Directorate of Intelligence

China: Economic Performance in 1987 and Outlook for 1988

EA 88-10018
May 1988

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China: Economic Performance in 1987 and Outlook for 1988

This paper was prepared by the Central Intelligence Agency for submission to the Subcommittee on National Security Economics of the Joint Economic Committee, Congress of the United States.

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China: Economic Performance in 1987 and Outlook for 1988

Summary

Information available as of 21 April 1988 was used in this report.

Two economic problems most concerned China's leaders last year—excessive inflation and lagging grain output:

- China's official inflation rate was 7 percent in 1987—an improvement over the 9-percent rate of 1985, but higher than any other year in the last decade. Urban consumers were especially hard hit. Food prices rose at double-digit rates. Inflation rates of over 20 percent were reported in several major cities. Indeed, Beijing has acknowledged that the real incomes of one-fifth of China's urban dwellers declined.

- Grain production did not meet Beijing's admittedly ambitious target level of 405 million metric tons, though China produced more than 400 million tons—a feat accomplished only once before. Strong consumer demand for grain-based foods—bread, meat, and beer—and moderate international grain prices led China to more than double its grain imports, becoming a net grain importer after two years as a net exporter. To dampen demand and inflationary pressures, Beijing resumed the practice of issuing ration tickets for pork, eggs, and sugar in several major cities.

Inflation and lagging grain output have led Beijing to avoid economic policies that run the risk of worsening, rather than improving, price stability and grain production. Tighter central controls over prices, bank credit, and out-of-plan investment, plus increased state spending on agricultural infrastructure projects—proven ways of reducing upward pressure on prices and stimulating agricultural output—form the core of Beijing's approach to these problems this year.

The economy turned in a solid performance in other areas. Urban industrial output rose nearly 15 percent, profits and taxes remitted to the state increased nearly 10 percent, and labor productivity was up about 8 percent in 1987. Chinese leaders generally credited the implementation of a contract system in industry—under which enterprises sign performance agreements with their supervisory bureaus specifying minimum output, earnings, and taxes—for the improved industrial performance. By last December, three-fourths of China's larger state enterprises had signed such contracts, and a majority of collective enterprises had adopted a parallel contract/leasing system. The contract system will remain in place for the near term, and some Chinese leaders would like to see it become a permanent feature of industrial policy. To introduce even greater fiscal accountability and managerial autonomy to enterprises, China adopted a

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new state enterprise law in March 1988 that spells out the responsibilities of factory managers and factory-level party officials, and Beijing may also implement bankruptcy regulations enacted in late 1986 before the end of this year.

The contract system also forms the basis for reforms of China's foreign trade sector, which also performed well in 1987. China's trade deficit declined by 70 percent, from $12 billion in 1986 to only $3.7 billion. Foreign direct investment picked up after a disappointing 1986, and China's foreign exchange reserves jumped more than 50 percent, to $15 billion. The particularly strong record has permitted the leadership to consider adopting more fundamental reforms in the management of foreign trade than it is likely to risk in agriculture or pricing industrial output. Virtually all of China's leaders have endorsed the strategy of export-led development in China's coastal areas enunciated by party Secretary Zhao Ziyang last January. Beijing also has placed many local branches of national trading corporations under provincial or municipal jurisdiction, increasing their autonomy from Beijing. To encourage individual factories to step up exports, Beijing has increased the portion of foreign exchange they may retain from exports. Beijing has even begun to allow Chinese enterprises to exchange surplus foreign exchange for domestic currency at premium rates in officially sanctioned swap centers, another inducement to export. As in industry, these changes are designed to make individual factories and corporations more responsive to market conditions.

China's economy will probably turn in another mixed performance in 1988. There are preliminary indications that droughts may decrease grain yields, limiting the near-term benefits of price and investment increases. In contrast, Chinese statistics for the first quarter of the year indicate that growth in industrial output may surpass last year's level. Primarily because of continued strong growth in exports, moreover, China's first quarter 1988 trade deficit was 40 percent below the level of a year earlier. Imports will probably pick up, however, as Beijing eases controls over purchases of materials, components, and equipment for use in export-processing ventures in China's coastal areas.

Beijing's chief problem in 1988 may be managing inflation. China's retail price index reached double digits in the first quarter of 1988—twice the level of first quarter 1987—and Chinese officials acknowledge they will have a difficult time keeping inflation below 10 percent for the year, even if it tapers off in the second half as planned. Sharp increases in industrial output will strain already tight supplies of energy and raw materials. Inflation, moreover, will also be fueled by workers' demands for increased bonuses after a year of belt-tightening.

Crucial but politically sensitive price reforms will proceed slowly over the near term in order to minimize economic dislocations among consumers. This year, Beijing will incrementally increase state-set prices for grain in order to stimulate production. But efforts to erode differentials between in-plan and market prices for raw materials and other industrial inputs will be slowed until Beijing reduces inflationary pressures.

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Economic Performance in 1987

China's real GNP rose 9.4 percent in 1987, up from a 7.8-percent increase in 1986, but below the double-digit growth rates of 1984 and 1985. After particularly rapid growth during the first half of the year, Beijing tightened credit in order to rein in investment, which had seriously strained industrial supplies and exerted upward pressure on prices. Fixed asset investment nonetheless increased 17 percent in 1987, with the strongest gains coming from collectives and private individuals. State investment in raw materials, energy, light industry, and factory renovation projects also grew fairly rapidly.

China's retail price index rose 7.3 percent during the year, according to official Chinese statistics, and some cities recorded double-digit inflation rates. Food price increases—up more than 10 percent—were responsible for most of the rise in the price index, roughly half of which is based on food. In real terms, accordingly, urban per capita income increased only 1.7 percent, and one-fifth of China's urban households experienced a decline in their real incomes. Inflation also eroded gains in rural per capita income, which showed a 5.3-percent increase in real terms.

The Rural Economy

Gross agricultural output rose 4.7 percent in real terms last year, up from 3.4 percent in 1986, largely because of a strong performance in cash crop production. Grain production reached 402 million metric tons, up 3 percent from 1986, but still below the record harvest of 407 million metric tons in 1984 (see figure 1). After two years of being a net grain exporter, China last year resumed its status as a net importer of grain, purchasing approximately 16 million metric tons—primarily from Canada, Australia, and the United States (see figure 2).

China's lagging grain production is in part a reflection of the success of reforms in the rural sector. For example, after achieving double-digit growth rates in the early 1980s through a combination of favorable weather, increased financial incentives for peasants, and implementation of household-based farming, Beijing loosened central controls over peasants in 1985, allowing them to produce the crops of their choice after fulfilling contractual obligations to the state for grain production. At the same time, Beijing relaxed state controls over the prices of nonstaple foodstuffs such as vegetables, fruit, and meat. Free market prices for cash crops soared, while the state dropped grain prices to avoid another grain surplus the size of that in 1984. Cash crop production consequently began to draw an increasing share of China's farmland, and as a result, cash crop output gains have far outpaced increases in grain production. Low feed-grain prices also encouraged peasants to raise livestock. However, the ensuing jump in meat production in 1985 and 1986 reduced the profitability of producing livestock and led to last year's return to rationing of pork (see table 1).

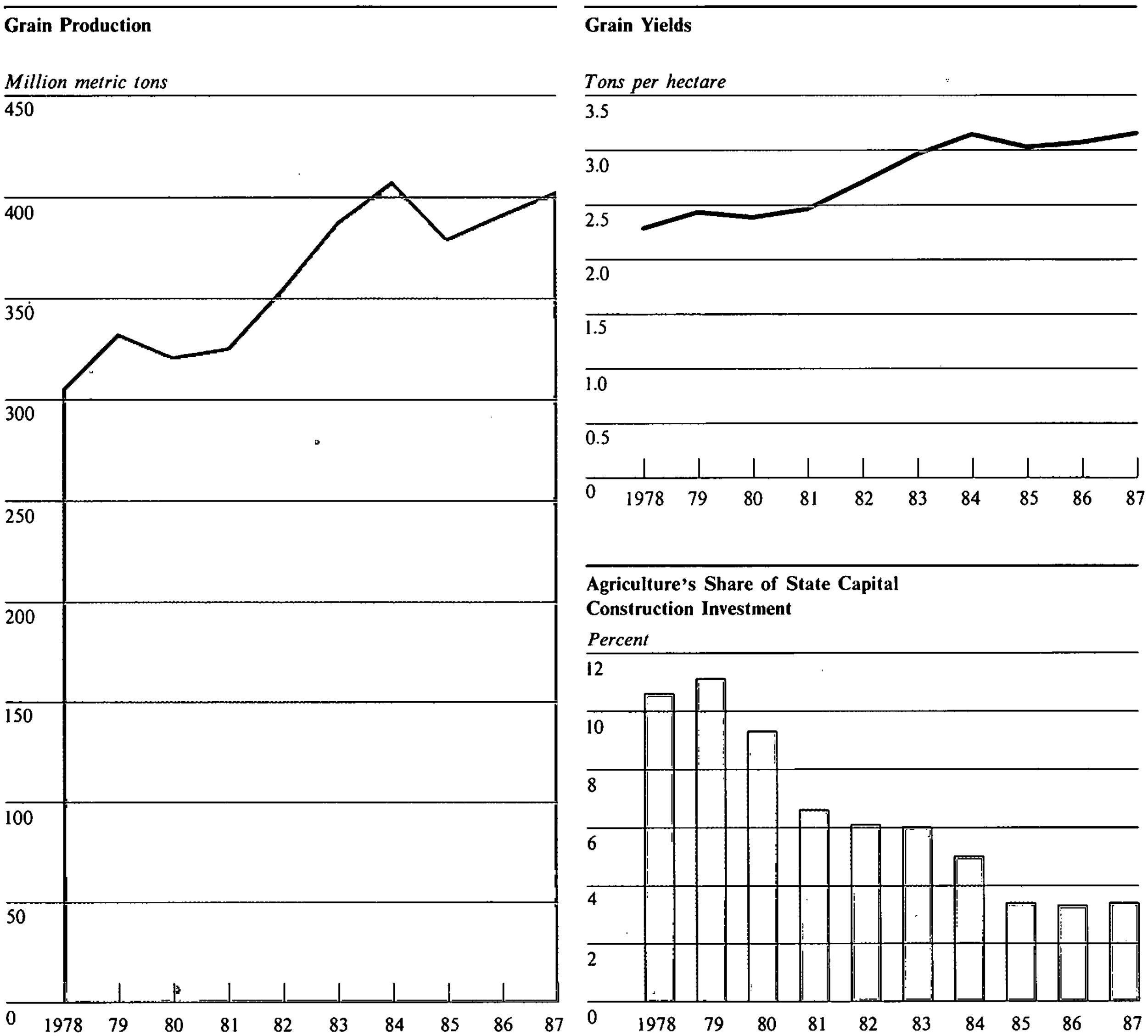
Table 1
Chinese Output of Major Agricultural Crops, 1987

	Million Metric Tons	Percent of Change From 1986
Grain	402.4	+2.8
Cotton	4.2	+18.4
Oil-bearing crops	15.3	+8.1
Sugarcane	46.9	−6.7
Fruit	15.5	+15.1
Pork	17.8	−0.9
Beef and mutton	0.2	+16.9
Aquatic products	9.4	+14.1

Source: China's State Statistical Bureau.

