Title
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To: Richard
With appreciation and warm esteem,
Jack.

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**Restructuring Centrally-Planned Economies:
The Case of China in the Long Term**

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RESTRUCTURING CENTRALLY-PLANNED ECONOMIES: THE CASE OF CHINA IN THE LONG TERM

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I. Introduction

A primary factor in the long-term development of a successful market-oriented economy is the form of agencies and institutions to which is granted the legal rights to implement the allocation of economic activities. A voluminous literature has recently appeared on the shifting of centrally planned economies to market economies, but insufficient attention has been devoted to the differences between those former centrally planned economies which have abandoned communism and those which plan to retain it. Though both sets of countries have encountered many similar macroeconomic and microeconomic problems of reform, certain issues, such as privatization of large state-owned enterprises and national decisions to invest, are different in kind--though, to date, in the case of China and Eastern Europe they have also revealed pragmatic similarities.[1]

II. Restoring Economic Equilibrium Under Neo-classical and Market-Transforming Conditions

If markets are to perform efficiently, they must, of course, operate under specified conditions. These have been carefully discussed in the literature and recently surveyed in an excellent article by Leonid Hurwicz.[2] An important objective of his paper, building on the survey, was to indicate the theoretical imperfections of various price mechanisms in order to "help avoid disillusionment"[3] when countries undergo the many hard transitions entailed in moving toward a market-oriented economy. He also hoped to stimulate discussion about measures that might be needed to supplement the actual market processes to avoid some of their potential disadvantages. It is my objective to examine several significant relationships that came immediately into view during the process of transition toward a market economy in virtually every country in question, revealing that certain assumptions taken for granted in the neo-classical theory of markets were inapplicable to these circumstances. The results in the short term have been worse than those which would have been anticipated on the basis of assumptions upon which the theory rests.

First, and I believe most important, is the issue of what may be termed the "primary agency" principle: who has fundamental control over the direction and management of day-to-day economic activity? Neo-classical theory assumes that when an economy is in a state of disequilibrium the adjustment toward a new equilibrium occurs through the decision-making activities of numerous firms and households acting on the basis of their economic incentives, with a resulting maximization of welfare for the society as a whole. Implicitly, the theory assumes the existence of a sufficiently large number of entrepreneurs willing and capable of undertaking such adjustments. When these conditions do not exist, the transformation toward a market economy necessitates not only their creation but also the recognition at the highest level of political authority that the persistent maintenance of political agents as directors or managers of the actual implementation of the bulk of economic activity inevitably becomes incompatible with the development of a successful market mechanism.

The core of this argument, expressed in terms of the primary-agency effect, applies as well to impediments at the regional and local level. If reforms occur at the national level, say in regard to production, sales, and prices of most agricultural products, the decentralization of authority from national to regional organs may--and, indeed, has--often brought about the usurpation of authority by regional officials over the market allocating activities of farm collectives and households.

Further, the principle applies to the organizational goals of state enterprises and to the commitment of those who manage them. For in shifting toward a market mechanism, if hybrid forms of privatization are introduced, with the retention of former managers and labor councils, it is likely that the capitalization of assets will take place. When property is not privately owned or leased, and managers are not appointed or employed specifically as managers, the incentives for both the managers and labor councils would be to utilize as much of the cash flow as feasible to raise their own salaries and wages, rather than strive to maximize profits, enhance the value of the enterprise, and serve public goals.[4] In practice, this situation often represents an abberation to the laws of private property and, as we shall note, can be removed to be compatible with either a "socialist" or "capitalist" market mechanism.

The primary agency principle also applies at the consumer's level. When governments make decisions on political-economic grounds, say on the proportion and price of certain agricultural crops to be delivered to them, clearly this reduces the volume remaining to be sold on freer markets. The greater the degree of such segmented markets and the resulting price differentials, the larger the extent to which they influence the structure of consumer demand, the incentives for corruption, and the spread of black markets. Hence, the inapplicability of assumptions on which neo-classical theory is based to the practical conditions of China's transition renderes the primary-agency factor of the utmost importance in the restructuring of a centrally planned to a market-oriented system in production, pricing, capital formation, and consumption.

Second, neo-classical market theory usually assumes that, excluding depressions, when a developed market economy adjusts from a state of disequilibrium toward a new equilibrium, long established property rights for capital and labor, combined with macroeconomic stabilizers, reinforce an environment in which it is expected that moderate adjustments in costs and prices, say during a normal recession, would tend to restore equilibrium in a reasonably short period of time.[5] The significant facts are not only that these assumptions are irrelevant to any centrally planned economy putting into effect reforms to establish a market-oriented system, but that the reforms themselves are most likely to render the assumptions even less applicable to the period of transition. The restrictive trade and exchange-rate systems of a centrally planned economy, combined with characteristic impediments to entrepreneurial innovation, reduce the competitiveness of the bulk of its manufactures in world markets, aggravating its customary lag in technological advance. Reforms, freeing prices and exchange rates, bring into the open the need to improve the quality and range of domestic manufactures, to scrap obsolete structures and equipment, to modernize the infrastructure, to raise labor productivity relative to bloated wages. In particular, competition impels the rapid destruction of much obsolete capital, bringing about mass unemployment. The required adjustments in costs and prices, as well as the adjustments throughout the economy--toward equalizing the ratios of relative domestic and international prices, marginal rates of substitution, and marginal rates of transformation--are large, not moderate. The prevailing uncertainties as to property rights, the need to establish new institutions for the provision of financial capital and for macroeconomic stabilization require much time to be dealt with adequately; otherwise, uncertainty with respect to profitability is bound to impede essential capital formation on the part of both domestic and foreign investors. The form and magnitude of adjustments required, therefore, call for adequate recognition of the differences between adjusting to disequilibria in developed market economies and adjusting to disequilibria in the process of transforming centrally planned to market-oriented economies.[6]

