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# China: Turning to Fiscal and Monetary Policy

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An Intelligence Assessment

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# China: Turning to Fiscal and Monetary Policy [redacted]

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**An Intelligence Assessment**

This paper was prepared by [redacted] 25X1
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# China: Turning to Fiscal and Monetary Policy

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**Key Judgments**

*Information available as of 26 May 1984 was used in this report.*

One of the most troublesome side effects of China's five-year experiment with economic reform has been Beijing's perception that it has lost control over macroeconomic activity. The problem was a major factor behind the extended debate within the party in 1981 and 1982 over the need for reform versus the need for tighter central planning. Proponents of reform prevailed, in part by advocating the use of fiscal and monetary tools to control aggregate demand. 25X1

Beijing has been forced to make major institutional changes to facilitate the use of fiscal and monetary policy. The moves have enabled the government to restore a measure of control over the economy and, hence, are partially responsible for Beijing's recent decision to push ahead with new economic reforms. In the wake of new efforts to decentralize decisionmaking authority, we expect several fiscal and monetary tools to become even more important over the next few years:

- Bonds and foreign borrowing to finance budget deficits.
- Major experimentation with new taxes and changing tax rates.
- Establishment of a competitive banking system and increased reliance on bank loans instead of budgetary allotments.
- Active control of the money supply, probably by the newly established Central Bank Council. 25X1

Several of China's top leaders—including Politburo members Zhao Ziyang, Hu Yaobang, and Wan Li—have staked their careers on resolving China's economic problems. Although the reforms they promoted helped improve overall economic performance somewhat, serious problems remain. Much of the waste and inefficiency still present in the industrial sector stems from China's irrational price system, and demand-management tools are particularly unsuited for dealing with price problems. Because conservative critics are quick to attack shortcomings, the leadership is under pressure either to achieve improved results or abandon the controversial reforms. If Beijing continues to eschew major price reform, we believe it could become disenchanted with the results of industrial reform and may be forced—perhaps as early as 1986—to resume tighter central control. 25X1

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# China: Turning to Fiscal and Monetary Policy

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Since the watershed Third Plenum of the 11th Central Committee in 1978, China has been involved in an unprecedented experiment with economic reform. In an effort to eliminate the tremendous waste and inefficiency that characterized the economy since the 1950s, Beijing began to push decisionmaking authority—once reserved for central planners—to local enterprises. It also promoted competition and loosened control to stimulate profit-oriented performance. The experiments, though limited, represent a major turnaround for what had been one of the world's most tightly controlled, egalitarian economies. 25X1

Although the devolution of decisionmaking authority spurred productivity—at least in agriculture—it also left Beijing with sharply diminished control over macroeconomic behavior. Consumer and investor demand spurted, straining raw material and energy supplies and putting strong upward pressure on prices. Fierce competition in the foreign trade sector also created damaging price pressures. Faced with dropping the reforms or finding other control mechanisms, Beijing began adopting variations of fiscal and monetary policies used in the West. 25X1

This paper briefly describes the tightly controlled, centrally planned economy that Deng Xiaoping and his fellow pragmatists inherited, shows the degree of control that was lost when reforms were introduced, and highlights the fiscal and monetary measures taken to reassert control. The paper also assesses the preliminary results of monetary and fiscal policies, as well as some remaining problems that are not resolvable using monetary and fiscal policy. 25X1

## Direct Control—The Legacy of Mao

The Chinese Communists spent much of their first few years in power systematically dismantling the existing market-oriented system and replacing it with a planned economy modeled after that of the Soviet Union. Chinese economists hoped that central planning, aside from meeting their ideological needs, would enable them to assert direct control over aggregate demand [1] and avoid a recurrence of the economic disasters that had plagued the Kuomintang regime. Under that regime, sharp increases in consumer and investor spending—fueled by the printing of money to cover government spending—sparked a period of hyperinflation. To avoid this and all other cyclical fluctuations in economic activity, a tightly controlled system was designed:

- Private enterprises were controlled, then turned into state-owned units.
- Land was redistributed, then collectivized in 1955-56, then communes formed in 1958.
- Prices were rigidly fixed (producer goods artificially high, consumer goods low) to promote industrial production and to prevent inflation.
- The currency (renminbi) was made inconvertible, and the Ministry of Foreign Trade monopolized all imports and exports to insulate China from fluctuations in aggregate demand caused by international trade. 25X1
- Investment was incorporated into the planning process, with the state determining both the quantity and direction of most investment.

[1] Aggregate demand refers to the total demand for goods and services produced in a given economy. In simple mathematical terms, the equation most often used to express aggregate demand is: $Y = C + I + G + (X - M)$. That is, aggregate demand for a country's total output (Y) can be broken into four component parts: consumption (C), investment (I), government expenditure (G), and net foreign trade—exports (X) minus imports (M). For a market economy, C, I, X, and M are commonly regarded as subject to the whims of private behavior; only G is under direct government control. For a planned economy, the state monopolizes virtually all industrial, commercial, and financial activity. Only C is considered to be largely outside the government's direct control. 25X1 25X1

- The use of cash was restricted. Enterprises were forced to conduct most of their business through account transfers at state banks.

- Private consumption was regulated by wage and price controls, commodity-rationing schemes and forced savings, and denial of consumer credit. Inflationary pressures showed up not as higher official prices, but as longer queues.