State investment in agricultural infrastructure has continued to decline both in real terms and as a share of total capital construction expenditures, and neither local government agencies nor peasants have taken up

Figure 1
China: Trends in Agriculture, 1978-87



Source: Official Chinese statistics and US Department of Agriculture.

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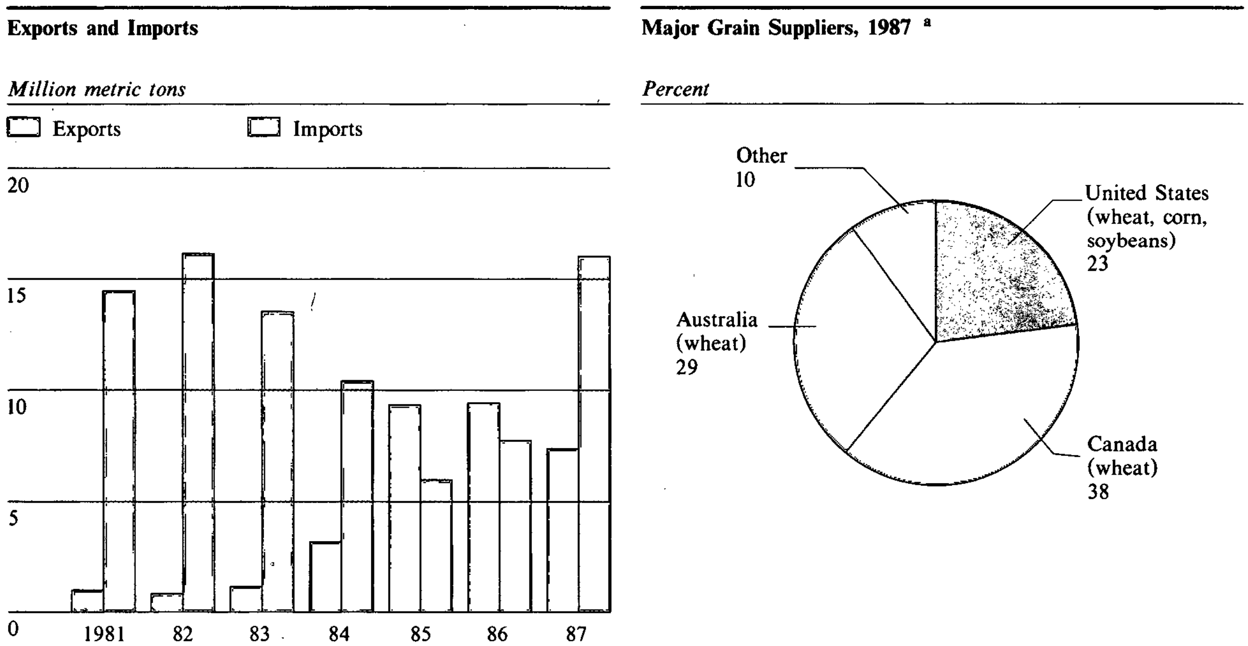
Figure 2
China: Grain Trade, 1981-87



[a] Calculated by volume of exports.

Source: Chinese Customs statistics and partner country trade statistics as reported to the United Nations.

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the slack. Beijing has permitted local officials to exercise greater autonomy in deciding how to allocate state investment funds in rural areas—and rural officials often have chosen to develop profitable rural industries on farmland rather than to make investments in agricultural infrastructure projects. Meanwhile, peasants have invested their savings in housing or consumer goods, fearing that changes in Beijing's agricultural policies might deprive them of benefits from infrastructural investments. Thus, total farmland has decreased and improvements needed in rural infrastructure have been lacking.

Tight grain supplies in 1987 were also the result of a continuing rise in consumer demand, as rapidly rising incomes raised purchases of a variety of foodstuffs requiring grain inputs. Strong demand for bread, beer, cooking oil, meat, and eggs has strained supplies of high-quality grains, oilseeds, and feedgrains. To dampen demand and minimize inflationary pressures, Beijing has resumed the practice of issuing ration tickets for such food products as eggs and sugar in several major cities.

In contrast to grain, China's rural industrial output posted strong growth in 1987. Indeed, rural industry and commerce are among the most dynamic segments of the Chinese economy, and now employ about 15 percent of China's labor force—more than 85 million

Table 2
China: Major Trade Partners, 1987

	Billion US $	Percent
Imports		
Total	**43.2**	**100**
Japan	10.1	23
Hong Kong	8.6	20
United States	4.8	11
West Germany	3.1	7
Soviet Union	1.3	3

	Billion US $	Percent
Exports		
Total	**39.5**	**100**
Hong Kong	14.2	36
Japan	6.4	16
United States	3.0	8
West Germany	1.2	3
Soviet Union	1.2	3

Source: Chinese Customs statistics.

people. Rural industrial output grew by 36 percent in 1987 in real terms, and rural industries earned $5 billion from exports—about 15 percent of China's total export earnings.

Industrial Performance

China's urban industrial output grew 15 percent in 1987 in real terms (see figure 3). Growth was especially rapid in the private and collective sectors, and the output of foreign-invested enterprises nearly doubled during the year—although it remains a very small portion of China's total industrial output. Production of consumer goods, farm machinery, motor vehicles, and chemical fertilizers and pesticides grew at double-digit rates.

China's output of electricity grew at a recordsetting pace—roughly 10 percent—but nonetheless failed to match the growth in industrial output. Power shortages continued to idle roughly one-fifth of China's industrial capacity. In contrast to healthy growth in electricity output, China's production of coal and oil rose only 3 percent.[1]

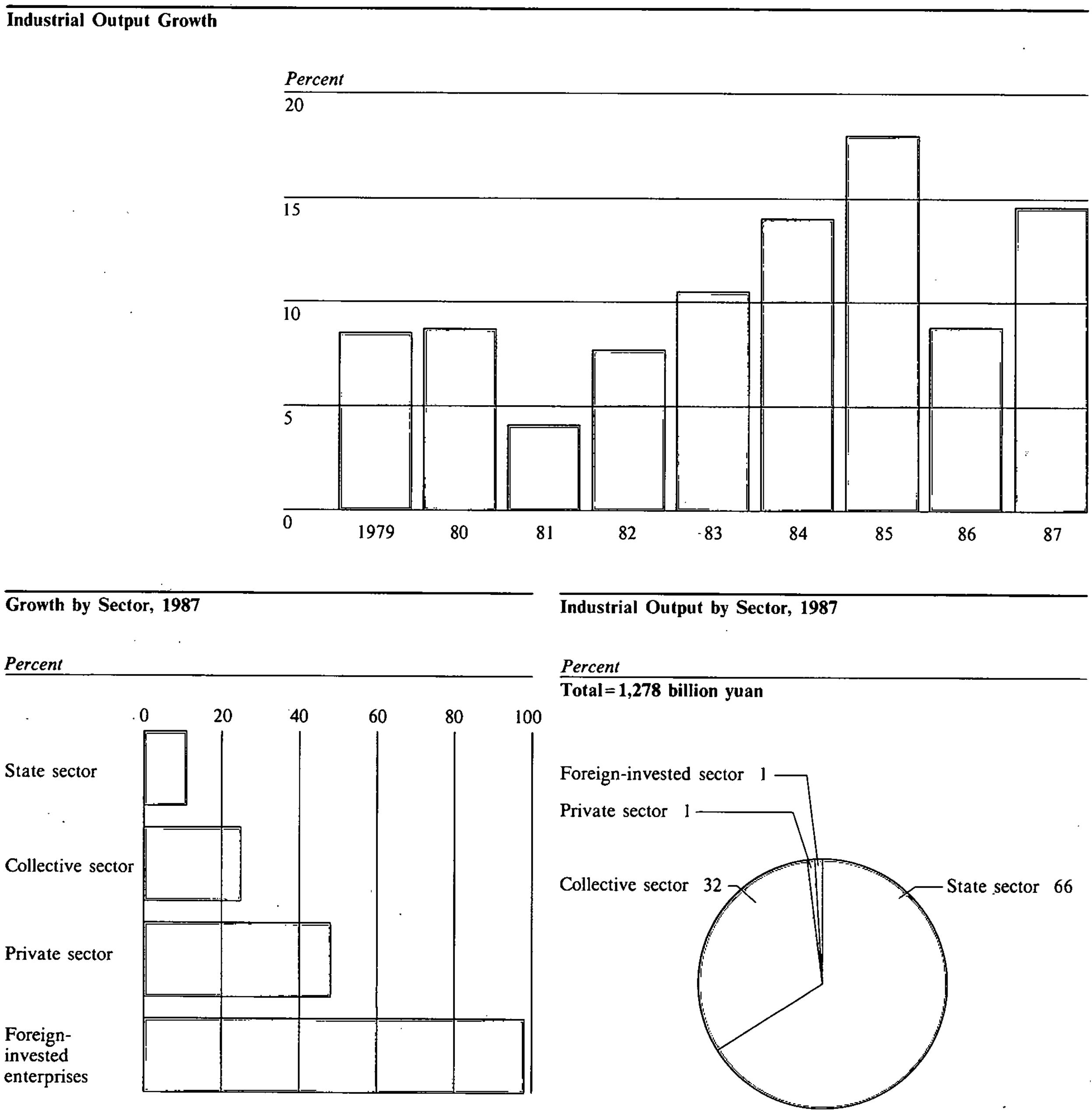
Chinese statistics indicate that state enterprises improved their operating efficiency in 1987. Profits rose 6 percent and labor productivity increased by nearly 8 percent. But one-eighth of China's state enterprises continued to lose money, and the size of those losses was larger last year than in 1986. By and large, factory managers have faulted rising input prices for their losses. Beijing last year deliberately increased state procurement prices for industrial crops such as cotton in order to stimulate production; at the same time, Beijing has encouraged the development of a raw materials market in which producers and users of such goods as steel, cement, and lumber buy and sell industrial inputs at free market—and substantially higher than state-set—prices. Last year, for example, for the first time a majority of China's rolled steel was distributed outside of the state plan.