Third, there have recently been important advances in economic theory on the relations between increased specialization, extension of markets, increasing returns to scale and scope, and imperfect competition that point to the need of a long-term framework for the essential reforms toward a successful market system as compared with policies that lead to stop-go economic fluctuations which engender ill-advised, short-term reversals toward mandatory controls. Limitations of space permit only brief mention of the most cogent considerations. All the countries undergoing transformation toward market systems have key characteristics of developing economies. As regards increased specialization and extension of markets, the new literature has built on earlier evidence that people in developing countries are no less motivated to work hard than those with incomparably greater advantages in developed countries when facing the opportunity of adapting to economic incentives in reasonably well-functioning market systems. Ample evidence has been marshalled to show that the principle applies to investment in human capital, including investment in entrepreneurial ability. New research demonstrates that the analysis applies, powerfully, to firms and households restoring equilibrium under economic modernization.[7] Under contemporary conditions, furthermore, ever increasing specialization and extension of markets are no less applicable to modern agriculture than to high-tech industry. The implications of these contributions to centrally planned economies undergoing transition to market systems have not been well recognized, either for the short term or the long. In these countries, managers and workers have been unaccustomed for decades, in certain cases for generations, to make decisions comparable to those required for adjustments to market incentives and dislocations. Though the literature has, of course, made reference to this problem, the disillusionment that has occurred in virtually every country making the transition is only to be matched by the failure of our profession and the respective governments involved to recognize the magnitude of decline in industrial output and the rise in unemployment that would be brought about during the transition.

Alternatively, for the long term, the new economic theory and evidence strongly suggests that once entrepreneurs, managers, labor, and households learn to adapt to the changes in the market system--given a well-sequenced pattern of institutional progress and price reform--they would most likely face a propitious environment for their adjustments to economic modernization. As for increasing returns to scale and imperfect competition, the new international trade theory has shown that internal and external economies of scale are frequently associated with the production of differentiated products, and with technological opportunities often related not only to investment in physical and human capital, but also to location, historical accident, talent in design, and industrial policy.[8] Under such conditions, economic advance could be achieved without a significant increase in industrial concentration and monopoly. Moreover, modernizing countries with similar levels of GNP would be expected to benefit from an expansion of trade in differentiated products and from rising levels of intra-industry trade. It is the preceding conditions, according to the new trade theory, that play a more significant role in explaining the much more rapid expansion of recent intra-industry and intra-firm trade than the mere differences in the structure of resources among nations which, according to the law of comparative advantage, explain inter-industry trade. For all countries undergoing a transition to more decentralized market economies, an application of the new theory--as well as the old--to appropriate industries and firms points to immeasurably greater opportunities than was assumed heretofore. By emphasizing more realistic economic conditions, and potentialities under truly reformed institutions and market structures, the new trade theory also reinforces an important political-economic argument: while monopoly, especially in large state-owned enterprises, can do much harm during the transition and, therefore, must be held in strict control, no less injurious is the tendency of officials in high places to use the alleged dangers of "monopoly power" or "economic scandal" as a scapegoat for ill-advised economic policies and as propaganda for retrenchment from market reforms to mandatory controls.

III. Restructuring China's Economy: The Long View

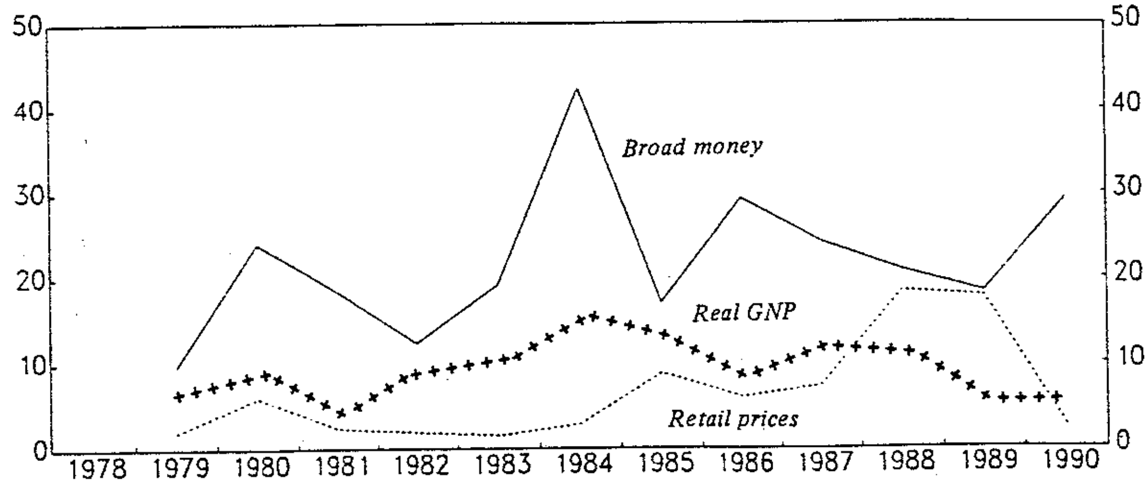
Since the government of China plans to maintain a "socialist economy," it is my purpose to apply the foregoing concepts within that context. Though there have been strong ideological and political forces impeding the organization of a national market in industry, agriculture, and commerce under socialism, the experience of China since late 1978 suggests that other sources--much more managable--have been the major stumbling blocks. It has been the difficulty in establishing and strengthening institutions indispensable for the maintenance of reasonable macroeconomic stability that has been the major factor responsible for the lack of continuity and extension of market reforms. Views to the contrary notwithstanding, from 1978 through 1990, China's agricultural reforms have been an outstanding success. Reforms in industry, banking, and finance, instituted primarily since 1983/84 have been much less successful. In all fields, however, the process of market reform has been partial and irregular, with periodic retrenchments and reversals. For the most part, this tendency has been the result of extreme fiscal and monetary instability.

From 1978 through 1990, China experienced three periods of stop-go economic fluctuations: 1979-82; 1984-86; 1986-90. Each economic fluctuation had distinguishing elements of its own; but they all pointed to a similar relationship between the respective phases of economic "overheating" and retrenchment in market reform. This phenomenon became most acute during the third economic fluctuation. As can be seen in graph 1, an inflationary situation began to develop in early 1987: the retail price index rose from 7.8 percent in the second quarter in 1987 to 26.7 percent in the fourth quarter in 1988, remaining above 21 percent through the second quarter of 1989.[9] Consumer goods prices in rural and urban areas, on the average, rose 30.3 percent in the pivotal year 1988; in that year, real GNP grew 10.8 percent, and real industrial output--including village-run industries--rose by 17.4 percent.[10] These were unsustainable growth rates, resulting from "overheating."