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**Inefficiency—The Iron Rice Bowl**

Although the economy recovered sharply and performed well during the early stages of Communist rule, major problems began to surface in the late 1950s and worsened throughout the following two decades. When Beijing abandoned market pricing and assumed the job of allocating resources, it introduced tremendous inefficiencies. Resources began to move where they were directed, not where they were needed. Political clout—not efficiency—determined the direction of flow. The government's emphasis on increasing output at all costs led firms to produce large quantities of unwanted, unusable goods. Maoist egalitarian principles prevented factory managers from rewarding quality work or firing unproductive labor. Because factories were required to pay the salaries of employees they laid off, few workers were let go under any circumstance. This "iron rice bowl"—guaranteed income and employment regardless of performance—has been the factor most often cited to explain the waste and inefficiency that has become inherent in the Chinese system. The leftist leadership under Mao viewed these economic problems as necessary, acceptable costs of ideological purity.

**Economic Reforms: Efficiency at a Price**

As Deng Xiaoping and his pragmatic followers consolidated their power, it became increasingly clear that one of their top priorities would be to attack this inefficiency. Since 1978 they have introduced a series of "economic reforms," the basic thrust of which has been to decentralize decisionmaking authority, giving local government and enterprise managers greater autonomy, but also making them responsible for profits and losses. Rather than a comprehensive program carried out in stages, the reforms came as a series of groping experiments. Various proposals have been implemented, sometimes nationwide, sometimes only regionally. Where a specific reform was deemed effective, it was widely promoted. Where Beijing believed a reform created more problems, it was curbed.

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Although the reform program remains controversial, almost all sectors of the economy have been affected:

- *Agriculture.* Over three-fourths of the land is now under effective control—though not legal ownership—of peasant households.[2]

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***The Bonus System: Trial-and-Error Reform***

*The implementation of the bonus system serves as a useful example of Beijing's groping approach to economic reform. In 1979, in an effort to spur productivity, Beijing gave enterprise managers authority to distribute bonuses to their work force. Instead of using the bonus system to reward meritorious performance and enhance incentives, however, managers—many of whom achieved their positions during the Cultural Revolution as a result of their political orthodoxy—distributed bonuses in egalitarian fashion, across the board. Xinhua complained that in 1981, even after some factories were closed down, their unemployed workers continued to draw their full wages and bonuses. The result of this misuse of bonuses was constant or even declining productivity and sharp upward pressure on prices. Beijing responded in 1982 by curbing the amount of retained earnings available for bonuses and by issuing orders that payments were not to exceed productivity gains. This year, however, provincial authorities successfully pressured Beijing into allowing enterprises more autonomy. Rather than setting upper limits on bonuses, Beijing now applies a progressive tax on these payments. There is no penalty for a yearend bonus amounting to less than two and a half months' wages. Enterprises awarding bonuses larger than the equivalent of six months' wages, however, will be required to pay four times that amount in taxes.*

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- *Industry*. Enterprises that formerly remitted all but a small share of their profits now retain a much larger share, which, with limitations, they may use to pay bonuses, fund welfare programs, or invest in new facilities.

- *Finance*. Provincial governments now have greater discretion in spending locally generated revenues.

- *Commerce*. Free markets have reappeared with official blessing, and enterprises are permitted to sell some of their products outside the government-run commercial system.

- *Banking*. Loans are gradually replacing government grants as sources of fixed and working capital.

- *Foreign Trade*. Beijing has allowed some provincial- and municipal-level organizations to conduct their own trade and has established four special economic zones with freedom to trade and accept foreign investment.[3]

- *Private enterprise*. Individuals may now establish small businesses employing up to five "helpers or apprentices."

**Losing Control—Reform's Weak Link**

By reintroducing competition and profit-maximizing behavior—crushing the iron rice bowl—Beijing hoped to capture the efficiency of the marketplace while retaining the benefits of planning. In the agricultural sector, at least, the results have been satisfactory (see table 1). For example, the combined effect of higher farm prices, increased individual incentives, and good weather boosted the value of agricultural output at an average annual rate of nearly 8 percent during 1979-83. With each step forward in reform, however, Beijing gave up another element of control over investment and foreign trade decisions and thus opened the door to potentially damaging fluctuations in aggregate demand. The problem was exacerbated by the indiscriminate payment of bonuses and increased procurement prices for agricultural products, both of which pumped cash into the household sector. The increased household income gave Beijing further cause for concern about rising consumer demand.

[3] Although Beijing has made several attempts over the past two years to recentralize trade, it still exerts much less control than it did in 1978.

**Table 1**
**Economic Indicators of Reform**

*Average annual percentage increases*

| | Prereform (1974-78) | Reform Era (1979-83) |
|---|---|---|
| Gross value of agricultural output | 4.4 | 7.9 |
| Average unit yield [a] | | |
| Grain | 3.4 | 5.4 |
| Cotton | 0.4 | 8.7 |
| Gross value of industrial output | 8.7 | 7.9 |
| National income | 5.4 | 9.2 |
| Retail sales | 7.0 | 12.8 |
| Exports | 14.7 | 18.7 |

[a] Prereform data are averages for 1965-78, reform-era data are for 1978-82.

Evidence of Beijing's gradual diminution of control was most clearly reflected in investment trends (see figure 1). In 1978, nearly 85 percent of total investment in capital construction was funded through the state budget, but that share fell to less than 50 percent in 1982. The bulk of extrabudgetary investment came from local governments and enterprises using retained earnings or funds borrowed from banks. The initial 1982 plan called for a 10-percent reduction in total capital construction investment; yearend results showed instead a 25-percent increase to 55.6 billion yuan. More than 28 billion yuan came through extrabudgetary avenues, a 45-percent increase over 1981. The projects that local enterprises financed out of extrabudgetary investment siphoned off construction materials such as cement, steel, and glass that the government needed to carry out work on priority infrastructure projects. And once completed, many of these locally financed projects began competing for raw materials needed by larger, more efficient state-run enterprises.