International Trade and Investment

Concerned about the level of foreign exchange reserves resulting from two years of substantial trade deficits and lackluster foreign direct investment inflows, Beijing tightened controls over imports and foreign exchange expenditures last year. At the same time, Beijing stepped up efforts to boost the country's export earnings. As a result, China's trade deficit shrank from $12 billion in 1986 to only $3.7 billion in 1987, according to Chinese Customs statistics (see table 2 and figure 4). With a net gain of $3.4 billion in earnings from tourism and other services, Beijing's current account was nearly in balance. Accordingly, official foreign exchange reserves grew from $9.9 billion in January to $15.2 billion in December 1987, sufficient to cover more than four months' imports.

[1] China is the world's second-largest producer of coal, after the United States, and fourth-largest producer of crude oil, following the Soviet Union, the United States, and Saudi Arabia.

Figure 3
Trends in Chinese Industry, 1979-87



[a] In state-sector enterprises.
Source: China's State Statistical Bureau.

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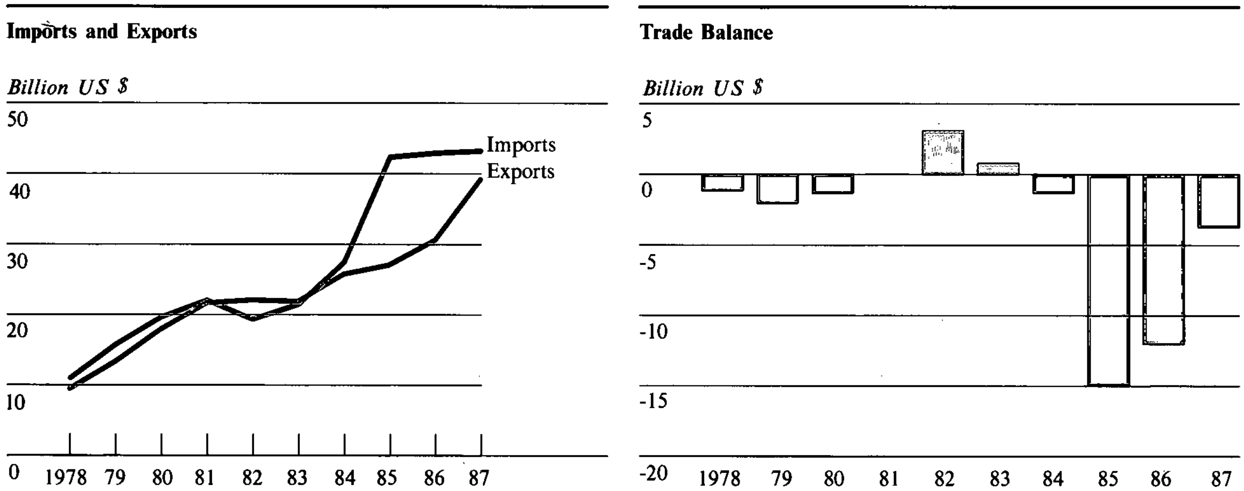
Figure 4
China: Imports, Exports, and Trade Balance, 1978-87

Note scale change



Source: Chinese Customs statistics.

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Hong Kong displaced Japan as China's top trading partner as Beijing curbed its purchases from Japan to reduce the large bilateral trade imbalance, diversify sources of supply, and find lower cost suppliers less affected by currency appreciation. Hong Kong also drew a larger share of China's exports, many of which the territory subsequently reexported to the United States and other destinations—including Taiwan and South Korea. The United States, West Germany, and the Soviet Union followed Hong Kong and Japan as China's major trade partners.

China's imports remained stagnant for the second year in a row as a result of tighter procedures for allocating foreign exchange and closer monitoring of purchases to avoid duplication and encourage import substitution when possible. Purchases centered on industrial machinery not available domestically, equipment and raw materials to be used in export processing, and agricultural inputs such as fertilizer and pesticides. Reflecting Beijing's concerns about lagging grain output, imports of grains increased by more than 60 percent in value terms, totaling $1.6 billion. Reduced international grain prices also contributed to the surge in grain imports; Beijing took advantage of prices driven down by subsidies from the European Community and by the US Export Enhancement Program to complement domestic output (see table 3).

On the export side, China's 1987 performance demonstrates the success of Beijing's efforts to promote rapid growth by:

- Providing priority domestic investment funds to export-producing projects.
- Allowing export-producing Chinese factories to retain a share of their foreign exchange earnings.
- Providing state subsidies to cover the losses of exporters selling goods at world prices that are below China's costs of production.

- Devaluing the Chinese currency relative to most major world currencies.[2]
- Giving foreign investors special tax and other incentives for participation in factories producing for foreign markets.

China's export earnings grew by more than one-fourth last year—to nearly $40 billion. Export earnings from industrial and manufactured goods increased from 63 percent of the total in 1986 to 66 percent. China's most striking export gains have come in textiles and apparel shipments—which last year accounted for about one-fourth of China's total exports. According to Chinese press reports, China is the world's largest silk producer and exporter—with its raw silk exports accounting for 90 percent of global sales volume, and silk fabric exports making up 40 percent of the world market. China also has become the world's second-largest supplier of raw cotton by volume, after the United States. Raw cotton exports earned Beijing nearly $750 million last year, a 50-percent jump over 1986.

Beijing recognizes that foreign managerial and technical expertise has contributed significantly to China's ability to boost exports. Export earnings by foreign-invested enterprises doubled in 1987 to $1 billion. According to China's Ministry of Foreign Economic Relations and Trade, China has signed contracts for more than 10,000 foreign-funded enterprises, 4,300 of which are now in operation. China's paid-in foreign investment reached $8.5 billion by the end of last year, showing a $1.9 billion increase in 1987—probably reflecting both investors' more favorable view of China's investment climate in the wake of new legislation adopted in late 1986 and appreciation of the Japanese yen and other currencies that have encouraged investment in regions with lower labor costs. But the apparent improvement in China's ability to draw foreign investment also reflects the depressed level of investment in 1986 as Beijing curbed inflows of foreign funds to nonproductive activities such as hotels.[3]

[2] Beijing has not devalued the Chinese yuan against the US dollar—to which it is unofficially pegged—since mid-1986. As the dollar has fallen, however, the value of the yuan has effectively declined relative to many other currencies.

[3] For further information in China's changing foreign investment picture, see appendix B.

Table 3
China: Major Import and Export Commodities, 1987 [a]

	Billion US $	Percent
Imports		
Specialized machinery	4.8	11
Iron and steel	4.8	11
Cereals and cereal preparations	1.6	4
General industrial machinery	1.5	3
Electrical machinery and apparatus	1.4	3
Telecommunications equipment	1.3	3
Fertilizers	1.2	3
Road vehicles	1.1	3
Plastics	0.8	2
Textile fibers	0.8	2
Exports		
Textile yarn, fabric	5.3	13
Petroleum	3.7	9
Clothing, apparel	3.5	9
Textile fibers	1.5	4
Miscellaneous manufactured articles	1.2	3
Oilseeds	0.8	2

[a] Projected. Based on data available through September 1987.

Source: Chinese Customs statistics.

US-China Trade. China's exports to the United States rose by one-third last year, according to US Commerce Department statistics, reflecting the success of China's overall export push. US sales to China increased by 12 percent—recovering from a slump in 1986—but remained below the record level of 1985. Accordingly, the US deficit widened to $3.4 billion, 60 percent higher than in 1986.

Paralleling trends in China's overall exports, light industrial goods are becoming an ever larger share of China's sales to the United States. Exports of sporting goods, toys, travel goods, handbags, footwear, and tape recorders have grown especially rapidly. Textiles and apparel last year accounted for 40 percent of

Table 4
Selected US Imports From China, 1987

	Million US $	Percent
Total	**6,287.3**	**100**
Clothing	1,987.5	32
Miscellaneous manufactured articles, including toys and sporting goods	1,170.6	19
Textile yarn, fabrics	521.3	8
Petroleum	476.8	8
Travel goods, handbags	294.5	5
Telecommunications and recording equipment	239.6	4
Electrical machinery	146.3	2
Metal manufactures	140.7	2
Footwear	139.3	2

Source: US Department of Commerce. Imports valued free alongside ship.

Table 5
Selected US Exports to China, 1987

	Million US $	Percent
Total	**3,488.6**	**100**
Aircraft and parts, railway stock	500.8	14
Fertilizers, manufactured	270.0	8
Plastic materials	254.6	7
Specialized machinery	234.6	7
Cereals	234.1	7
Office machines, ADP equipment	189.3	5
General industrial machinery	177.4	5
Scientific instruments	169.0	5
Wood, lumber, cork	167.4	5
Organic chemicals	149.9	4

Source: US Department of Commerce. Exports valued free on board.

China's exports to the United States (see table 4). In value terms, according to US Commerce Department statistics, China ranked as the United States' second-largest supplier of textile yarns and fabrics and as its fourth-largest supplier of clothing. The United States, in turn, was China's largest market for clothing, and third-largest purchaser of yarns and fabric, after Hong Kong and Japan, according to Chinese Customs statistics. Despite the signing of a four-year bilateral textile accord last December that limits increases in the volume of China's exports in specified categories to 3.3 percent annually, the value of China's textile exports to the United States will probably continue to increase as Chinese apparel producers continue their move into higher quality and higher priced articles.