GRAPH 1

CHINA

Broad Money, Real GNP, and Retail Prices: 1978-1990



Sources: Chinese official data: Statistical Yearbook of China (various issues), and data provided by the Chinese authorities.

With inflation already under way, in June 1988, the authorities announced plans for a major price (rising) reform to be implemented in 1989. As should have been expected, panic buying erupted and, in major cities, during August 1988 inflation reached the level of 50 percent per annum. The ratio of import volume growth to real GNP growth rose from -0.3 percent in 1987 to 1.8 percent in 1988.[11] China's current account balance turned from $0.3 billion in 1987 to $-3.8 billion in 1988.[12] Foreign exchange reserves, which had been rising since 1986, sharply declined.[13] To deal with the crisis, the government introduced austerity measures--a program of "rectification" was announced, including the halt for about two years in price liberalization.

In the fall of 1988, state outlays began to be slashed. The People's Bank of China (which had become the country's central bank in 1984) instituted a contractionary monetary policy, primarily via a strengthening of direct credit controls. To reduce national spending and in an attempt to convert some of the "monetary overhang" into bank deposits, long-term interest rates on deposits were indexed to the rate of inflation. Indeed, all interest rates were raised; but since the prices of commodities were rising at a much steeper rate, real rates of interest remained extremely low and, at times, were negative. During 1988 the high growth of bank credit, denoted in graph 1 by broad money, continued gradually to be reduced. In effect, tighter credit rationing had been imposed for months and, in consequence of other factors as well, local authorities were short of cash to pay peasants for state grain deliveries. At first the authorities resorted to the issuance of I.O.U.s. But when the peasants complained, and reduced deliveries, the authorities instructed official brigades to collect the quota deliveries. Realizing that increasing differentials in the relatively free-market price for grain and the state delivery price would further engender evasion and profiteering, the authorities closed the grain market from the fall of 1988 until April 1989.[14] A similar phenomenon occurred in regard to the cotton market. During the periods of closure, any out movements of the commodity in question from one area to another was strictly and administratively controlled by the local authorities.

Furthermore, price controls and rationing were reinstituted on a substantial number of important commodities. In addition to the changes in grain and cotton markets, controls were generally imposed on key raw materials used for subsequent processing. Rural markets for some food products were restricted. According to Chinese authorities, the proportion of retail sales sold at market prices was lower in 1988 than it had been in 1986. As foreign exchange controls were tightened, eight products--including automobile and motorcycle parts, camera bodies, and coffee--were added to the list of items subject to import licensing. The use of preferential rates of interest for selected government investments was increased.

Invariably, since 1978, during the inflationary phase of each one of the economic fluctuations, similar tendencies have occurred. Given the prevailing, multiple-price system, extreme macroeconomic instability--particularly as it pertains to periods of inflation--has been the fundamental factor in bringing about unevenness, and occasional retrogression, in the process of China's economic reforms.

This phenomenon has occurred in both the agricultural and non-agricultural sectors. How, then, to explain the fact that, despite set backs, China's agricultural reforms have been successful, whereas the reforms in industry, banking, and commerce have been much less effective? Inter alia, the arguments presented in Section II may be applied, here, for explanation and policy formation. Consider first, the "primary agency" effect. From late 1978 through 1984, the agricultural and rural reforms progressed rapidly; the household responsibility system had been generally established and the communes virtually abolished. With the leasing of agriculture land to farm families and cooperatives for a period of 15 years, and with the freeing of markets for agricultural products in both rural and urban areas, incentives for improving agricultural activity were greatly enhanced. As regards non-agricultural activities in the rural areas, most enterprises were transferred to township organizations, which may be called (roughly) agricultural, industrial, and commercial corporations. The running of these corporations was entrusted to the townships, but most governmental functions were dispersed among the county, township, and village governments. This established a basis for the possibility of making decisions primarily on economic rather than political grounds. In technical, legal terms, land remains under the "collective ownership of peasants." Understandably, however, the "collective unit" has undergone change, and former managers of production teams in the communes have often been selected as managers of the new corporations and cooperatives. Consequently, the agricultural and industrial-rural enterprise reforms have had the effect of transferring to a large degree the decision-making power in these activities from the political arena to economic agents, providing the expected beneficial results from what we have termed the "primary agency" effect. This, however, has occurred to a much smaller degree in the urban financial and industrial sectors.

Once a serious effort is made at establishing a market mechanism, the process has a momentum of its own, with or without reforms. Nonetheless, price reforms that work in the direction of bringing relative prices of goods and services closer to relative costs of producers and to relative utilities of consumers constitute the very foundation of market reforms. The agricultural reforms of late 1978 served as a basis for the spread of limited reforms throughout the Chinese economy. They were introduced in fiscal and monetary spheres, in labor markets, in retail trade--such as small shops and enterprises, restaurants and repairs, in foreign trade and exchange rates, and above all in foreign investment and joint projects in the special economic zones.

Fundamentally, the basic Decree of December 22, 1978 drew attention to the need for halting the substitution of the Party for the Government, and of the Government for Enterprise Managers. This, however, was to be done under guidance from the top in accordance with unified state planning. But these two sets of objectives, it was soon realized, were likely to be in sharp conflict with one another. Moreover, while the Decree proposed an extreme increase in investment as a proportion of industrial output, it saw no need for any basic structural or institutional reform in the urban, industrial area.

Regarding fiscal policy, the reforms of 1978/79 had the effect of intensifying decentralization of power (a tendency that had been strengthened as a result of the Cultural Revolution), with the central government losing a substantial amount of control over the budget to provincial and local governments.[15] As a trend, from the initiation of the reforms through 1990, the central government tended to reduce its expenditures as a percent of GNP, but this was counteracted by a decline in its revenues as a percent of GNP, increasing its budget deficit and reducing its control over macroeconomic stabilization. In June 1979, reforms were announced to reduce central control over the actual operation of enterprises. In line with market reforms, the enterprises were to pay interest on borrowed funds. In return, they would be permitted to retain part of the profits and depreciation allowances that formerly went into the government budget. The latter scheme was widely adopted; but, generally, the reforms were only partially implemented. Rather than obtain much autonomy and direction over their operations, the controls of the central government were replaced by those of provincial and local governments. Indeed, the central government encouraged an increasing proportion of total fixed investment to be made at the local level, a proportion that rose from 34 percent in 1978 to 58 percent in 1981.[16] Since the enterprises could repay bank loans with pre-tax income, the provincial and local governments--as well as enterprise managers--promoted local economic expansion even at the cost of excessive salary and wage increases. This expansion raised local revenues, while further increasing central government deficits. An even more underlying impediment to long-term market reform was the central government's increasing use of differential pricing, rather than taxation and support payments, as an instrument of income distribution and welfare policy. As the government increased prices to farmers for quota-deliveries of such products as grain, meat, poultry, rice, and vegetable oils, it practically always increased subsidies to urban consumers for such daily living necessities, establishing a trend for price distortion and budgetary imbalances.[17]