Burgeoning budget deficits were further evidence of Beijing's problems with control. After registering

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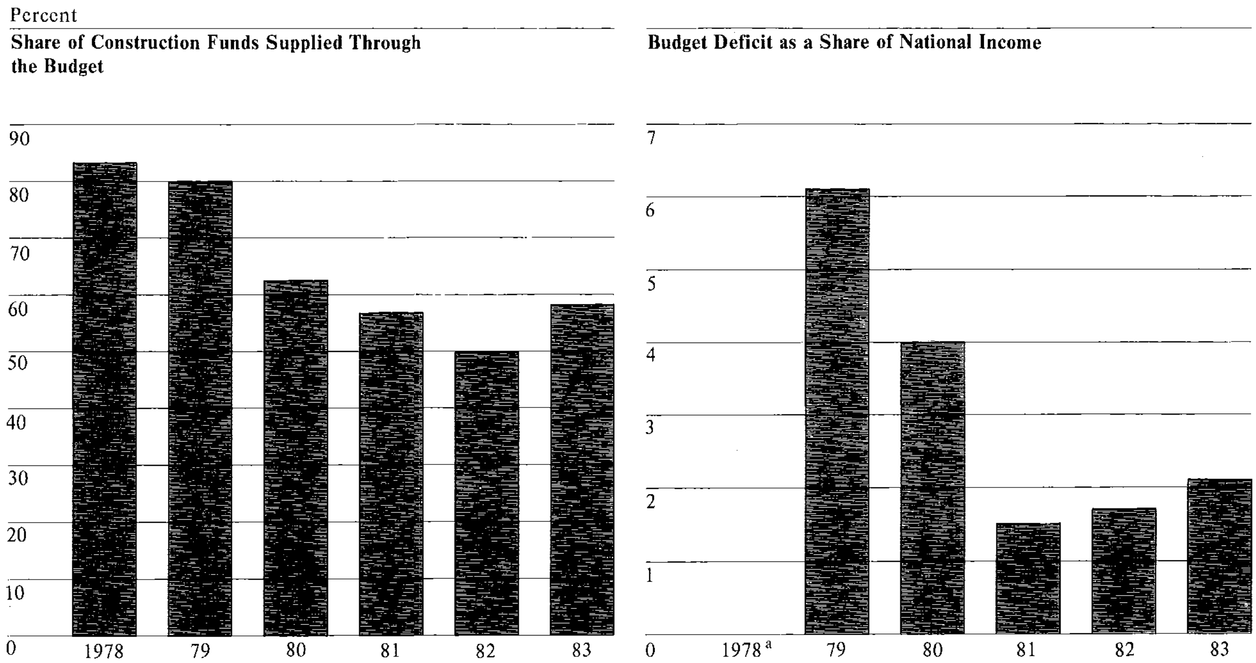
**Figure 1**
**China: Selected Indicators of Weakening Government Control, 1978-83**




[a] Budget in balance.



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small surpluses in 1977 and 1978, expenditures exceeded revenues by a record 21 billion yuan in 1979.[4] Although Beijing was able to reduce the size of succeeding deficits, the budget remained in the red a total of 28 billion yuan between 1979 and 1982. Subsidies jumped an estimated 390 percent between 1978 and 1982 as Beijing boosted agricultural procurement prices (in an effort to improve rural living standards) while holding the line on retail food prices (to avoid cutting into urban consumption). By 1982, government subsidies outweighed capital construction as a share of the total budget.

[4] The figures given in this paper have been modified by the IMF to meet standard Western accounting practices and hence differ from official Chinese statistics. Beijing includes domestic and foreign borrowing as revenue items, while Western practice is to exclude them from budgetary calculations and consider them, instead, as means of financing a given deficit. On the expenditure side, Chinese statistics exclude payment of subsidies.

Revenue shortfalls increased the deficit. Enterprises, exercising their decisionmaking authority, found ways to avoid remitting profits to the government by overstating costs, giving across-the-board wage bonuses, and understating actual revenues. The drop in net profit remittances from state enterprises was unexpectedly sharp, from over 51 percent of total revenue in 1978, to only 29 percent in 1982.



In the foreign trade sector, Beijing saw its control wane because of reform. Provincial and municipal authorities engaged in open bidding wars for foreign business. Hard currency losses from the price competition were large, perhaps as much as $1 billion in 1981 alone. The Ministry of Foreign Trade watched from the sideline as its newly adopted policy of avoiding duplicate purchases of expensive Western equipment—by acquiring the technology and reproducing it domestically—was ignored by enthusiastic local traders. Instead, under the reforms, several enterprises willingly laid out the foreign exchange necessary to acquire the equipment directly from the West. Hence, Beijing began to see inventories build in its own machine tool industry. [redacted]

The unanticipated surge in aggregate demand put strong upward pressure on prices. Official prices in China are generally allowed to rise only 2 to 3 percent per year to bolster Beijing's claim of no inflation, but evidence suggests that, in fact, rates were much higher after reform. For example, late last year [redacted] a "flourishing black market" was evidence of China's suppressed inflation. Moreover, Guangdong Province published figures that, though undoubtedly understating the level of inflation, probably give an accurate indication of the trends. The provincial paper reported that commodity prices rose at annual rates of 3, 8.5, and 2.3 percent in 1980, 1981, and 1982, respectively. The pressure prompted Beijing to issue "Provisional Regulations Governing Price Control" in August 1982. The regulations restated which product prices were still subject to strict state control and set the limits on fluctuations for most other prices. In May 1983 a circular reemphasized the main theme of price control, while in mid-1983 new sanctions were issued against unauthorized price increases. [redacted]