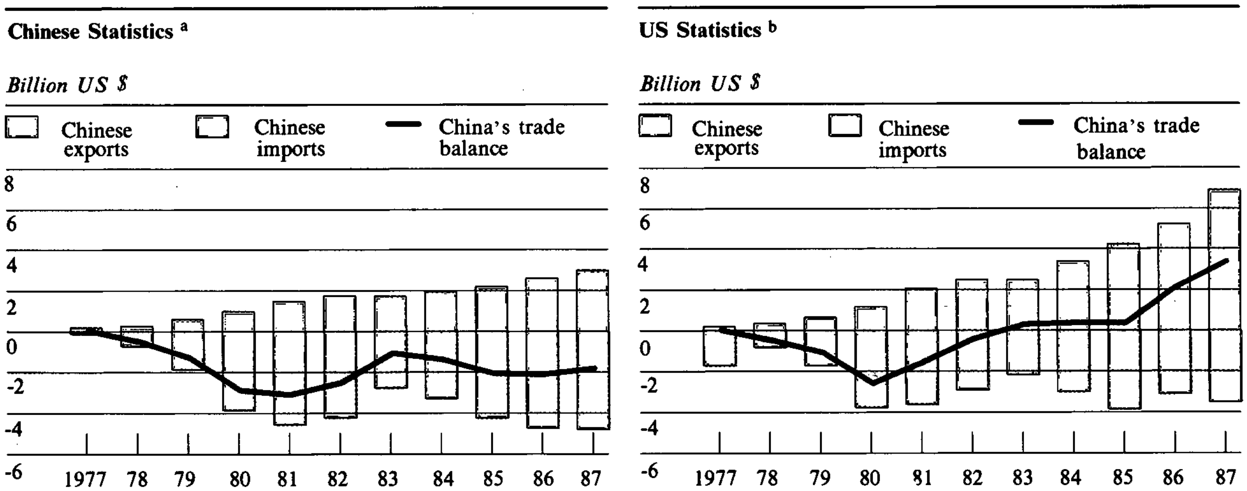
Regarding US exports to China, the most rapid gains have occurred in agricultural commodities. China's purchases of US grains jumped more than twentyfold in 1987, while its imports of fertilizers, organic chemicals, edible oils, live animals, and oilseeds more than doubled. Machinery and transport equipment accounted for more than 40 percent of US sales to China in 1987, as the United States continued to benefit from China's strong demand for capital equipment for upgrading factories and aircraft for upgrading the civil air transportation network (see table 5). High-technology equipment (computers, aerospace equipment, telecommunications gear, scientific instruments, machine tools, and microelectronics devices) accounted for roughly one-third of China's purchases from the United States, as it has for the last three years. By the same token, the United States continued to supply about one-third of China's imports of high-technology goods, a share of the market that has remained strong for the last five years (see tables 6-8).

Sino-Soviet Trade. Sino-Soviet trade dipped in 1987 to $2.5 billion, after reaching $2.6 billion in 1986. A number of factors contributed to the modest decline:

- Tight domestic grain supplies constrained Beijing's ability to meet export commitments.

- Chinese dissatisfaction with the quality and technical level of Soviet industrial equipment postponed many of the 24 industrial cooperation projects slated to take place under the five-year accord signed in July 1985.

Figure 5
China: Trade With the United States, 1977-87



[a] Source: Chinese Customs statistics.
[b] Source: US Commerce Department.

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Statistical Discrepancies

China's Customs statistics differ considerably from those recorded by the US Commerce Department. China calculates it had a $1.8 billion deficit with the United States last year, rather than a $3.4 billion surplus. A major reason for the discrepancy is that the United States tallies all goods shipped to and from China, regardless of whether they are shipped directly or through third parties such as Hong Kong; China only includes direct shipments. In addition, the practice of including insurance and freight costs in the value of imports from the other partner accounts for about $1 billion of the $5.2 billion gap in trade statistics. The discrepancy between Chinese and US trade statistics has grown in recent years because China is shipping a larger share of its exports to the United States via Hong Kong.

- Trade reform and decentralization in both countries have made it more difficult for Beijing and Moscow to ensure that individual factories and trade corporations adhere to trade commitments made at the central level.

Other factors will doubtless continue to constrain Sino-Soviet trade even if the countries iron out some of the specific problems that arose last year. For example, barter trade is by nature a cumbersome arrangement, with trade officials required to meet annually to negotiate the types and values of goods to be traded. Moreover, China and the Soviet Union both generally prefer to export their better goods to the West for hard currency instead of to each other, leading to reciprocal complaints about the dumping of inferior goods. Bilateral trade should therefore remain a small percentage of each country's total trade and

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Table 6
Known Chinese Imports of High-Technology Equipment, 1979-86 [a]

Million US $

	1979	1980	1981	1982	1983	1984	1985	1986
Total	**867**	**930**	**674**	**581**	**1,103**	**1,422**	**3,336**	**3,561**
Australia	1	1	1	1	2	3	7	11
Austria	2	25	10	0	1	1	10	18
Belgium/Luxembourg	3	2	2	3	1	6	28	73
Canada	4	3	7	4	6	11	34	54
Denmark	8	6	5	6	11	16	17	20
Finland	1	2	1	0	1	1	5	14
France	26	44	34	40	32	41	238	192
Hong Kong	5	11	11	17	33	114	199	108
Ireland	0	0	0	0	0	0	1	3
Italy	6	11	11	6	10	23	70	121
Japan	139	204	310	176	279	467	887	1,040
Netherlands	11	10	10	4	4	7	13	24
New Zealand	0	1	0	0	0	0	0	0
Norway	0	4	1	1	4	6	7	7
Singapore	0	2	2	4	7	16	22	24
Spain	0	0	0	0	0	1	5	5
Sweden	15	11	10	7	16	20	47	59
Switzerland	48	32	40	76	48	47	86	126
Thailand	0	0	0	0	1	1	1	0
United Kingdom	152	129	70	55	53	76	113	139
United States	91	257	105	145	514	471	1,332	1,085
West Germany	354	175	43	36	79	96	214	438

[a] High-technology equipment includes advanced computers, telecommunications equipment, aerospace equipment, scientific instrumentation, machine tools, and microelectrics devices. We have defined the category based on five-digit commodity categories according to the United Nations' Standard International Trade Classification (Revision 2) to exclude items for which research and development expenditures constitute a small share of final product cost, such as calculators, telephones, and simple machine tools. Data are based on sales reported to the United Nations by China's trade partners. Several of China's trade partners—including Soviet Bloc countries and South Korea—do not report trade with China to the United Nations.

Table 7
High-Technology Equipment Share of US Exports to China, 1979-86

	Percent
1979	5
1980	7
1981	3
1982	5
1983	24
1984	16
1985	35
1986	35

Table 8
US Share of China's Known Imports of High-Technology Equipment, 1979-86

	Percent
1979	10
1980	28
1981	16
1982	25
1983	47
1984	33
1985	40
1986	30

will be dwarfed by their trade with the United States and other Western partners. The Soviet Union is China's fifth-largest trade partner, accounting for about 3 percent of China's total trade, according to Chinese Customs statistics.

Government Budget and Spending Priorities

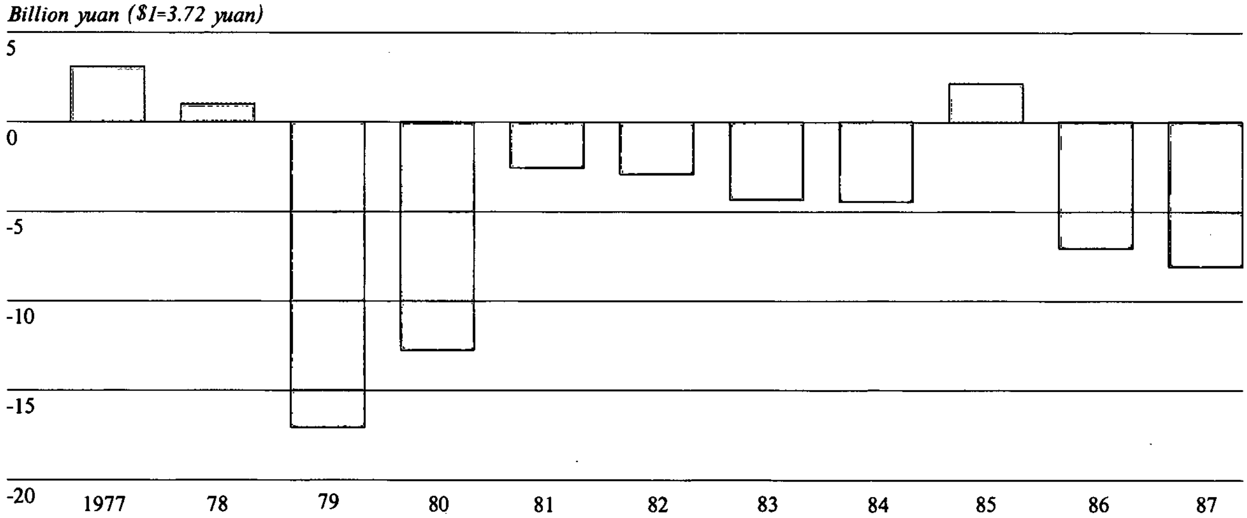
China's budget deficit widened in 1987 to $2.2 billion (8 billion yuan), equivalent to 3 percent of state revenue and about 1 percent of GNP [4] (see figure 6). This increase was not unexpected. Increased state investment expenditures accounted for some of the drain, as Beijing targeted priority construction projects in energy, raw materials, and light industry. But higher state subsidies to cover the losses of money-losing enterprises and state trading corporations exporting goods priced higher in China than in foreign markets, as well as payments to urban consumers to soften the impact of higher food prices, accounted for a growing share of the budget. Subsidy payments exceeded one-fourth of state expenditures.

[4] Using Western accounting procedures, China's budget deficit was probably twice the level reported, equivalent to 7 percent of government revenue and 2 percent of GNP. China records receipts from domestic bond sales and central government borrowing from foreign sources as state revenues. China's net domestic bond issues in 1987 were equivalent to $1.1 billion (4 billion yuan), and its net foreign borrowing to cover state expenditures was equivalent to $1.4 billion (5.1 billion yuan).

Beijing expects the budget to remain in the red for several more years, and is projecting another $2.2 billion shortfall for 1988, despite an anticipated $500 million (2 billion yuan) gain in tax revenues and a planned 50-percent increase in treasury bond issues. According to the Finance Minister, food subsidies will rise by 22 percent, and state investment in agriculture will jump 15 percent. Earlier this year, China's State Council instructed government offices and state-funded institutions to reduce spending by 20 percent in 1988 and banned purchases of a variety of items.

The streamlining of government ministries and commissions announced at the National People's Congress (NPC) in March is also expected to cut costs. Beginning in June, China will create a new State Economic Planning Commission by merging two existing commissions, and replace 12 other industrial ministries and bureaus with nine new ministries and four state-operated corporations. The net result is an expected reduction in State Council personnel from approximately 50,000 to 40,000. In addition to the fiscal benefits expected from the reshuffling, China's leaders expect it to reduce government interference in enterprise management and to transform ministries into more efficient government organs.