Even during the first, moderate economic fluctuation of 1979-1982, there were signs that the reform in industry and finance would face much more difficult conditions than those in agriculture. While mandatory planning was slowly being dismantled, no new macroeconomic system had as yet been established to exercise its functions, and deregulation of state powers was leading to loss of fiscal and banking control. From 1979 to 1980, currency in circulation, broad money, and the retail price index surged. The real net material product declined, and the negative trade balance critically worsened.[18] By the third quarter of 1980, China was in crisis. The government imposed a deflationary policy, including a 40 percent slash in planned budget investment. Not surprisingly, the process of urban and industrial reform was brought to a halt.

At the end of 1982, with the crisis over, the government announced a series of tax reforms designed, inter alia, to improve the operation of domestic markets. The existing sales tax was retained and new taxes were introduced on: (1) fixed capital; (2) circulating capital; (3) income; and (4) profits. The tax on profits is particularly noteworthy, for it is an "adjustment tax," meant to offset the effects of distortions resulting from such factors as differential subsidies to enterprises and the lack of markets in urban land and mining property. Though these measures indicate some advance, throughout the 1980s there did not appear a systematic and comprehensive scheme for China's urban and industrial reforms.

However, in 1984, a brilliant framework for such a scheme was presented to the Chinese leaders.[19] The provisions ran along the lines of the agricultural reforms: "delegating powers and conceding interests to individuals"[20] in urban and industrial enterprises. China was to remain a planned economy, but the planning system was to be fundamentally reformed. Only major economic activities, or products, such as transport and energy, were to come under the state plan.

The rest of the economy, it was recommended, should come under a form of "guidance planning" or to be left entirely to the operation of market forces. As the distinguished economist Wu Jinglian has averred, when he was drafting the reform program--one of the nine commissioned by the State Commission for Restructuring the Economic System--he held these views: "Our target is a planned commodity economy, which is market economy under macromanagement."[21] Government departments--at any level--should not manage or operate enterprises directly. Each enterprise should be able to act as a legal person, as a relatively independent economic entity with respect to decisions on output, distribution, prices, and profits in a system of socialist commodity production. The role of government agencies, and the planning agency, was therefore to be fundamentally reduced. The price system was to be reformed, including the wage system, which should permit the incomes of staff members and workers to be related to their job performance. This, it was noted, entailed the application of the economic "responsibility system" to urban enterprise, embodying the "contract management" system whereby the government contracts out management of an enterprise, stipulating the amount of taxes to be paid and, usually, profits to be realized.

The new structure, Wu Jinglian observed, was to be based on this concept: ". . . the state regulating the market, the market guiding enterprises [guo jia tiao jie shi chang, shi chang yin dao qi ye].[22] It strongly emphasized the integration between enterprises, the market and state "macroscopic" regulation, and that reforms in these three areas must proceed "synchronously."

On October 20, 1984, the objectives of these reforms were adopted by the Communist Party of China. The document states, however, that since the party is to guarantee and supervise the implementation of the principles and policies of the party and the state, it might prove to be difficult to determine whether the local party organization, and especially the secretary is interfering with the prerogatives of the enterprise director. Unfortunately, once again, macroeconomic instability, as a result of "overheating," appeared in the fourth quarter of 1984, and the authorities decided that the time was not propitious to carry out these reforms.[23] In fact, as of the end of 1990, most of the reforms envisaged in the 1984 Decree had not been implemented.

In the field of monetary policy, which is critical to the stability of a market mechanism, the lack of efficacious reforms is to be matched by an insufficient agreement among the authorities on what the objectives of this policy should be--especially in time of conflict with other economic objectives--and by the need for clarification of its potential role in the transition from a centrally planned to a market-exchange economy. Before 1978, monetary and banking policy was merely an adjunct to state planning: the central government strictly controlled the wage bill and all capital construction projects by state enterprises. The banks turned over their deposits to the state and, in turn, requested loans from the state.[24] Since 1979, steps have been taken to strengthen monetary policy as a tool of macroeconomic stabilization. The government has made attempts to rely more on indirect instruments of control, such as setting reserve requirements by the commercial banks, influencing interest rates, determining the volume of lending by the People's Bank of China (PBC) to both the commercial banks and the specialized banks. Still, the government of China considers it essential to rely predominantly on centrally imposed credit ceilings for the management of the stock of money. As decentralization spread, the banks made loans largely at the provincial level on the basis of their own deposits. To a large degree they were permitted to make their own managerial decisions. But they often found it practically impossible to turn down loans demanded by provinces, cities, and counties; particularly on large construction projects already approved by powerful officials. Nor were they in a position to turn down loans demanded by state enterprises eager to expand or by unprofitable state enterprises threatening economic contraction and unemployment. The PBC, the commercial banks, and the specialized banks, therefore, remain significantly under political influence and control.

Within the context of national and regional output programs, however, the PBC has begun to establish annual credit plans, specifying the amount of credit that would be required by enterprises to meet both their own and the aggregate national targets. These projections include targets for broad money (mostly credit to enterprises) and for currency. Furthermore, from the second half of 1989 through 1990 the PBC played a distinct role in controlling inflation, and this has contributed to its increasing influence in the formation of monetary policy. However, the PBC has not been delegated authority to control the main monetary aggregates. It is still the State Council that maintains primary control over monetary and budgetary policy. Since budget deficits have been financed in China by a comparatively small volume of bond sales and predominantly by bank credit, the operations of the banking system are manifestly interdependent with those of budgetary policy. But to date the PBC has not been granted sufficient power to have much, if any, professionally independent influence on budgetary policy. The problem of transforming the PBC into a modern central bank still awaits government decision.