Although some reform economists had foreseen the development of such problems and had advocated simultaneous adoption of new tools to control aggregate demand, the regime was hesitant, largely for political reasons. On the one hand, the reforms had not proved their economic value decisively, and planners were concerned about introducing too much change too fast. On the other hand, a fierce debate was raging within the party during 1981-82 over the need for reform versus the need for tighter control over economic behavior. Party conservatives, led by Chen Yun, favored a more comprehensive planning process and somewhat less reliance on the market as means to reassert economic control. The pragmatists, on the other hand, advocated an expansion of the reforms. At times, this debate brought reform nearly to a standstill and gave Chinese economic policy a distinctive cyclical pattern of rapid advance and measured retrenchment.[5] [redacted] 25X1

Gradually, the reformers were able to convince the rest of the leadership that fiscal and monetary policies as practiced in the West offered improved control over macroeconomic behavior without cutting gains in productivity. [redacted] 25X1

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## A Shortage of Demand-Management Tools

The use of demand-management tools posed two major obstacles for the reformers. In the first place, lack of experience meant Beijing had no idea how 25X1
sensitive aggregate demand would be to various fiscal 25X1
and monetary instruments. More importantly, most 25X1
instruments commonly used for demand-management in market economies were not even available to Chinese planners in the early 1980s. [redacted] 25X1

The principal weapons of discretionary fiscal policy are government expenditure and tax rates. In China, though, government spending was viewed as only one part of the overall economic plan. Hence, government expenditure by itself was not viewed as a tool to mitigate unemployment or price pressures. Nor could Beijing rely on tax policy as even a long-term fiscal instrument. Until 1982, state enterprises remitted virtually all their profits to either central or local governments.[6] [redacted] 25X1
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Beijing did have some success in the 1950s using government bonds to ease aggregate demand pressures. When China entered the Korean war in 1950, it issued 250 million yuan in war bonds to dampen consumer demand in the wake of sharp increases in government spending. "Economic construction bonds"—2.5 billion yuan worth—served the same purpose between 1954 and 1958, offsetting a sharp

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[5] The possibility that Politburo Standing Committee Member Chen Yun is gravely ill may help account for the rapid advances in reforms advocated at the May 1984 National People's Congress. [redacted]

[6] A tax structure—including sales, profit, and agricultural taxes—remained on the books; however, when Beijing began requiring that all goods be sold at state prices to state-controlled units, the tax ceased to perform any major controlling function. [redacted] 25X1

*China: Currency Flows*

***Currency Put Into Circulation***

- *Wages, bonuses, and other payment to workers*
- *Withdrawal of savings*
- *State purchases of agricultural and sideline products*
- *Credit to the rural sector*
- *State purchases of industrial and mining goods*
- *Miscellaneous cash business*
- *Overseas remittances*

***Currency Withdrawn From Circulation***

- *Money received from state and cooperative sales*
- *Savings deposits*
- *Taxes on individuals*
- *Service trade income*
- *Loan repayments*
- *Bond purchases*

increase in official investment spending. Although purchases were to be voluntary, in practice the party exerted considerable pressure to market the bonds. The fact that Chinese workers viewed bonds as just another tax was probably the major reason Beijing abandoned their use in 1958.

Not one of the traditional monetary tools available to market economies—direct control of money in circulation, manipulation of reserve requirements, or changing interest rates—was available to Chinese policymakers. The volume of currency in circulation was a reflection of the plan. Hence, monetary policy was passive in the sense that it was not altered to offset fluctuations in aggregate demand. Money in circulation depended heavily on the government's policy toward households—the only sector relying heavily on cash to carry out day-to-day transactions. Increases in wages, bonuses, or purchases of products from the household sector all increased the amount of currency in circulation. Periodic campaigns to encourage savings reversed the flow.[7] All, however, were to a large degree determined at the time of the plan and not altered to meet cyclical fluctuations. 25X1

The rapid growth of currency in circulation at the outset of the reform movement—26 percent in 1979 and 29 percent in 1980—reflected changing government priorities rather than an expansive monetary policy. The decision to improve the lot of the Chinese consumer by increasing agricultural procurement prices and urban wages contributed to sizable budget deficits, which in those years were financed by the People's Bank of China. The substantial injections of currency into the economy were not fully offset by withdrawal of currency through sales of commodities by state commercial departments, inflows into savings deposits, service trade income, agricultural credit repayments, or income from taxation. 25X1

Nor were banking authorities able to control credit expansion. During the Cultural Revolution (1966-76), China's banking system was reduced to little more than a cashier/accountant for the Ministry of Finance. Budgetary allocations were deposited in state banks and funds drawn as required. Even when credits demanded were above planned levels, it was generally true that well-explained applications for credit—short or long term—were always accepted. The only major check on the amount an enterprise could borrow has been the stigma of not meeting the exact terms of the plan. 25X1

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Interest rates, like most official prices in China, went almost unchanged from 1965 to 1978. Even if they had fluctuated with world rates, however, their impact on borrowing—and hence on aggregate demand—would probably have been negligible. The restrictive power of rising interest rates stems from the additional costs that these rates impose on borrowing enterprises. In China, the influence of subsidies, easy access to credit, and the central government's emphasis on output almost regardless of cost all ensure that—in a financial sense—true investment failure is rare. Higher interest rates also do little to encourage industrial savings. Chinese firms generally believe it is more important to expand capacity, even at a lower rate of return, than to earn interest on savings deposits. 25X1