Figure 6
China: Budget Surpluses and Deficits, 1977-87



Source: Official Chinese statistics.

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Defense Spending. China releases statistics on national defense spending as a line item in the annual state budget, but provides neither a definition of the categories of expenditure included in the figure nor a breakdown of the total. Our own estimates of Chinese defense expenditures cover spending for investment (primarily weapon procurement); operating expenses (including maintenance and personnel costs); and research, development, testing and evaluation (RDT&E). Using a building-block approach for valuing the costs of these various components, we estimate that China's total defense expenditures for 1986 were roughly 45 billion yuan, more than twice that of the announced budget of 20 billion yuan. Using current exchange rates, this is about $12 billion. We believe the defense budget increased modestly in 1987.

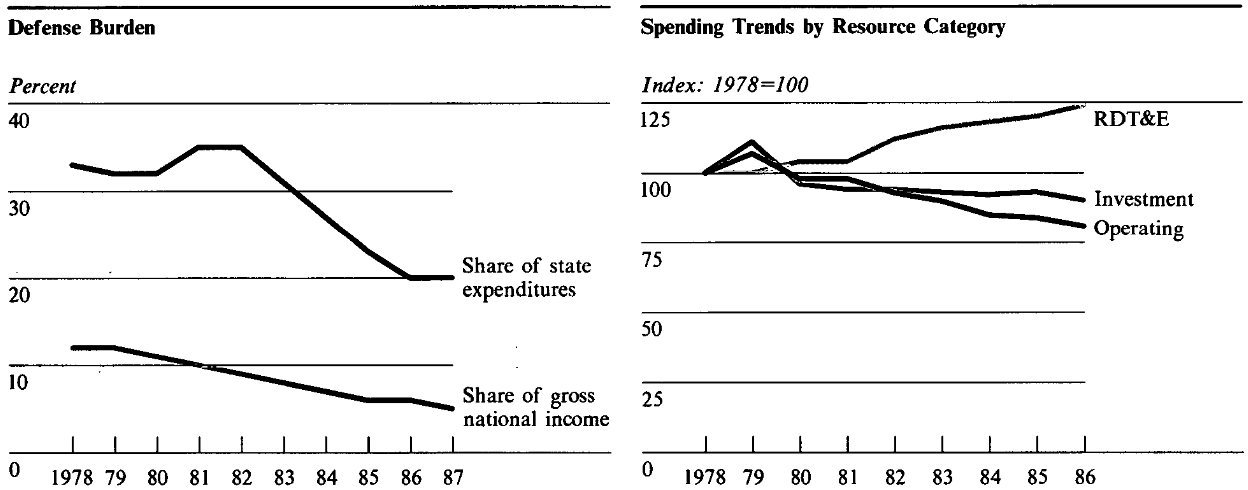
Despite the difference in absolute values, China's announced figures and the CIA estimates both show declining trends in the defense sector's share of China's budget as well as in the size of the defense budget relative to gross national income [5] (GNI). CIA estimates indicate that defense expenditures accounted for about one-third of China's total budget in 1978, and only one-fifth of the budget in 1987. Moreover, we estimate China's defense spending dropped from 12 percent of gross national income in 1978 to only 5 percent in 1987—somewhat less than the 7 percent for the United States, and significantly less than the 20 to 25 percent for the Soviet Union (see figure 7).

China has cut military spending by slashing personnel costs and postponing the procurement of most major weapon systems. Beijing has reduced its armed forces by about 3 million men since 1977, with most of the

[5] China began to publish gross national product (GNP) figures in 1985, but has provided gross national income (GNI) statistics for the entire 1949-87 period. In recent years, GNI has been roughly equal to 80 percent of GNP.

Declassified and Approved For Release 2013/01/08 : CIA-RDP11S00229R000301520001-8

Figure 7
Estimated Chinese Defense Expenditures, 1978-87



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cuts coming from its ground forces. We believe China's military operating budget—nearly half of which goes for salaries—has declined by about one-fifth during the last eight years. Beijing intends to complete the force reduction by the end of this year, but we believe that it may take several more years before demobilized men find civilian jobs and are moved from military posts. Expenditures on weapon procurement also declined about 10 percent between 1978 and 1986 because Beijing has elected to postpone major weapon purchases until more technologically advanced systems become available. In contrast, we estimate that RDT&E expenditures have increased about 25 percent since 1978, although this category continues to account for only about one-eighth of China's defense expenditures.

Economic Policy in 1988

Beijing has announced a modest reform agenda for this year that postpones crucial but politically sensitive price reform pending reductions in the inflation rate, increases in grain output, and improvements in enterprise efficiency. Premier Li Peng announced in mid-February—and reaffirmed in his report to the National People's Congress in March—that China's top economic priorities in 1988 would be controlling inflation and improving agricultural output.

Controlling Investment and Inflation

Complementing a freeze imposed on state-controlled prices of consumer goods and public utility fees last fall, in January Beijing announced tighter state controls on prices of key raw materials—including goods

The 13th Party Congress

The 13th Party Congress of October-November 1987 was a crucial test of strength for China's reform leaders. In the aftermath of the ouster of Party Secretary Hu Yaobang in January 1987, reform-minded Chinese officials sought to install younger, more pragmatic leaders in positions of authority, defuse ideological questions about the reform program, and obtain an endorsement for a wider role for market forces in the Chinese economy. Those goals were generally achieved:

- *Zhao Ziyang was confirmed as Party Secretary, and joined by four new appointees on the Politburo Standing Committee—the most powerful body in the party. These represented a balance between market-oriented reformers aligned with Zhao and officials who, like Premier Li Peng, favor a greater role for the central government in managing the economy. New appointees to the Politburo and the Central Committee also gave these bodies a more reformist cast. And former Party Secretary Hu Yaobang remained on the Politburo, a rebuff to reform opponents who forced his ouster as General Secretary.*

- *The Congress endorsed an ideological justification for a wide range of reform proposals contained in Zhao Ziyang's work report to the Congress. The "initial stage of socialism" theory provides for a century of experimentation with economic reforms—including private ownership, and the leasing of land and enterprises—as long as the "publicly owned" sector of the economy is predominant.*

- *Zhao's work report endorsed greater use of markets for distributing raw materials, capital, technology, and labor. The report also indicated that central ministries should focus primarily on making overall industrial policy, leaving the implementation to lower-level entities responding to economic levers. Zhao also previewed some of the foreign trade reforms planned for 1988 as a result of impressive trade performance in 1987.*

Reformers' gains were not unqualified, however. Decisionmaking by consensus continues to involve a wide spectrum of opinion about the pace and scope of reform, and a number of influential Chinese leaders remain more comfortable with an economy predominantly controlled by administrative fiat, rather than by market forces. Moreover, reformers face significant practical problems in implementing many policies in the face of high inflation, growing state budget deficits, and large out-of-plan capital investments.

produced in excess of state quotas and previously sold at market prices. In addition, Beijing plans to limit growth in the money supply by tightening controls over bank lending, and by requiring successful state enterprises to fund planned expansion by issuing bonds rather than drawing on bank loans, which carry a lower interest rate. The state is also reducing its investment in capital construction. Finally, Beijing is trying to trim personal consumption. Leaders hope that enterprise reforms will slow growth in worker wages and bonuses, thereby curbing demand. Meanwhile, Beijing expects that rent increases resulting from a reduction in state housing subsidies will soak up some of the excess funds now available to consumers.

Managing Agriculture

In the agricultural sector, Beijing is undertaking several major initiatives designed to stimulate grain production:

- Raising purchase prices for grain produced and sold under state contracts. Beijing intends over time to phase out the current dual-track agricultural pricing system either by reducing the share of grain procured under contracts and increasing free market transactions, raising the prices the state pays for contract grain, or instituting price differentials based on quality with the aim of eventually selling high-quality grain at free market prices.

- Increasing state investment in fertilizer and pesticide production, in transportation and distribution networks, and in agricultural infrastructure projects such as irrigation. Beijing is concentrating rural loans as well as state investment on grain production. Beijing may also invest tax revenues collected from nonfarm rural land use in agriculture.

- Allowing peasants to purchase and transfer land-use rights, which would permit more efficient, larger scale operations. Beijing also recently lengthened the leasing period for rural land from 15 to 30 years. These measures are designed to give farmers a greater stake in the land's upkeep.

- Encouraging peasants to use better seed strains and more tractors and other agricultural machinery in production. Beijing has introduced several state-sponsored S&T initiatives in the last few years that are designed to improve productivity by providing training and funds to rural areas.

Beijing is sensitive to the inflationary impact that substantial increases in grain purchase prices could induce and is searching for ways to minimize costs that must be borne by urban consumers. At the same time, Beijing recognizes that it cannot continue to increase subsidy payments, which are already a substantial drain on the state budget. A variety of possibilities are under consideration and will likely be the subject of continued debate in 1988.

Improving Enterprise Profitability

In the industrial sector, Chinese officials have said that the "contract system"—under which state enterprises sign performance contracts with supervisory bureaus specifying minimum output, earnings, and taxes—will form the basis for improvements in enterprise management and efficiency in 1988. China's leaders acknowledge that enterprises must become more efficient before they can absorb increases in input prices that would result from price reform and believe they must be put on a sound financial footing before they can cope with a hardening of the budget constraint.

Three-fourths of China's large- and medium-sized state industrial enterprises and commercial entities had adopted the contract system by the end of 1987, according to Chinese statistics. In addition, a majority of China's smaller state and collective enterprises had adopted a parallel contract/leasing system that allows factory managers to retain a share of aftertax profits and requires them to put up collateral to cover potential losses.

Chinese leaders believe the contract system has improved labor productivity and increased profits. In addition, they maintain that the contract system has helped Beijing improve control over unwarranted enterprise investment spending, although China's practice of permitting enterprises to deduct loan principal repayments from taxable income still tends to encourage excessive credit demand. Proponents of the contract system also contend that contracts have relieved some of the pressure on managers to issue blanket bonuses to workers, keeping real wage increases in 1987 below the rate of improvement in labor productivity (see figure 8).

