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China: Policy Response to Economic Instability

Summary

Economic developments in 1985 highlighted the fundamental problem of managing an economy that is being transformed from a centrally planned system to one that mixes planning and market elements. We believe Beijing's response to the problems, particularly the absence of a reflexive clamp down on reforms, provides insight into the leadership's approach to economic policymaking, and reform prospects in general.

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A Fundamental Problem

As Premier Zhao Ziyang stated in a recent interview, one of the key problems Beijing's reform program faces is how to maintain economic stability while reducing direct government control over state enterprises. Reforms implemented in the past two years have significantly diminished administrative control over production, investment, and pricing decisions. Enterprises now retain a much larger share of earnings--which they can use for investment or worker remuneration--and are permitted to sell

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overquota production of industrial goods at prices above state-set levels. Price controls have been relaxed for some products, and more retail goods are marketed outside government-run commercial channels. [Redacted]

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Although mandatory planning still plays an important role in China's economy, in our view, Beijing has given up an element of direct control over aggregate demand by allowing increased enterprise autonomy. Reformers hope to control aggregate demand, and maintain economic stability, by employing indirect economic levers such as interest rates, credit levels, and taxes. [Redacted]

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We believe Beijing's ability to implement comprehensive economic reform depends on its success in using indirect economic levers in place of administrative directives. When reforms were launched in 1979, opponents warned that Beijing could lose control of the economy if the central planning mechanism was weakened--and argued that strict limits should therefore be placed on economic decentralization. Reforms proceeded, in part, because Chinese leaders became convinced that macroeconomic levers could be used to regulate economic activity occurring outside of the plan. [Redacted]

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We believe economic developments in 1985 highlighted the fact that Beijing has not yet perfected a new macroeconomic control mechanism. A surge in investment, wages and bonuses, and credit that began in the middle of 1984 caused industrial output to shoot up at a 23-percent annual rate during the first half of last year. Efforts to cool the overheated economy gradually reduced the industrial growth rate, but inflation tripled and Chinese imports soared. At the beginning of 1986, Beijing was still concerned with overly rapid growth in credit, capital construction, and wage levels. [Redacted]

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Party conservatives, who oppose some aspects of the pragmatic reform program, criticized reformers for the economic problems last year. The sharpest attack came at a party conference in September 1985, when Chen Yun, a Politburo Standing Committee member and the doyen of China's economic bureaucrats, warned that market forces were unreliable economic levers. According to Chen, "market regulation involves no planning, blindly allowing supply and demand to determine production...planning is the essence of macroeconomic control." We believe, that in a broader sense, Chen's argument carried the clear implication that economic reform was progressing too quickly and that there are limits on how far economic decentralization can go without threatening social disorder. In our view, reformers themselves recognized the need to improve economic controls and have therefore decided that major economic reforms will be put on hold until after 1986. [Redacted]

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The Transition Process

In one sense, the potential for economic dislocations is endemic to the reform process. In the transition from a centrally planned economy to a more market-oriented system, Beijing must loosen some types of central controls before testing the economic levers slated to replace them. In our view, enterprises have been quick to respond to

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enhanced decisionmaking authority--such as the right to sell overquota production at market prices--but have not been as responsive to macroeconomic levers as Beijing expected. For instance, higher interest rates on loans do not effectively curtail borrowing by some enterprises that rely on the state budget for their operating expenses. Other enterprises have proved adept at evading taxes or raising funds for capital construction outside of the banking system. To increase the responsiveness of enterprises to economic levers, we believe Beijing must press ahead with industrial reforms--but further decentralization may temporarily increase economic instability. In our view, the conflict between enhancing enterprise autonomy and maintaining macroeconomic control will impart a pattern of rapid growth followed by government-induced retrenchment to China's economic performance.

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Sources of Instability

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We believe that policy errors, a one-sided grant of enterprise autonomy, and strong local pressures for rapid growth contributed to economic problems last year.

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Policy Errors

A major source of economic instability was the 50-percent increases in currency in circulation and loans to industrial enterprises that occurred in 1984. In our view, the money supply surge was caused by errors in the implementation of new banking reforms. In 1984, Beijing granted increased autonomy to local banks and urged them to adjust their loan policies to support economic reform. Intense demand for funds by enterprises and local officials, and lax oversight and muddled accounting by the central bank, however, allowed credit to increase much more than Beijing intended.