[7] Fluctuations in domestic savings or remittances from abroad were also capable of altering the amount of currency in circulation. The former has, periodically, been a major concern for policymakers. The latter has been of much less importance. 25X1

Wage and price controls played an important role in regulating aggregate demand during the past two decades. These controls were directed at the rural and urban household sectors. One of Beijing's major concerns has been that a sudden increase in consumer spending would drive domestic prices upward. By holding agricultural prices relatively constant from the 1950s to the late 1970s, Beijing prevented surges in the amount of currency circulating in rural sectors and, hence, was able to curb excess demand. Wage controls did the same in urban areas. The controls were a major factor in holding the line against inflation. When Beijing opted in 1979 and 1980 to relax wage and price controls in an effort to improve consumer welfare, it gave up, temporarily, one of its most effective demand-management tools.

### Experimenting With New Fiscal Programs

At the outset of the reform movement, Beijing attempted to control aggregate demand using the only powerful fiscal tool in its arsenal—government spending. Government investment in capital construction was held flat in 1979 and then slashed 17 percent in 1980 and 28 percent the following year in an attempt to curb mounting inflationary pressure. Defense expenditures—after rising sharply in 1979 to finance the war with Vietnam—were also cut in 1980 and 1981. Beijing attempted to use moral suasion—threats against disobedient enterprises—to curb extrabudgetary expenditure by domestic firms. Government threats proved fairly successful in 1979, probably because local enterprises were unsure how hard Beijing might respond to disobedience. But when it became clear that the government was anxious to move ahead with reform and would not clamp down, extrabudgetary investment doubled to about 20 billion yuan in 1980 and 1981, then hit 28 billion yuan in 1982.

Beijing also used control over the foreign trade sector to reduce potential capital outlays and hence lessen pressure on aggregate demand. In 1979 and again in 1981, Chinese officials refused to approve billions of dollars worth of turnkey plant contracts that its foreign trade corporations had signed with Western firms. Part of the motivation for the suspensions was to ease mounting balance-of-payments problems, but Beijing was also attempting to reduce domestic budget outlays. For each dollar spent on imported equipment, Beijing claimed that it had to lay out approximately 4 yuan (the equivalent of US $2) for infrastructure projects, wages, and other local costs. By refusing to honor the import contracts immediately, Beijing postponed capital expenditures of more than 10 billion yuan. 25X1

The attempt to relieve pressure by cutting back government investment proved less than totally effective. In the first place, reductions were offset by other government outlays. Subsidies, for example, rose 21.6 billion yuan between 1979 and 1982, more than offsetting the 21.2-billion-yuan decline in government spending for capital construction. 25X1 Furthermore, by withdrawing resources from much-needed infrastructure projects, government investment cutbacks may have adversely affected China's future growth potential. The share of total expenditure allocated to key projects dropped from 42 percent in 1978 to 30 percent in 1982. 25X1

Recognizing the deficiencies in its initial attempts at demand-management, Beijing tried other fiscal measures. In 1981, Beijing returned to the practice of issuing government bonds. It sold nearly 5 billion yuan in treasury bonds to state and collectively owned units almost entirely on an involuntary basis. As they had in the 1950s, the bonds once again proved useful fiscal tools for slowing aggregate demand. With the funds siphoned from enterprises, the government covered a portion of its ongoing budget deficits without resorting to inflationary printing of money. At the same time, the bonds crowded out extrabudgetary investment that almost certainly would have occurred had the enterprises been allowed to retain their full profits. More recently, Beijing also used the bonds to help curb increasing consumer demand. About half of the 4 billion yuan in bonds issued in 1982 and again in 25X1 1983 went to individuals and half to organizations. The former, purchase of which is voluntary, carry an 8-percent annual interest rate; the latter, only 4 percent.[8] 25X1

[8] As in the 1950s, Beijing has again taken pains to emphasize that the bonds are to be issued on a voluntary basis. Nevertheless, considerable pressure sometimes goes into these "voluntary" purchases. 25X1

By far the most difficult fiscal reform attempted was replacing the system of profit remittances with a system of profit taxation. The new program was designed to raise government revenue, to put more pressure on losing enterprises by ending automatic subsidies, and to encourage other enterprises to earn higher profits on the understanding that these would be shared with the tax authorities rather than confiscated. China introduced a nationwide, eight-tier tax structure in June 1983. Small enterprises with annual income of less than 300 yuan were taxed at 7 percent, while large and medium-sized state enterprises (those with annual incomes in excess of 80,000 yuan) fell into the highest bracket and were taxed at 55 percent of profit. A special "adjustment tax" was also levied to tax away special advantages that certain enterprises enjoyed as a result of irrational prices, new technology, location advantages, and so on. Any profit the state deemed as a windfall—not directly attributable to efficient operation—was subjected to the higher tax. Beijing intends to phase out this adjustment tax over time, but at present it has cut retained earnings to the point that, according to a recent Chinese publication, state enterprises remitted 83 percent of total profits to taxes in 1983.[9] 25X1

More recently, the state has decided to increase its share of the pie by introducing other taxes. In October 1983, Beijing levied a 10-percent tax on extrabudgetary capital construction expenditures. The tax is intended to discourage unwanted investment and, at the same time, to help finance the central government's major infrastructure projects. Other taxes being tried experimentally include taxes on fixed assets and circulating capital and on value added in production. Surcharges have been levied against inventories to discourage the production of unwanted merchandise. A user tax on crude oil was introduced in July 1982 to encourage enterprises to burn coal. 25X1