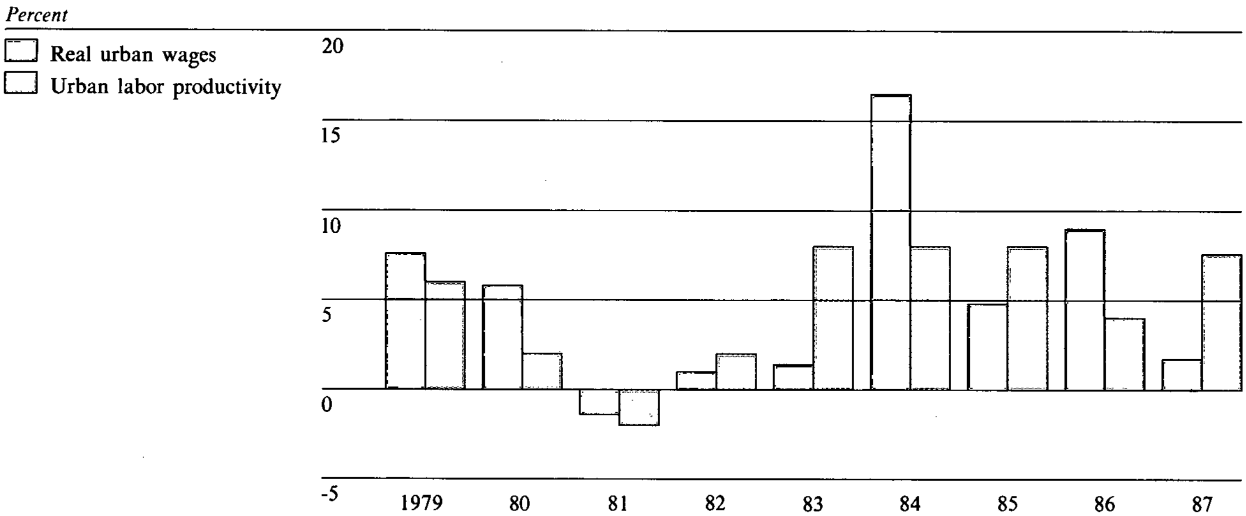
Chinese critics argue that the prospects for continued gains under the contract system in 1988 and beyond are less bright, however. For example, many of the one-year contracts were signed in the second half of 1987, thus large worker bonuses for fulfillment of annual contract targets will not be paid until the second half of this year. This, in turn, could exacerbate Beijing's difficulties controlling inflation while also cutting into enterprise profitability.

Critics have found fault with several more fundamental shortcomings as well:

- Contracts do not make good managers out of bad ones, and China's 1987 statistics suggest that, while the number of unprofitable enterprises is not increasing, poorly run enterprises are losing ever larger amounts of money.

- The system rewards managers for negotiating low targets that can be easily achieved, rather than for necessarily improving production efficiency.

Figure 8
Real Growth in Urban Wages and Productivity, 1979-87[a]



[a] In state-sector enterprises.
Source: China's State Statistical Bureau.

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- The ability of the contract system to encourage greater managerial accountability is limited by Beijing's requirement that large state enterprises employ surplus workers and produce specified goods, regardless of profitability or market demand.

- Rising prices for industrial inputs—and a freeze on the prices most enterprises can charge for their final products—means that some factory managers have legitimate excuses for low profitability or even deficits.

- Finally, contracts—which generally carry a one- to five-year term—tend to discourage investments in new technology and capital equipment, which have substantial long-term benefits but little immediate payoff.

Still others point to the stultifying effect of the contract system on China's reform program as a whole, especially on needed changes to the wage and price system. Because last year's strong industrial performance can be traced—at least in part—to the implementation of the contract system, advocates of other industrial and price reforms will face an uphill battle in any attempts to introduce changes to the current tax or price structure that would significantly affect the performance of enterprises that have signed performance contracts.

Chinese leaders expect a new *enterprise law* approved during the National People's Congress to further improve enterprise performance by curbing the meddling by party officials in factory operations and by paving the way for the institution of bankruptcy proceedings against faltering state enterprises. The state enterprise law is one of several recent changes in industrial policy designed to professionalize enterprise management and to hold enterprises and managers responsible for deficits. But, like the contract system, ambiguities remain. Moreover, almost every responsibility spelled out for managers and enterprises in the legislation is subject to other plans and regulations. For example, although the law allows enterprises to set prices for their finished goods, they are still subject to extensive price controls imposed by Beijing. Moreover, the law is vague about the powers of factory party committees, assigning them responsibility for implementing "all party and state policies." Finally, the law does not reduce the authority of government administrative bureaus to set mandatory production targets for factories and to manage supply and distribution of most industrial inputs.

Passage of the enterprise law provides the legal framework for Beijing to institute *bankruptcy proceedings* against unprofitable state enterprises under the provisions of a trial bankruptcy law passed by the NPC Standing Committee in December 1986. But managers will resist moves to institute bankruptcy proceedings, arguing that they cannot be held accountable for deficits resulting from an irrational price structure, raw material shortages, and bloated work forces. Beijing will probably close only a few enterprises at first and will find new jobs for displaced workers in order to minimize workers' fears that enterprise reforms are a threat to their job stability.

Reforming the Foreign Trade System

Following the 13th Party Congress, Chinese leaders announced plans to undertake a major reform of the country's trade system—originally planned for 1987 but derailed by both political uncertainties and the tight foreign exchange situation at the start of 1987. In recent months, trade reform has been reaffirmed in several major policy statements:

- The State Council approved a Draft Plan for Reform of the Foreign Trade Sector in December 1987 that calls for individual factories and trading corporations to have greater autonomy in conducting import and export transactions and to become more responsible for their profits and losses.

- In January 1988, after making several trips to China's coastal provinces, Zhao Ziyang pronounced that the country should undertake an export-driven economic growth strategy centered on attracting foreign investment and expertise to coastal areas. The strategy focuses on using imported raw materials and parts to produce higher value-added labor-intensive industrial goods for export. Acknowledging the crucial role of foreign managerial and technical expertise in developing China's export industries, Zhao's plan calls for further improvements to China's investment climate.

- Beijing sponsored three high-level meetings in February and March of this year to discuss foreign trade reforms, China's environment for foreign investors, and the coastal development strategy. Leaders discussed reform experiments planned for Guangdong and Fujian Provinces, as well as for Hainan Island—China's newest province and special economic zone.

- Premier Li Peng's March work report to the National People's Congress listed trade reform and the coastal development strategy among China's priorities for 1988.

Two factors account for the attention Chinese policymakers are giving to foreign trade this year. Chinese leaders have said they believe recent changes in the world economy occurring as a result of the appreciation of the currencies of Japan, South Korea, and

China's Private Sector

During the 1988 National People's Congress, China's constitution was amended to provide a legal basis for China's growing private sector. Chinese statistics indicate that the country's private sector now includes up to 300,000 enterprises and an additional 20 million "individual enterprises." Most of these are one-person or family-run operations, although a few employ several hundred people, according to Chinese press reports. Although the private sector generally leads the country in growth in productivity and output, it employs less than 3 percent of China's industrial labor force and produces less than 1 percent of the country's industrial output. The private sector is more prominent in retail trade, however, handling nearly one-fourth of all retail sales in 1987.

Taiwan present China with an historic opportunity to make inroads in Western markets with Chinese export goods priced low relative to similar products from other Asian countries. Second, China's strong trade performance in 1987 and buoyant foreign reserves have given this sector more room for experimenting with reforms.

China has not yet approved a final plan for reforming the foreign trade sector. From the numerous statements by Chinese leaders on the topic, however, we believe the reforms will include:

- *Decentralization.* Provinces and municipalities will assume control over local branches of national trade corporations and sign contracts with them—similar to those now used throughout China's industrial sector—assigning levels of exports and foreign exchange earnings. More individual factories will be allowed to handle trade transactions. China's Ministry of Foreign Economic Relations and Trade (MOFERT) and central foreign trade corporations will continue to provide overall policy guidance, handle most of China's barter trade with the Soviet Union and Eastern Europe, approve large-ticket purchases, and monitor foreign sales of items China must restrict because of either domestic supply shortages or foreign import restrictions.

- *Raising Foreign Exchange Retention Rates.* Corporations exceeding their contract targets for foreign exchange earnings will be allowed to keep a larger share of the surplus. Beijing has also begun to allow exporters of light industrial goods, arts and crafts, and garments to keep a higher percentage of their foreign exchange earnings than most other enterprises. The foreign exchange retention rate also varies from province to province, and as part of China's experimentation with economic reforms in Guangdong, Fujian, and Hainan, these areas have been given higher rates than the norm.

- *Easing Currency Controls.* As an outgrowth of the new policies on foreign exchange retention, Beijing has announced that Chinese entities with excess foreign currency will be allowed to swap foreign funds for Chinese currency at premium exchange rates in swap centers to be set up in many large Chinese cities. This is an extension of a practice Beijing has permitted for more than a year for foreign-invested enterprises in China and for state-sector Chinese enterprises operating in the special economic zones. While easing central control over the exchange of Chinese currency for foreign exchange, Beijing is also preparing to loosen controls over arbitrage between convertible foreign currencies. China's State Administration for Exchange Control, in March of this year, authorized financial institutions to handle the buying and selling of convertible foreign currencies on behalf of Chinese enterprises. This will allow enterprises that earn foreign exchange in one currency to import goods purchased with another currency. Chinese factories also will be able to avoid losses in the value of their primarily dollar-denominated foreign exchange holdings if the dollar continues to decline.

Other changes are also contemplated. For example, Beijing may adjust the domestic tax system to favor exporters of high-value-added products. Some Chinese leaders have also proposed that wages of workers in enterprises producing for export be linked to foreign exchange earnings. Finally, there has been much discussion of a plan to make trading corporations into commissioned agents that handle import and export transactions for a simple service fee. This approach would be designed to make enterprises—rather than subsidized trade corporations—shoulder the financial burden of their imports and reap the benefits accruing from successful export programs.

The impact of these reforms will probably be limited as long as wide discrepancies exist between China's domestic prices and those prevailing in the international marketplace. Although trade corporations and factories will be asked to take responsibility for profits and losses, many will point to factors beyond their control as being responsible for deficits. As a result, decentralization of trade authority may merely transfer responsibility for subsidizing enterprise losses from the central government to a lower level, rather than eliminating the practice. In addition, even though some factories and corporations will be allowed to have foreign exchange accounts, Beijing will retain control over most of the country's foreign currency reserves, as well as the use of retained foreign exchange for imports subject to license approval by the central government. Members of the General Agreement on Tariffs and Trade (GATT), to which China is applying for membership, will be watching the progress of China's foreign trade reforms closely to determine whether the changes bring China's foreign trade system more in line with GATT principles.