The evidence suggests that, from 1978 to 1990, variations in China's stock of broad money have been correlated with variations in GNP, industrial output, and imports. In effect, the stock of broad money has been the most significant, direct, and independent policy variable.[25] Consequently, for a reasonable dampening of macroeconomic fluctuations, more effective control of the stock of broad money is a primary requisite.

Though some reforms have been legislated in regard to labor and bankruptcy, they need to be strengthened and enforced. The labor reforms appear to have had the intention of linking earnings with productivity, but in fact earnings have been linked with the volume of work done. Indeed, state-owned enterprises have tended to link variations in earnings with seniority, male gender, and the privilege of working in these enterprises. In personal discussions with government authorities, enterprise managers, and economists during extended visits to Bejing, Shanghai, and Wuhan in 1985, 1987, and 1989, the view was often expressed that the inability to dismiss workers on grounds of inefficiency was the most important single factor in causing unprofitability in the state-owned enterprises. The combination of enforced labor redundancy and repeated government bail-outs of state enterprises have rendered the reforms in both labor and bankruptcy practically inoperative. These factors notwithstanding, increased competitive market forces have impeled many state-owned enterprises to restructure their facilities and to improve their efficiency; especially during the economic contraction of 1989/90.

IV. Timing of Reforms and Underlying Causes of Inflation

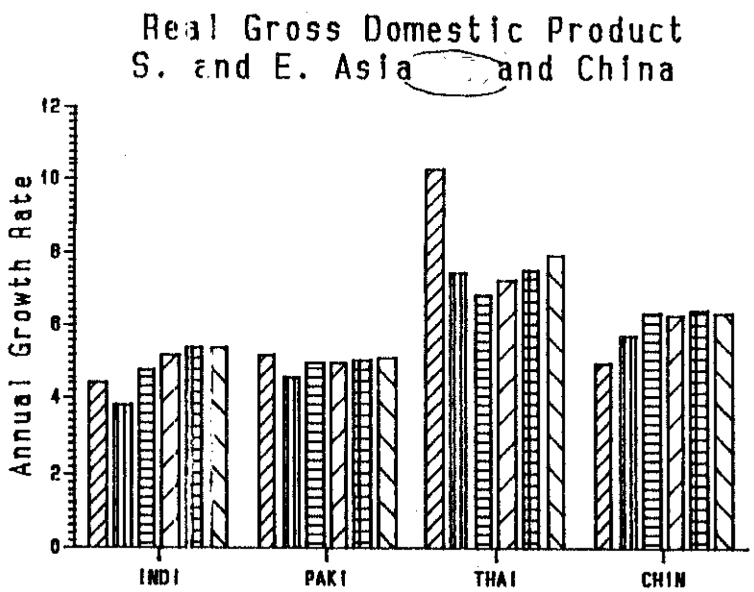
Even though no overall, consistent strategy is discernible in China's reforms during the decade of 1978-1988, which was followed by the standstill and some retrenchment in 1989/90, the objectives and direction of the reforms generally have been toward a more open market-oriented economy. The indirect and cumulative effects of the reforms on the continual extension of markets appear to have been no less significant than the reforms themselves for China's economic modernization. Jointly, they provided an energizing atmosphere within which China achieved its spectacular real GNP growth rates in the 1980s, averaging 9.23 percent per annum.

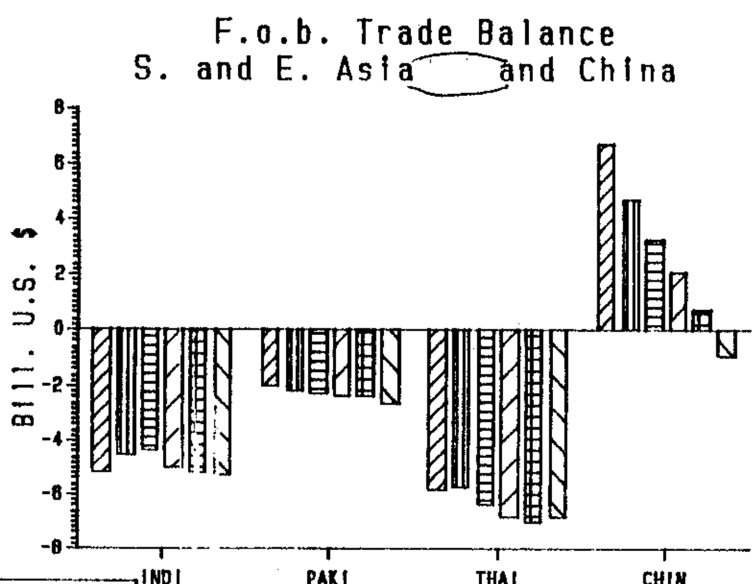
Referring mostly to Eastern Europe, particularly to Hungary and Poland, a number of economists recently have advocated that these countries should rapidly implement a set of comprehensive and consistent reforms. Otherwise, one leading writer has argued, "It will be much, much harder or simply impossible to undertake another operation."[26] This may well be the case for a number of East European countries, both on economic and political grounds. It has been rightly emphasized, however, that abrupt solutions should not be sought where one can proceed only gradually.[27] This, ~~I believe,~~ is now the situation in China. Nonetheless, as recommendations in the next section indicate, certain economic reforms need to be put into effect in China at the earliest possible time. Though these recommendations, I believe, follow directly from the arguments in the text, they are strengthened by a brief explanation of the manyfold causes of current stop-go inflations in China.

Thus, after the sharp decline in real GNP growth from 10.8 percent in 1988 to 3.6 percent in 1989, the authorities stabilized the economy and a turn-around occurred in the fourth quarter of 1990. As is shown in Diagram 1, for the entire year 1990, real GNP grew by 5.0 percent and the rate of inflation was reduced to 4.0 percent. But the economic projections of the Link-United Nations' model for the period 1991-1995 are for lower growth rates than in the 1980s and for inflation at about 10 percent per annum, with a deteriorating trend in the trade balance. If these projections prove correct, it probably would become even more difficult to achieve consistent and accelerating reforms. At the time of writing, on an annual basis, the first quarter of 1991 already has recorded a real GNP growth rate of 6.0 percent and a rising rate of inflation above 6.0 percent per annum. If reforms are not introduced to alleviate macroeconomic instability, we may again witness volatile economic fluctuations with their injurious inflationary effects.