Revenue collection has also been strengthened. An Office of General Financial Inspection was established in mid-1983 to audit units nationwide and crack down on tax fraud. By early 1984, more than 190,000 auditors had been mobilized to spot-check a third of the nation's enterprises and establishments. Violations amounting to 3.5 billion yuan were discovered, 1.9 billion of which were owed to the state. 25X1

Although still in its early stages, the tax reform program is already creating problems. In an effort to increase its revenues, the steepest adjustment tax has been applied to the most profitable enterprises—a practice Beijing refers to as "whipping the fast ox." As a result, some firms now retain less than 5 percent of total profits, making it difficult for them to award bonuses or to acquire needed technology. The firms probably benefiting most from the new system are the few that remain outside it. The Ministry of Metallurgy, which has been allowed to set its own guidelines, adopted a "profit responsibility system," where each factory remits a fixed quota to the state and retains the remainder as its profits. Some firms reportedly retain as much as 80 percent of profits under this system. 25X1

## Making Monetary Policy an Option

### Banking

Perhaps the most convincing evidence of China's willingness to experiment with market-oriented demand-management tools has been its reform of the banking system. Although use of fiscal tools required innovative policy moves, monetary reform involved major institutional rebuilding. Over the past four years, Beijing has been setting up a network of commercial and industrial banks to relieve the People's Bank of China (PBOC) of the burden of exercising financial supervision over all public enterprises:

- On 1 January 1984, all commercial banking responsibilities were taken from the PBOC, which is now to function solely as a central bank, formulating and carrying out overall monetary policy.

- Commercial banking functions previously carried out by the PBOC have been delegated to the newly formed Industrial and Commercial Bank.

[9] During 1979-82, when selected regions were experimenting with tax reform without an adjustment factor, the Chinese reported that some enterprises retained as much as 70 percent of profits. Beijing was clearly unwilling to give enterprises this much latitude over profits. 25X1

- The Agricultural Bank—formally reestablished in February 1979 after a 10-year hiatus—now serves as the main channel for both state investment and credits to agriculture as well as for collection of revenue in the countryside.

- The Construction Bank has been placed under joint supervision of the Ministry of Finance and PBOC, and is charged with supervising construction investment.

- A Central Bank Council—made up of executives from all the banks—has recently been formed to discuss important national financial policy questions (see figure 2).

The long-term goal of banking reform is to set up institutions that eventually will be capable of pursuing an active monetary policy. Monetary authorities under such a system could cut back lending when aggregate demand is considered too strong and could make additional loans when demand is weak. The monetary authority itself would determine the course that aggregate demand would take. At present, banks are forced to lend to almost every enterprise that demonstrates a need for funds to meet planned production. In the future, Beijing wants the banking system to assist in the drive for efficiency by making loans on the basis of profitability.

**Interest rates**

Beijing has also attempted to make greater use of interest rates to influence microeconomic decision-making. To encourage savings and reduce the amount of cash in the hands of consumers, interest rates paid on deposits have been raised three times since 1978. New types of deposits have been created, broadening the range of financial assets available. In 1982, enterprises and organizations were for the first time permitted to hold time deposits, which earn higher interest. Perhaps the most important adjustment, however, was the general increase in interest rates on loans, implemented in January 1982. The standard rate on circulating capital loans was raised from 5.04 percent a year to 7.2 percent. Certain other loan interest rates were raised even more. These adjustments have made the structure of interest rates more rational and hence are beginning to make Chinese borrowers and lenders more aware of the true cost of capital (see table 2).

Despite these major changes, the PBOC continues to have little independent control over economic activity. Branch banks—bowing to pressure from local authorities—still tend to supply credit according to enterprise needs, even when those needs exceed plan. Higher interest rates, imposed on borrowing for extrabudgetary investment, are beginning to influence demand, but the central bank's ability to control excess expenditure is still largely indirect. When a local unit's demand for funds becomes excessive, the bank, rather than refusing to disburse the loan, attempts to correct the situation by notifying the government organizations directly responsible for the units where the deviation occurs. The reforms have, however, given the monetary authorities more influence over the mobilization of savings. Households have apparently responded well to both higher interest rates and the improved service offered by local banks.



## Performance and Prospects

The experiment with fiscal and monetary policies deserves at least partial credit for curbing aggregate demand pressures that had built up between 1979 and 1981. After increases in the supply of currency in 1979 and 1980 that exceeded the rise in retail sales by a large margin, there was a return to near balance in 1981 and 1982. Currency in circulation rose only 14.5 percent in 1981 and 10.9 percent in 1982, while retail sales showed gains of 9.8 and 9.4 percent, respectively. Reduced government spending and the sale of treasury bonds enabled Beijing to avoid monetizing large amounts of domestic debt. The budget deficits for the two years, though large by Chinese standards at about 6 billion yuan in 1981 and 7 billion in 1982, remained well below the 1979 and 1980 deficits of 21 billion yuan and 15 billion yuan, respectively. Tighter control of wages and bonuses plus, in 1982, stable procurement prices for agricultural goods were the most important contributors on the monetary side to reducing aggregate demand pressure.