Outlook for Price Reform

Chinese leaders apparently have not reached a consensus on how and when to make further changes in China's irrational price structure, although most now probably accept the need for prices to accurately reflect relative scarcities in the economy. Without price reform, China's attempts to make enterprises more responsive to market signals—and to hold them accountable for poor investment, production, and personnel decisions via the initiation of bankruptcy proceedings—will fall short. Firms that are well run and turn out needed products may operate at a loss simply because production costs exceed their product prices. Similarly, Beijing probably recognizes that the problems in China's agriculture sector cannot be resolved without an increase in the price paid to farmers to encourage production of needed agricultural commodities as well as an increase in the state-controlled prices paid by consumers for nonessential foodstuffs for which Beijing wants to curb demand.

But considerable uncertainty remains over precisely how to accomplish needed price adjustments without disrupting the economy, provoking complaints among consumers, or substantially increasing the state's subsidy burden. Chinese leaders apparently are willing to proceed slowly in order to minimize dislocations. Rather than simply freeing all prices and having current economic conditions determine their equilibrium level, Beijing is working to erode the differentials between in-plan and market prices for a variety of commodities—including grain and raw materials—while also boosting production of items in short supply by gradually reducing the share of such items procured under state plans and by increasing the share sold at market prices.

Appendix A

Evaluating Beijing's Reforms

China is approaching the 10th anniversary of the watershed Third Plenum of the 11th Party Congress (December 1978), which marked the emergence of Deng Xiaoping as preeminent leader and the adoption of Beijing's economic reform policies. The core of China's reforms is pragmatism. Beijing has scrapped Maoist-period theories of "class struggle" and the pursuit of modernization through political mass mobilization in favor of rational development strategies, including decentralization of economic decision making authority, greater use of material incentives, and increased economic contact with the West. Many of the reforms are not new to China, but had been tried or were at least discussed in the mid-1950s and the early 1960s. But the period since 1978 is the first time that these policies have been implemented without interruptions such as the Cultural Revolution of the mid-1960s.

Changes came first and have progressed furthest in the countryside. Only isolated remnants remain of the Maoist commune system under which local party officials exercised almost absolute control over rural production decisions and peasants' daily lives. Farming is now conducted by individual households, which lease land from the state under long-term contracts. Apart from having to supply some grain to the state according to procurement agreements worked out at the local level, peasants have wide latitude to decide whether to grow grain or cash crops and livestock. Millions of peasants have left farming in the past few years to work in rural industries and transport or commercial enterprises. Nevertheless, the government still retains an important role in the rural economy. For instance, peasants still depend on state supply units to market some of their excess grain and to supply farm inputs, including machinery and fertilizer.

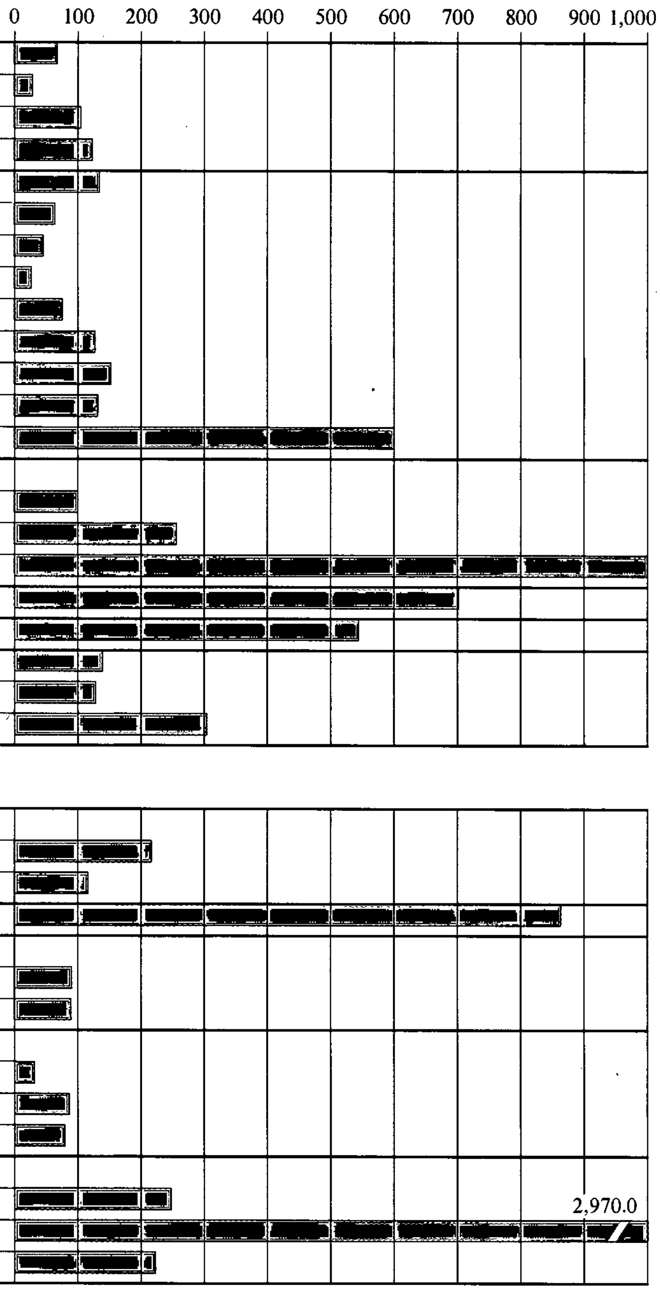
Significant changes in the leadership and operations of urban state enterprises have also been implemented in the past nine years. Beijing has replaced many factory directors with younger and better educated managers. Moreover, Beijing has increased the amount of revenues that factories can retain and has allowed managers greater discretion to use those revenues for capital construction or worker wages. Because factories are allowed to sell at market prices any production exceeding the quotas assigned in the central plan, output of key industrial materials, such as coal and steel, have increased rapidly. Thus many enterprises now purchase at least some output at prices well above those set by Beijing for in-plan production. However, upper-level economic bureaucracies and factory party officials still maintain close ties to and supervisory control over most state enterprises. And political and economic restraints limit managers' decisionmaking authority. For instance, managers have the right to fire workers, but choose to maintain bloated work forces rather than face the wrath of displaced workers. To diminish resistance to layoffs, reformers have argued that China should construct a social safety net that would supplant the welfare functions that state enterprises now assume, but Beijing has not made much progress in implementing one.

That Chinese workers on the whole have benefited from reform is indisputable. Rapid gains in standards of living are evident in the countryside, where a housing boom is under way, and in Chinese cities, where an improvement in the quality and style of clothing is readily apparent. Increases in agricultural and industrial output have caused an improvement in workers' diets and an increase in per capita ownership of durable goods such as bicycles and refrigerators. However, despite these signs of improvement, urban residents complain about housing shortages, pollution, and inadequate services such as an overcrowded transportation system. Moreover, the real income of some urban residents has fallen in recent years, and both urban and rural per capita income remains low by

Figure 9
China: Selected Economic Indicators

Percent change over eight-year period

Macroeconomic Indicators	1978	1986
GVAO [a] (billion yuan)	180.1	301.0
Grain (million tons)	304.8	391.0
Fruit (million tons)	6.6	13.5
Pork/beef/mutton (million tons)	8.6	19.2
GVIO [b] (billion yuan)	439.9	1,031.0
Raw steel (million tons)	31.8	52.2
Coal (million tons)	618.0	894.0
Crude oil (million tons)	104.1	130.7
Electricity (billion kWh)	256.6	449.5
Chemical industry (billion yuan)	47.7	108.5
Textile industry (billion yuan)	52.2	131.7
Machine-building industry (billion yuan)	101.8	235.1
Village-run industry (billion yuan)	18.3	128.1
GVIO [b] (by ownership)		
State (billion yuan)	356.0	711.0
Collective (billion yuan)	84.0	299.0
Private and individual (billion yuan)	Less than 1.0	10.0
Imports (billion US $)	11.0	88.0
Exports (billion US $)	10.0	64.0
Graduates of higher education	164,581.0	392,800.0
Engineers	1,571,200.0	3,581,200.0
Scientific researchers	90,500.0	365,800.0
Standard of Living Indicators		
Per capita income		
Peasants (yuan)	134.0	424.0
Urban workers (yuan)	614.0	1,329.0
Per capita savings (yuan)	21.9	211.0
Per capita living space		
Urban (square meter)	4.2	8.0
Rural (square meter)	8.1	15.3
Per capita food consumption		
Grain (kilogram)	195.5	255.9
Pork (kilogram)	7.7	14.3
Sugar (kilogram)	3.4	6.1
Ownership of consumer goods		
Bicycles (million)	74.3	258.0
Televisions (million)	3.0	92.1
Sewing machines (million)	34.0	109.4



[a] Gross Value of Agricultural Output.
[b] Gross Value of Industrial Output.

All figures in 1980 constant prices. GVAO and GVIO calculated according to new coverage, with village-run industry included under GVIO. Per capita peasant income and per capita urban and rural living space figures based on sample surveys.

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world standards. Finally, media discussion of an enterprise bankruptcy law and policies that would increase labor mobility have probably increased workers' concerns that new reforms will decrease job security.

Deng Xiaoping and other key reformers maintain that the gains from reform far outweigh the negative spillovers and argue that the shortcomings can be corrected only through implementing additional policies. Even so, the reform program has been buffeted by both political controversies and unforeseen economic developments. To track the progress of reforms to date, it may be useful to divide the program into three periods.

Phase One: Agricultural Success 1978-84

From 1978 to 1984, implementation of rural policies dominated the domestic reform program. The period began with limited experiments with the "household responsibility system," under which individual farm households took control of fields, making planting decisions and working the land with little interference from outside authorities. These experiments began in Sichuan Province under the leadership of Zhao Ziyang, and in Anhui Province under Wan Li. By the end of the period, this system had displaced the production team approach—the last vestige of the collective system established in the middle and late 1950s—throughout most of the country. Along with increased state prices for farm produce, greatly expanded free market outlets, and good weather, the reforms produced a string of bumper harvests culminating in the record 1984 crop. Indeed, China became a net grain exporter in 1985.

Most other domestic reforms—including those in industrial management, finance, and science and technology—have their roots in this period as well. Chongqing city in Sichuan, for example, was an early test site for experiments granting greater autonomy to factories. And selected research institutes began to sign contracts with factories as enterprises attempted to improve production and efficiency by applying new technology, and as researchers sought to make science serve the economy as a whole. But the scope of these nonagricultural reforms remained relatively limited through the early 1980s.