The causes of China's recent inflations have been manyfold and complex. Cost-push inflation, brought about by continually rising wages and salaries--accompanied by decapitalization of state-owned enterprises--has, as

DIAGRAM 1





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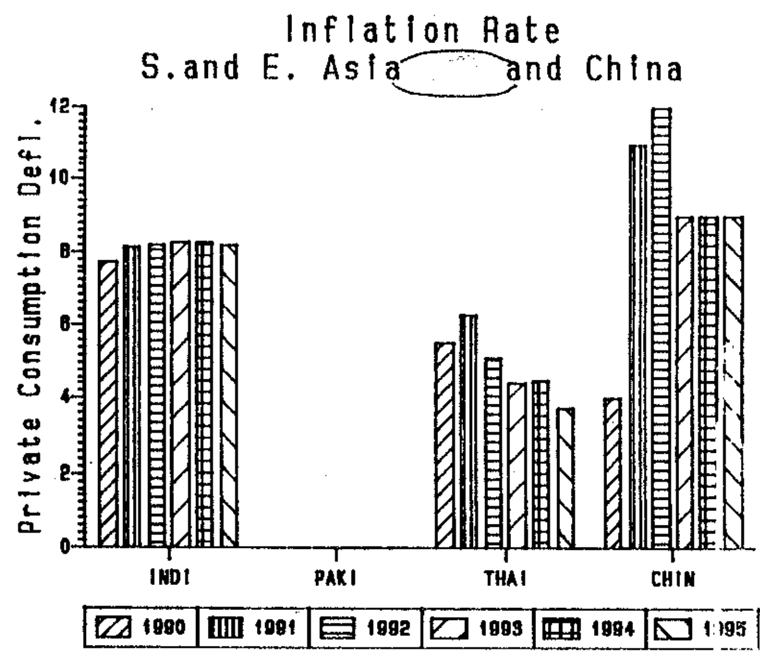


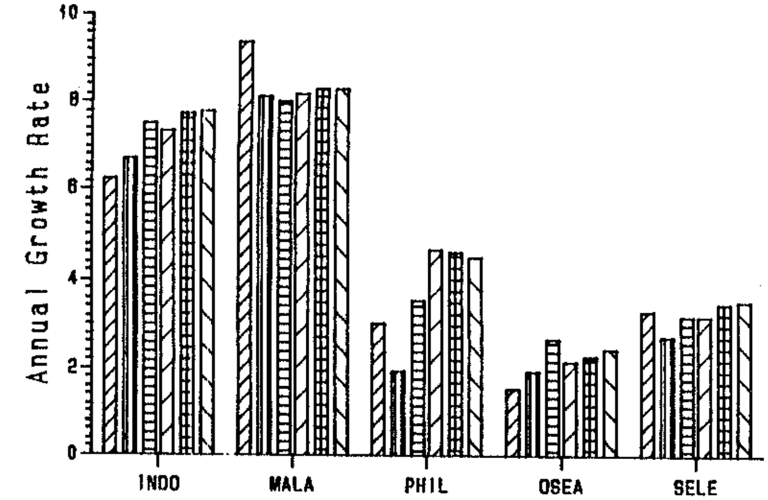
REAL GDP, INFLATION RATE AND TRADE BALANCE

		1990	1991	1992	1993	1994	1995
INDIA							
GDP REAL	PCT.	4.4	3.8	4.8	5.2	5.4	5.4
INFLATION	PCT.	7.7	8.1	8.2	8.2	8.2	8.2
TRADE BAL.	B.US$	-5.1	-4.5	-4.4	-5.0	-5.2	-5.3
PAKISTAN							
GDP REAL	PCT.	5.2	4.6	5.0	5.0	5.1	5.1
INFLATION	PCT.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
TRADE BAL.	B.US$	-2.0	-2.2	-2.2	-2.4	-2.4	-2.7
THAILAND							
GDP REAL	PCT.	10.3	7.5	6.8	7.2	7.5	7.9
INFLATION	PCT.	5.5	6.3	5.1	4.4	4.5	3.7
TRADE BAL.	B.US$	-5.8	-5.7	-6.3	-6.8	-7.0	-6.8
CHINA							
GDP REAL	PCT.	5.0	5.7	6.3	6.3	6.4	6.4
INFLATION	PCT.	4.0	11.0	12.0	9.0	9.0	9.0
TRADE BAL.	B.US$	6.7	4.7	3.3	2.1	0.7	-0.9

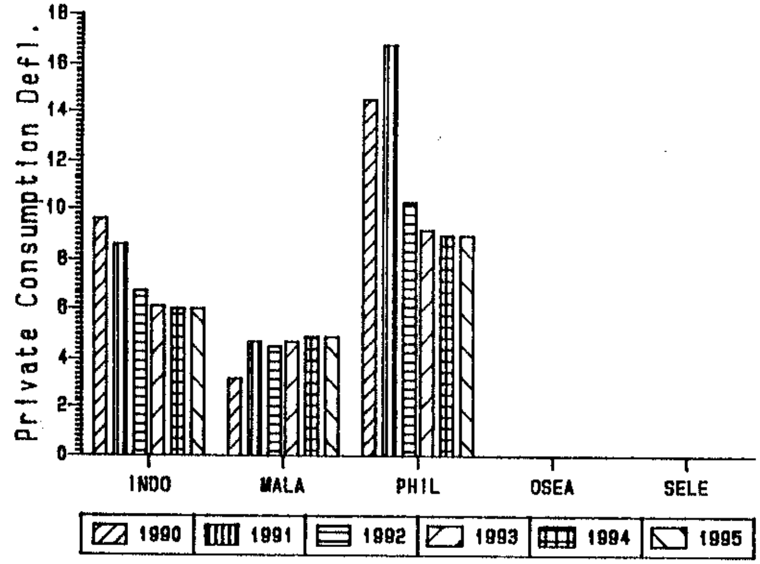
Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by the regional commissions, Project LINK and other sources (8 March 1991).

