweek**, a Hong Kong-based news magazine, reported in mid-July that the conservatives' strategy approaching the party congress would be to take advantage of any economic problems or public disturbances to press for endorsement of sharply limited reforms in the Congress policy document and for acceptance of their own personnel choices. Judging from past responses to economic problems, we believe conservatives want the Congress to strengthen central control of economic decision making and increase attention to mandatory plans. Conservatives would also like to lessen enterprise discretion over investment; lower monetary growth; tighten control over prices, land use, and trade; and emphasize hard work. They support efforts to increase enterprise efficiency, hence the Congress policy document may endorse wider implementation of enterprise performance contracts with supervisory bureaus. [REDACTED]

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The Reformers' Lament

Proponents of market-oriented reforms have overridden the practical and ideological objections of conservatives by arguing that monetary and fiscal policies can guide the economy when central controls are relaxed, and by insisting that reforms be judged by their ability to produce results, rather than by their conformity to dogma. Consequently, reform leaders have been vulnerable to conservative criticism when the economy performed poorly. It is thus no coincidence that in recent weeks reformers have orchestrated an intense media barrage to deflect attention from the conservatives' critiques, recounting improvements in the standard of living, economic growth, product variety, and other successes since the introduction of reforms eight years ago. [REDACTED]

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While conservatives argue that the economy's problems derive from the fast pace of reform, reformers believe that dislocations result--in part--from piecemeal implementation of reforms. For example, reformers argue that Beijing should substitute the threat of bankruptcy for the certainty of state subsidies, to motivate enterprise managers to control investment spending and wage increases. To reformers, more policy flexibility is the appropriate response, not greater central control. [REDACTED]

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The Clampdown on Prices

According to Hong Kong journals and diplomatic reports, since the early 1980s China's top leaders have feared the sort of public uprising that occurred in Poland when food price hikes contributed to the growth of the Solidarity trade union movement. With the release of the economic performance statistics for the first half of the year and the ensuing debates about policy, senior leaders decided to implement an across-the-board freeze on prices and to tighten restrictions on investment spending. Chinese press reports indicated that the price freeze was in response to widespread consumer complaints about rising prices, particularly of food:

- In late August, Beijing ordered prices of consumer goods, including foodstuffs, frozen for the remainder of the year. To accomplish this, it authorized local governments to set price ceilings on farm produce sold at village markets and on overquota production of industrial goods--thus retreating on recent policies that allowed sales at negotiated prices.
- Beijing announced that only capital construction projects already approved by the central government may be started in the second half of this year. And if locally funded investment spending exceeds the targets set earlier this year, the excess will be deducted from next year's target and responsible officials will be disciplined.
- Enterprise managers were ordered to keep wage increases from exceeding the growth of industrial productivity.

To ensure compliance, Beijing announced that its annual nationwide inspection of prices and finances will begin early this year.

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Reformers worry that, having exhausted the easy immediate gains from reform policies in the late 1970s and early 1980s, mounting economic problems could erode popular support for reform and slow its momentum. As a result, reform leaders are constantly on the alert for opportunities to press for further gains and avoid economic stagnation. We believe they would like to implement a series of related market-oriented policies which are especially contentious within the leadership:

- Reformers would like a **bankruptcy** mechanism to establish market accountability for state enterprises.
- Reformers argue that the state should **lease or sell small state enterprises**, particularly those sustaining losses, to individuals. This not only would ease the government's subsidy burden but would make the factories more responsive to market forces. Moreover, they view the expansion of private enterprises as a means of absorbing surplus labor.
- Reform leaders call for **further commercialization of agriculture**. Recent articles in the Chinese press argue that, to boost grain production, Beijing should hike procurement prices and continue to reduce the amount of grain peasants must sell under contract to state supply units.

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Looking Ahead to the Congress

Because the mixed performance of the economy this year has awarded no clear vindication to either the conservative or the reformist camp, we doubt that either side will score a clear-cut victory on this issue at the Congress. If anything, we believe conservatives have reached a modus vivendi with reformers that amounts to the lowest common denominator of acceptable policies, focusing reform on improving enterprise efficiency and deferring the hard choices--such as price reform--until after the Congress. Recent public statements by conservative leaders seem carefully crafted to appear supportive of reform--for example, by espousing reform of the planning system--while stressing that priority should be given to restoring economic stability.

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Thus despite this year's economic problems, the Congress's policy document will probably approve the general direction of economic reforms and affirm that market forces can play a key role in driving China's modernization program. A senior Chinese official told US Embassy Beijing that the document will lay the ideological basis for far-reaching future reforms.

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We believe, however, that, because of the sharp split among senior officials over economic policy, the document will not provide a detailed account of how Beijing plans to proceed with reforms. The Congress probably will couch its endorsement of reform in rhetoric that reaffirms China's long-term commitment to socialism, thereby watering down its endorsement of market mechanisms. Approval of the Congress document therefore will not reduce contention over economic policy. In fact, by treat the symptoms--excessive investment spending and price hikes--rather than attacking the disease--lack of market accountability--reformers probably have prolonged the period until Beijing will have adequate monetary and fiscal tools to moderate the strong demand pressures generated by relaxed central controls.

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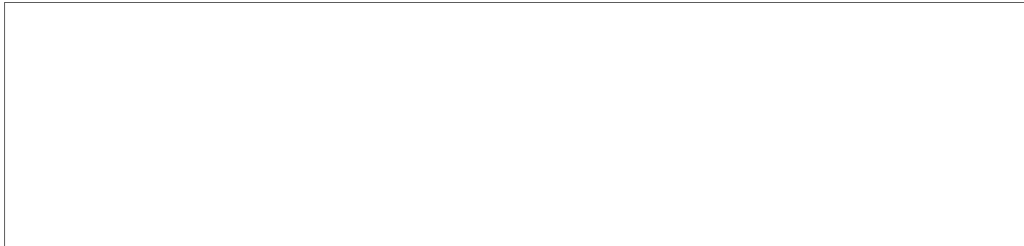
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