**Table 2**
**China: Annual Interest Rates on Deposits and Loans**

*Percent*

| | Pre-1980 Rates | Post-1980 Rates | Post-1982 Rates |
|---|---|---|---|
| **Deposits** | | | |
| Individual | | | |
| On sight | 2.10 | 2.88 | 2.88 |
| Six months | 3.60 | 4.32 | 4.32 |
| One year | 3.96 | 5.40 | 5.76 |
| Three years | 4.50 | 6.12 | 6.84 |
| Five years | 5.00 | 6.84 | 7.20 |
| Eight years | . . . [a] | . . . | 9.00 |
| Institutional | | | |
| On sight | . . . [a] | 1.8 | 1.8 |
| One year | . . . [a] | . . . [a] | 3.6 |
| Two years | . . . [a] | . . . [a] | 4.32 |
| Three years | . . . [a] | . . . [a] | 5.04 |
| **Loans** | | | |
| Industrial and commercial | | | |
| Working capital | NA | 5.04 | 7.2 |
| Short- and medium-term | | | |
| One year or less | NA | 5.04 | 5.04 |
| One to three years | NA | 5.04 | 5.76 |
| Three to five years | NA | 5.04 | 6.48 |
| Additional interest for overdue loans [b] | NA | 20.00 | 20.00 |
| Additional interest on bank loans diverted from their authorized purpose | NA | 50.00 | 50.00 |
| Agricultural bank loans | | | |
| Working capital loans | NA | 4.30 | 5.76 |
| Equipment loans | | | |
| State farms | NA | 4.30 | 5.04 |
| Communes | NA | 2.16 | 4.30 |
| Rural credit cooperatives | | | |
| Household | NA | NA | 5.76 to 10.8 |
| Preferential | NA | NA | 2.52 |

[a] Ellipses (. . .) indicate that the financial instrument was not used.
[b] Surcharges on the rate of interest.

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The evidence for 1983 suggests that, although Beijing continued to see some success in its demand-management efforts, problems have persisted. China's new tax and banking policies, combined with government exhortation, finally affected enterprise investment; extrabudgetary investment in capital construction fell 13 percent from the record 1982 level. But the budget deficit widened in 1983 to probably about 10 billion yuan. And because the People's Bank financed the increase, the amount of currency in circulation showed a sharp 21-percent rise. The rise in currency in circulation was the first economic problem that state councilor Song Ping highlighted in his address in May before the National People's Congress (NPC).

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Beijing remains concerned that, as the reforms proceed, aggregate demand will become increasingly difficult to control. Nevertheless, Chinese leaders reemphasized their commitment to reform at the NPC. Hence, we expect fiscal and monetary tools to become increasingly important supplements to China's combined planned/market economy over the next few years

On the fiscal side, the government is unlikely to return to the cutbacks in its own investment program that were imposed in 1980 and 1981. Recognition of the importance of the key infrastructure projects to economic development ensures increases in government expenditure over the next few years. The share of total investment going to the energy and transportation sectors jumped from 28 percent in 1982 to 38 percent last year, and will probably exceed 40 percent in 1984. Large domestic budget deficits—similar to those of 1979 and 1980—will be avoided by boosting tax revenues through tough enforcement of existing policies first but also through tax hikes if necessary. The government appears prepared, however, to continue to operate somewhat in the red, at least for the next few years. Because Beijing considers inflows from treasury bonds and from foreign borrowing as part of revenue rather than debt, it is also probable that these borrowing practices will continue.

The most obvious areas for continued fiscal experimentation relate to tax policy. The concept of making individual enterprises accountable for their profits and losses is central to the reform movement. Substituting taxes for profit remittances is the only way to harmonize the enterprises' needs for autonomy and the government's need for funds to finance public projects. We expect to see major alterations in the tax rates over the next few years. Beijing will probably use the tax structure to penalize industries it deems weak or undesirable and to reward those it favors.

In many ways, China's economic system is well suited for monetary policy. In Western economies, a multitude of constantly changing financial instruments make control of the money supply difficult, but Beijing has relatively few instruments for borrowing or lending. Then too, although China's banking system is less homogeneous than it was five years ago, it retains many of the characteristics of a monobank. The monetary authority should be able to exert significant control over the entire banking system. As a result, we believe Beijing will move ahead with monetary reform. 25X1

The banking system will probably play a much larger role in financing future investment. Interest rates will probably be raised again this year, and preferential rates may be offered for priority sectors of the economy. We do not know what degree of autonomy may be wielded by the new Industrial and Commercial Bank, but we expect that, over the short term at least, it will continue to function under the close supervision of the PBOC. 25X1 25X1

Although the application of monetary and fiscal policy has given Beijing a modicum of control over the economy that was seriously lacking in 1979-81, the government is clearly looking for more. China's leadership took significant risks in scrapping the system built up over the past 30 years. Several members of the party's reform wing—such as General Secretary Hu Yaobang, Premier Zhao Ziyang, and Vice Premier Wan Li—have staked their careers on the successful resolution of China's economic problems. Clearly they are expecting the entire experiment to create a more vibrant, efficient economy. Much of the remaining waste and inefficiency, however, stem from China's irrational price system.[10] 25X1 25X1

Macroeconomic demand-management tools are particularly ill suited for dealing with relative price problems. Restrictive fiscal and monetary policies operate by forcing firms in all sectors to scale back operations. The most efficient firms maintain reasonable profits even in a tight market, while the least profitable enterprises suffer or are driven out of business. In China, however, profits bear no relationship to efficiency or demand. Firms producing goods 25X1