DIAGRAM 2

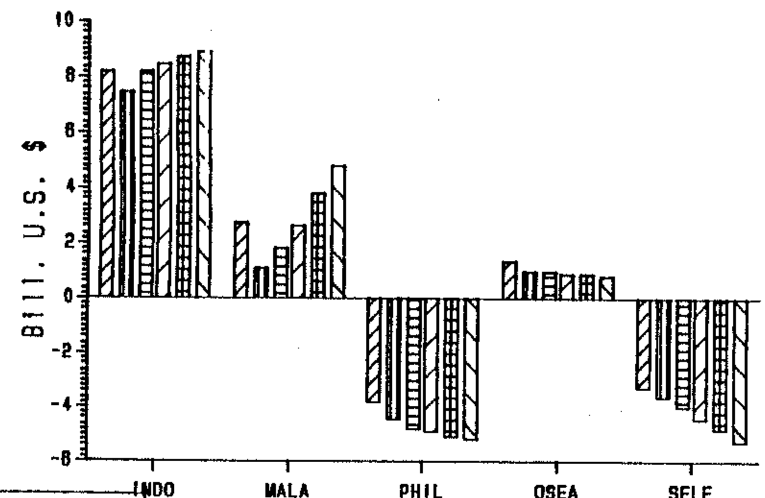
Real Gross Domestic Product
S. and E. Asia



Inflation Rate
S. and E. Asia



F.o.b. Trade Balance
S. and E. Asia



Project LINK
UN/DIESA.

REAL GDP, INFLATION RATE AND TRADE BALANCE

		1990	1991	1992	1993	1994	1995
INDONESIA							
GDP REAL	PCT.	6.2	6.7	7.5	7.4	7.7	7.8
INFLATION	PCT.	9.6	8.6	6.7	6.1	6.0	6.0
TRADE BAL.	B.US$	8.2	7.4	8.2	8.5	8.7	8.9
MALAYSIA							
GDP REAL	PCT.	9.4	8.1	8.0	8.2	8.3	8.3
INFLATION	PCT.	3.2	4.7	4.5	4.7	4.9	4.9
TRADE BAL.	B.US$	2.7	1.1	1.8	2.6	3.8	4.8
PHILIPPINES							
GDP REAL	PCT.	3.0	1.9	3.5	4.6	4.6	4.5
INFLATION	PCT.	14.5	16.8	10.3	9.2	9.0	9.0
TRADE BAL.	B.US$	-3.8	-4.5	-4.8	-4.9	-5.1	-5.2
OTHER S.E. ASIA							
GDP REAL	PCT.	1.5	1.9	2.7	2.2	2.3	2.4
INFLATION	PCT.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
TRADE BAL.	B.US$	1.4	1.0	1.0	0.9	0.9	0.8
S.E. ASIA LEAST DEV.							
GDP REAL	PCT.	3.3	2.7	3.2	3.2	3.5	3.5
INFLATION	PCT.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
TRADE BAL.	B.US$	-3.3	-3.7	-4.0	-4.4	-4.[illegible]	-5.3

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on data provided by the regional commissions, Project LINK and other sources (8 March 1991).

Definition of aggregates:

North America:
   Canada, U.S.A.
Developed East:
   Japan, Australia, New Zealand.
EEC:
   Belgium/Luxemburg, Denmark, France, Germany (F.R.), Greece,
   Ireland, Italy, Netherlands, Portugal, Spain, U.K.
Rest of Industrialized:
   Austria, Iceland, Finland, Norway, Sweden, Switzerland,
   South Africa. Israel
Latin America and Caribbean:
   Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador,
   Mexico
   Paraguay, Peru, Uruguay, Venezuela, Caribbean.
Africa:
   Algeria, Egypt, Ethiopia, Gabon, Ghana, Kenya, Libya,
   Morocco, Nigeria, Sudan, Tunisia, Other African Countries,
   Africa Least Developed Countries.
North Africa:
   Algeria, Egypt, Libya, Morocco, Tunisia
Sub-Sahara Africa:
   Ethiopia, Nigeria, Sudan, Gabon, Ghana, Kenya.
   Other Africa Countries, Africa Least Developed Countries.
South and East Asia:
   Hong Kong, Indonesia, Korea, Malaysia, Philippines,
   Singopore,Taiwan province, Thailand, India, Pakistan,
   South East Least Developed,
   Other South Asian Countries.
West Asia:
   Iran, Iraq, Kuwait, Saudi Arabia,
   West Asia Oil Importers.
Mediterranean:
   Cyprus, Malta, Turkey, Yugoslavia.
Eastern Europe and USSR:
   Bulgaria, Czechoslovakia, Germany (G.D.R.), Hungary,
   Poland, Romania, U.S.S.R.
Energy export countries and regions
   Bolivia, Ecuador, Mexico, Peru, Venezuela, Algeria, Gabon
   Libya, Nigeria, Egypt, Tunisia, Iran, Iraq, Kuwait
   Saudi Arabia, OWAO, Indonesia, Malasia, China
Energy import countries and regions
   Argentina, Brazil, Chile, Paraguay, Uruguay, Caribbean.
   Colombia, Ethiopia, Ghana, Kenya, Morocco, Sudan
   Other African Countries, Africa Least Developed Countries
   WAOI, Hong Kong, Korea, Philippines,
   Singopore,Taiwan province, Thailand, India, Pakistan,
   South East Least Developed,
   Other South Asian Countries.
   Cyprus, Malta, Turkey, Yugoslavia.

Note1: Regions are defined in the respective country tables.
Note2: In the trade aggregation table, the SITC 3 exports of WAOI has been moved from the Energy import group to the Energy export group

noted, definitely occurred. This, however, has not been a primary cause of China's contemporary inflations. At present, demand-pull inflation is a much more important explanatory cause. The two forces often have been interdependent, intensified by other price-raising phenomena. In particular, a substantial number of provincial governments have failed to meet their financial obligations to the state, skimming funds from enterprises under their control with the result of larger state deficits all financed by the PBC. As for the central government, it has encouraged an excessively high proportion of large-scale investment as a proportion of GNP. This has tended to raise the flow of earnings and effective demand in the capital accumulation industry relative to the supply of many consumer goods.

In addition, banking reforms have enabled state-owned enterprises to use their bank deposits quite freely, whereas before the reforms they were frozen by the state. In consequence, the monetary overhang has increased, and when price controls were removed in certain sectors, effective demand has--at least on several occasions--intensified the open inflation. For the most part, the monetary overhang has been the legacy of pre-reform repressed inflation. In toto, the reforms themselves were neither the cause of macroeconomic instability nor a significant, quantitative factor in the periodic inflations. They enabled essential price adjustments to occur, albeit with occasional large price increases of specific commodities.