Domestic reforms during this period were accompanied by a more open economic policy toward other countries and regions. Beijing, in particular, sought to attract Western investment and technology to Chinese industry. To persuade potential investors of its enduring commitment to open up to the outside world, Beijing passed a law on joint ventures in 1979 and began a massive technology import program that centered on purchases of complete plants and equipment from Japan, the United States, and Western Europe. By 1980, Beijing had also established four Special Economic Zones in South China to entice foreign investors by offering favorable tax rates and investment terms. Beijing intended for these zones to be "windows" where China could study foreign manufacturing technology and management, while keeping the negative side effects of capitalism out of China proper. The zones also had a political objective—to demonstrate Chinese tolerance of non-Communist economic forms as part of efforts to woo Hong Kong and Taiwan by Deng's "one-country, two-systems" approach.

Phase Two: Urban Reform 1984-87

Building on the success of rural reforms and having rebuffed a challenge during late 1983 by party members who believed that Western "spiritual pollution" threatened China's social fabric, reform leaders in late 1984 moved to apply market-oriented policies to the urban industrial sector. Zhao Ziyang's work report to the National People's Congress in May 1984 and Hu Yaobang's speech to the Party Plenum in October 1984 both marked this phase and stand as high water marks for reform optimism.

Despite this optimism, the period following Hu's speech brought reformers unexpected economic difficulties and sobering choices. To begin with, grain output fell in 1985 after four years of strong growth, initiating a period of lagging production and triggering debate over agricultural policies that continues.

Furthermore, reformers misjudged their ability to maintain macroeconomic control once urban reforms began. Beginning in late 1984, a surge in wage and bonus payments and imports contributed to economic overheating in 1985, forcing Beijing to rein in credit, slow price reforms, and recentralize control over foreign trade in the face of mounting inflationary pressure and a precipitous decline in China's trade balance.

Reform policies suffered another blow in early 1985 when criticism of the Special Economic Zones—especially Shenzhen—surfaced. Despite massive infrastructure buildup at Beijing's expense, the zones had failed to attract manufacturing investment, becoming centers of real estate and currency speculation instead. They were also a breeding ground for independent "briefcase" trading companies that engaged in profitable—but unproductive—import and export transactions. Shenzhen, in particular, became a conduit for imports of high-demand consumer goods and microcomputers entering China at reduced tariffs; independent traders also made money by exporting and then reimporting Chinese goods and collecting state subsidies on both transactions to cover the difference between domestic and international prices. A major car import scandal in South China that broke in early summer 1985 added fuel to the charges of corruption and mismanagement. China had invested too much political and economic capital in developing the zones to abandon them, but the developments of 1985 temporarily tarnished the reputations of the zones and of the local leaders.

Reforms in this period had their successes. Beijing boosted exports of textiles and other manufactured goods to make up for lost oil export earnings. The booming rural enterprise sector made progress in absorbing surplus farm labor. And overall economic growth continued at an impressive pace. But performance in key areas—particularly China's state-owned industrial sector—was disappointing. If anything, initial urban reforms worsened performance in some state factories, raising costs and making managers more concerned about worker welfare than about production efficiency. Critics also found fault with China's massive technology imports after discovering that shortages of qualified technical personnel, resource and energy constraints, inadequate incentives for factory managers, and poor technology choices idled much of China's expensive foreign equipment.

This period was also marked by an increasingly open debate over appropriate reform strategy. Deng helped maintain the appearance of leadership unanimity by carefully positioning himself between those who favored bolder initiatives and those who favored a slower pace and narrower scope for reform. But public disturbances, including student demonstrations in late 1986, reinforced the fears of some leaders that reforms were proceeding too quickly and might even undermine the authority of the party.

Party chief Hu Yaobang's fall in January 1987 was precipitated by complex political forces, but, in the process, reformers lost one of the most vocal and powerful supporters of faster political liberalization and of greater reliance on consumer-driven economic development. Although the orthodox-oriented "anti-bourgeois liberalization" campaign that followed Hu's fall was brought to a close within a few months, high inflation and lagging grain output during the year narrowed the range of policy options open to China's economic leaders in the near term, and thus limited the scope of policy debates.

Phase Three: Stressing Stability 1987-Present

The current situation in China is a mixed bag for reform proponents. "Reform" remains the political watchword, Zhao Ziyang—a key reform leader—has replaced Hu Yaobang as party chief, other young reformers have taken their place on the Politburo, and some party officials who voiced strong skepticism about the reform program have been soundly rebuffed. Indeed, it is no longer possible to speak simply of "reform leaders;" all Chinese leaders are now reformers in the sense that they are economic pragmatists who favor some degree of expanded scope for market forces in China's economy.

At the same time, however, strains in the economy have led Chinese leaders to postpone some important aspects of the reform program—including price reforms—and have led leaders to use administrative controls to rein in inflation and maintain control over imports. One indication of the increased caution that marks this period is the lengthening time frame for reform—reform leaders and economists now speak of decades to achieve basic reform goals. This trend toward a longer time horizon may in fact be a more realistic assessment of the changes China must go through as it moves toward a more market-oriented economy.

Another characteristic of the current period is the loss of a clear goal as well as the proper path to be followed, in contrast to 10 years ago when simply implementing pragmatic policies constituted a reform agenda. One assessment of the current state of reforms is that China now risks stalling out half way on the road to a market economy. Such an assessment can be read between the lines when some economists point to China's current half-reformed, half-planned state, or even in Zhao's statement that a "pause" in reforms could turn into a retreat. Other Chinese deny that the goal of reform is a market economy, asserting instead that it has been to create "socialism with Chinese characteristics" under which market forces would coexist with state control. Therefore, although all Chinese leaders now consider themselves reformers, a consensus over the ultimate shape of a reformed China is notably lacking.

Appendix B

China's Foreign Investment Policies

In recent years, Western investors have publicly voiced their concerns about limited access to the Chinese market; difficulties in obtaining the foreign exchange needed to remit profits and support their operations; rising costs of materials and wages; bureaucratic redtape; and China's inadequate transport, communication, and power infrastructure. Many have also expressed uneasiness with the paucity of commercial legislation pertaining to important investment issues.

Over the last year and a half, Beijing has published a number of national laws fleshing out more general guidelines on foreign investment that were promulgated in October 1986. The new legislation:

- Affirms the rights of joint ventures to hire and fire Chinese workers.
- Exempts joint ventures from import licenses and duties for components used to produce exports.
- Allows joint ventures with insufficient foreign exchange to obtain hard currency by exporting Chinese goods not produced by the joint venture itself or by using Chinese currency profits to buy foreign exchange from joint ventures with a surplus.
- Exempts remitted and reinvested profits from income tax, reduces tax rates for export-producing enterprises and ventures that employ advanced technology in production, and cuts in half the tax on income earned by foreigners resident in China.
- Gives joint ventures permission to charge Chinese customers foreign exchange for goods produced in Sino-foreign joint ventures that would otherwise have to be imported.

Beijing also has permitted cities and provinces to experiment with additional provisions designed to encourage investment inflows into their localities, and most have done so—often vying with other regions to attract needed foreign investment. And the March 1988 National People's Congress approved a new law on contractual joint ventures designed to encourage foreign partners to engage in nonequity forms of joint production activity. Although Beijing passed a law on equity joint ventures in 1979 and a law on wholly foreign-owned ventures in 1986, the legal status of contractual joint ventures has been poorly defined, leaving much room for negotiation during the initial stages of an agreement—and subsequent differences of interpretation. Even without the legislation, however, foreign firms signed more than 5,000 agreements to set up contractual joint ventures in China, and 40 percent of China's paid-in foreign investment has come from contractual joint ventures.

These changes have provided a legal basis for improvements in China's environment for foreign investment. Considerable uncertainty remains, however, in how the regulations will be implemented. For example, foreign investors must have their operations designated "export-oriented" or "technically advanced" in order to be eligible for preferential tax and other treatment; precisely how Beijing makes these determinations is unknown. There is also a great deal of discretion in how Beijing chooses to define "import substitutes" that are allowed to charge foreign exchange for domestic Chinese sales, as well as the percentage of the price that may be collected in hard currency.

Beijing, moreover, continues to determine prices of inputs supplied to foreign invested enterprises as well as the prices at which joint venture products may be sold within China. With the frequent price fluctuations now occurring in China, potential investors often have difficulty projecting their ability to earn a profit. And, despite the legal basis for joint ventures to hire and fire workers, as a practical matter, many continue to have difficulty attracting skilled Chinese workers to take jobs that are viewed as less secure than work in state-sector Chinese enterprises.

Appendix C

A Comparison of Chinese and Soviet Economic Reforms

	Similarities	Differences
Agriculture	Family contract system.	In the Soviet Union, the family contract is only one form of labor organization on the farms; in China, family contracts predominate.
		Soviets retain collective and state farms; Chinese dismantled communes.
		Less than 15 percent of Chinese grain output is under mandatory state procurement; two-thirds of net Soviet farm output under state procurement.
		Chinese peasants have more latitude to choose what to grow or to start rural industries.
Enterprise Management	Enterprises have more decisionmaking authority over day-to-day operations.	Soviet plan still predominates; Chinese have considerably reduced central planning.
	Enterprises may retain higher share of profits.	Soviet workers elect all managers, ministries "confirm" plant directors; Chinese supervisory bureaus appoint managers.
Prices, Wages	Increasing mechanisms to link pay to production.	Beijing already has decontrolled many prices, but prices of key goods are still controlled by central authorities; Soviets plan to give enterprises limited authority to set prices.
	Allowing some portion of goods to sell at market-influenced prices.	Soviets plan revisions of centrally controlled wholesale and retail prices; further Chinese price reform on hold.

Foreign Trade	Strong central control of trade.	China has opened Special Economic Zones with broad incentives for foreign investors.
	Selected entities allowed to deal directly with foreign firms.	
	Allowing joint ventures.	China permits wholly owned ventures and has agreed to thousands of joint ventures; Soviets limit foreign share to 49 percent and have established relatively few joint ventures.
Bankruptcy	Used as a threat to boost efficiency.	Soviets passed law last year; Chinese passed law in 1986, will take effect in late 1988 or early 1989.
	Not intended to force widespread plant closures.	
Private Enterprise	Encouraging some small, individual businesses, primarily in service industries.	Mostly confined to students, housewives, and pensioners in Soviet Union; widespread in Chinese countryside, about 3 percent of urban labor force.

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