[10] An irrational price is one that fails to reflect supply and demand in an economy. When Chinese prices were fixed in the early 1950s, it is reasonable to assume that they reflected relative scarcities at the time. In the subsequent three decades, however, Beijing made no attempt to maintain market balance in its infrequent price adjustments. The existence of long queues, black markets, and complex rationing schemes is a reflection of the irrational price system. 25X1

whose prices have been set high may show substantial profits despite inefficient operations even in a market depressed by tight fiscal or monetary policies. (In some cases these firms even produce goods that the government has extreme difficulty marketing, either because of low quality or lack of demand.) Conversely, an efficient firm that uses raw materials priced artificially high may suffer losses in a tight market. Under these conditions, restrictive fiscal or monetary policy could seriously damage China's best run industries. Moreover, the incentive for an inefficient firm to streamline operations is low, and neither the reforms nor demand-management tools offer much hope for change. [redacted]

Recognizing these weaknesses, China's leading economists have had some success pushing the government toward price reform. Last year, prices on more than 500 minor consumer items were allowed to vary depending on local conditions. In addition, peasants were given increasing latitude to negotiate prices for their surplus agricultural and sideline products. [redacted] 25X1

The question of major price reform, however, remains among the most contentious economic issues within China's top echelons. [redacted] 25X1
[redacted] Deng publicly criticized Hu Yaobang last summer for circulating—and apparently supporting—a research paper calling for a radical restructuring of the price mechanism. State President Li Xiannian also denounced the paper, calling it antistate and antiparty. These political and ideological concerns have been reinforced by practical problems involving price reform. Over the past few years, even rumors of pending price adjustments for major commodities have caused widespread panic buying among China's shortage-conscious population. Several major industries and their supporting state council bureaucracies have also resisted major price reforms because of the impact the reforms will probably have on these firms' irrationally high profit margins. [redacted] 25X1

The long-term success of monetary and fiscal policy—and for that matter the entire economic reform program—hinges on price reform. If, over the next few years, Beijing is able to couple its economic experiment with major price reform, sizable gains are possible. If Beijing continues to resist major price adjustment, however, waste, inefficiency, and economic crime will remain. Because the reform policies remain controversial, and conservative critics tend to attack shortcomings quickly, the longer that major economic problems persist, the more frustrated reformers will become. Failure to come to grips with price reform will, at a minimum, perpetuate the cycle of reform and retrenchment and could precipitate—perhaps as early as 1986—the discarding of some economic reforms in favor of more direct control. [redacted] 25X1

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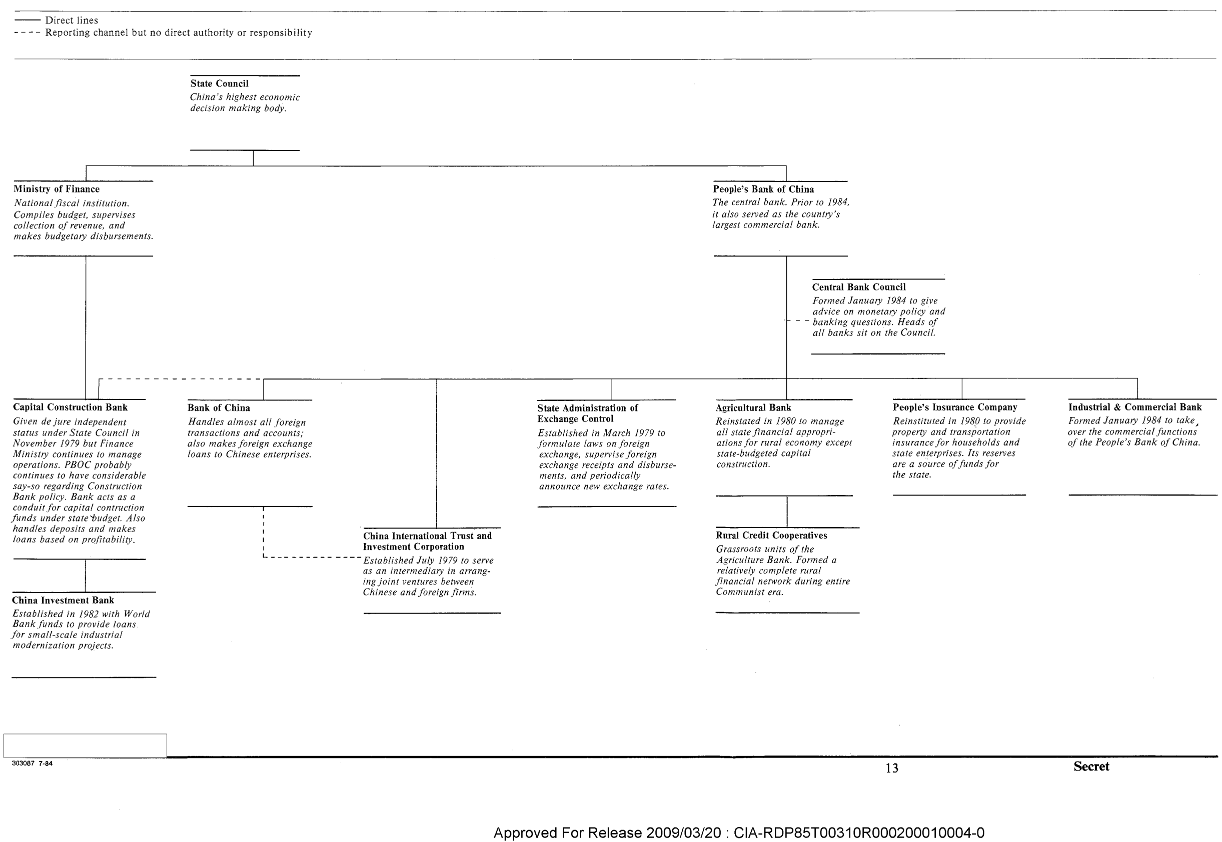
**Figure 2**
**China's Banking System**

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