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One-Sided Enterprise Autonomy

Chinese press reports indicate that many managers have taken advantage of increased autonomy by excessively increasing capital construction and rapidly expanding wages and bonuses. In our view, this growth in investment spending and worker remuneration was another source of economic problems. Chinese reformers recognize that the grant of autonomy is onesided--managers have more flexibility in using enterprise revenues, but their decisionmaking is not yet disciplined by market forces. Because Beijing still subsidizes state enterprises that lose money, managers increase wages--or take more loans--without worrying about bankruptcy. We believe reformers recognize that bankruptcy is a necessary lever for restraining autonomous enterprises, but experiments with bankruptcy laws have been limited: a working group was formed only recently to draft bankruptcy laws. A major impediment to enforcing bankruptcy, in our view, is China's irrational price system, which makes it difficult to determine whether enterprises are losing money because of inefficiency, or because of low state-set prices.

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We believe the implementation of bankruptcy laws also will meet strong resistance from local officials who fear they will have to bear the economic--and political--costs of workers who lose their jobs when enterprises close. [redacted]

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Local Interests

We believe Beijing faces enormous pressure from workers, managers, and local officials for rapid growth. Promotion of "10,000 yuan households" by the media in 1984 and exhortations to get rich through hard work generated rising expectations among workers for an improvement in their standard of living. Rising food prices have intensified worker demands for raises, while the relaxation of state controls over some enterprises has weakened the ability of managers to resist them. [redacted]

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Given years of emphasis on meeting quantitative targets, many managers still believe that they must prove their competence by rapidly expanding enterprise production. To boost local revenues, low-level officials pressure enterprise managers to increase output and speed completion of local construction plans. Although downplaying the extent of the problem, recent editorials have warned that, if officials set unreasonable output targets, enterprise managers may resort to falsifying production data--making it more difficult for Beijing to judge how well control measures are working. We believe Chinese leaders are also worried that rapid growth of enterprises operated by rural towns has caused a proliferation of small, inefficient, and redundant firms that compete with state enterprises for funds and raw materials. [redacted]

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Beijing's Response to the Economic Problems

We believe that the political strength of the reform coalition and the increased economic sophistication of its leaders was evident in Beijing's reaction to the economic problems in 1985. Instead of halting the reforms and quickly damping the overheated economy by reimposing strict administrative controls--as they might have in the past--Chinese leaders implemented a combination of market-oriented macroeconomic adjustments and state directives that were designed to slow the economy gradually.

We believe Beijing's willingness to use economic levers to stabilize the economy was particularly significant. China's 1985 budget, announced last April, called for a reduction in the rate of growth of government spending and a 10-percent cut in administrative expenditures. Beijing also clamped down on credit and twice raised the general level of interest rates. Administrative directives were issued that required enterprises to place wage funds in special accounts to be monitored by the banks, and that prohibited banks from extending credit for construction projects not listed in the state plan. [redacted]

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During the year, Beijing began to recentralize some aspects of its foreign trade, and it ordered a halt in construction of some projects, but it did not backtrack on fundamental reforms. Despite surging consumer and investment demands, Beijing

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implemented planned hikes in urban food prices, and introduced--after a lengthy delay--new wage scales for teachers and government workers. At the national conference last September, the Chinese Communist Party formally made reform its primary economic goal for the five-year period beginning in 1986. Although Beijing recently announced that major economic reforms will not be implemented this year, we believe that some types of reforms, such as the removal of central government units from the direct management of enterprises, will proceed. [Redacted]

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Improving the Mechanisms of Macroeconomic Control

To improve its ability to maintain economic stability with indirect economic levers, Beijing is increasing the powers of China's central bank and making greater use of taxes as regulatory tools. We believe Beijing has given the central bank expanded authority to administer China's specialized banks (such as the Agricultural Bank and the Industrial and Commercial Bank). For instance, the central bank's credit plan now includes the funds of all of the specialized banks, and the specialized banks no longer have overdraft rights with the central bank. Beijing recently announced a new tax scheme for individual entrepreneurs, and Chinese press reports suggest that in 1986 Beijing will increase enforcement of taxes on capital construction. Media reports also suggest that Beijing will boost taxes on rural industries, in part to slow their rapid growth. Beijing also is improving its ability to collect taxes from enterprises. We believe these changes in the banking and taxation systems will eventually provide Beijing with better economic levers. [Redacted]

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