In the field of foreign trade, essential devaluations of the overvalued renminbi have tended to raise the domestic price of imports, as have occasional external price shocks of significant importables. These one-time price adjustments have been necessary. With the exception of underlying and continuous cost-raising factors that have been permitted to become embedded in the price structure, the noncontinuous price-raising effects cannot correctly be considered as causes of inflation: for they could not prevail, in the long term, unless supported by credit creation of the Central Bank. Nonetheless, most of the preceding discontinuous price-raising factors have had the effect of seriously distorting the price structure, hindering the operation of market reforms. Therefore, a long view of China's transformation to a freer, market-oriented economy would appear to call for the following reforms.

V. Recommended Reforms

(1) The process of budget formation requires urgent reform. Concrete steps must be taken to bring greater order to fiscal relations between the central government and the provinces. To a substantial degree, when measured in terms of the definitions contained in the IMF, Manual on Government Financial Statistics (1986), recent large budget deficits and their fluctuations have been the result of decentralization, with the consequence of provincial governments failing to meet their financial obligations to the center. Institutionalized, annual meetings are needed between China's minister of finance and the provincial finance ministers to recommend ways and means of rectifying this problem. At present, there is unnecessary uncertainty in regard to the periodic meetings that are held and the principles upon which decisions are made. Equity, efficiency, uniformity, and simplicity are hallmarks of a modern, federal fiscal system. Equity demands that the

provinces contribute for general state services on the basis of the size of people's income and the profits of state and private enterprises. Efficiency denotes payment for specific services on the basis of cost. Uniformity means the same tax paid for the same adjusted income or profit. And simplicity implies that the formula used be as clear and uncomplicated as possible, for the greater the complexity, the more loopholes, special pleading, and political abuse. These criteria should form the bases for the required fiscal reforms.

(2) At the central level, consideration should be given to the establishment of a National Budget Office, the function of which would be to prepare estimates under the most likely assumptions of the federal government's expenditure and revenue for the forthcoming fiscal year. The chairman of this office should be appointed by the president and confirmed by the National People's Congress. The objective is to have a professional and, as much as possible, non-political organ providing objective analysis on which budgetary deliberations could be based. Annually, the National Budget Office would have the responsibility to present and appraise its budget projections to the National People's Congress. At the central level, consideration also should be given to the passage of legislation capping government expenditure and reducing the budget deficit in a specified period of time. The imposition of penalties may be required, including the stoppage of practices--especially in state-owned enterprises--that are contrary to the government's economic objectives, such as excessive salary and wage settlements at the comparative expense of the central government's collection of revenue. Among the highest priorities must be the continued restructuring of the national revenue service into a highly

respected agency functioning under the aforementioned principles, with the aim of minimizing the practice of negotiating and bargaining about taxes with state-owned enterprises.[28]

(3) Central Bank management must be brought under strict control, preferably through the revision of existing legislation. Under present conditions, it appears that independence of the PBC is not a realistic alternative. It is therefore important to establish procedures whereby the State Council and the PBC agree on a range within which the central bank would endeavor to maintain the rate of growth of broad money and currency in circulation. The governor of the PBC would then be obliged, under law, to deliver a report, biannually, to the National People's Congress explaining and appraising the objectives and performance of the country's monetary and banking policies. The experience of other countries suggests that a large and regionally complex country such as China would benefit from the development of regional or provincial central banks operating under the aegis of the board of governors of the PBC. No

matter what the form of arrangements might be, and even though all central banks must at times reach a compromise between internal and external objectives, generally the major responsibility of the central bank should be the maintenance of a reasonably stable wholesale price level. At present, the PBC does not have sufficient control over the specialized banks, the universal banks, or the rural credit cooperatives to achieve this objective. The PBC, furthermore, should be delegated more control over the use of foreign exchange reserves, which are now too widely dispersed. As it gains experience and a record of accomplishment, the interests of China would be well served by increasing the independence of the central bank. Reform in this sphere along the more detailed lines discussed in the text could be put into effect in the very short term.

(4) Since the success of market reforms are fundamentally dependent upon price reforms, in turn, dependent upon the effective operation of relative prices, a long view demands the reform of China's subsidy schemes. As a percent of total government expenditure, they have grown so large that urban consumers and industrial state-owned enterprises have become dependent upon them to an extent which, for political and economic reasons, renders it unfeasible for the government to eliminate them rapidly. A long view, however, calls for their systematic and steadfast reduction with the aim of their virtual removal in the medium term, say 3-5 years. If necessary, they should be replaced by an improved system of taxation, moderate indexation, and/or welfare payments. This is indispensable for rendering market reforms more effective and for meeting the GATT rules.

(5) China's successful reforms in agriculture and rural industrial enterprises need to be reinforced and adapted to the rest of the economy. The reinforcement applies to strengthening, under law, the validity, clarity, and guarantee of the "property rights" of farm people and collectives in regard to the farm land that has been leased to them. In terms of what we have called the "primary agency" effect, to date the available evidence shows that in most fields, whenever management could operate under economic incentives, the results have met with reasonable success. Reforms, therefore, should be considered for the privatization of the relatively small state-owned enterprises. This could be done quite rapidly.

(6) As for large state-owned enterprises, consistent with socialist "property rights," the government should consider the establishment of holding companies--responsible to the National People's Congress--which would have the responsibility of appointing the directors of the enterprises who, in turn, would operate the enterprises on strictly economic grounds. The holding companies would exert state "property rights" through the boards of directors of the individual enterprises: these boards would be directly responsible for setting enterprise policies, monitoring performance, hiring and, as necessary, dismissing enterprise managers. The managers would be responsible for the day-to-day management of the enterprise, including the power to determine the organization of production; to negotiate and/or to set the offered price and composition of output; to hire, reward, or dismiss workers; and to manage the enterprise's finances. To insulate holding companies from political pressures, it would be essential to establish very strong management incentives at both the individual enterprise and holding company

levels tied to the medium-term success of their companies. Many of the large state-owned enterprises have considerable monopoly power. In a large number of cases, the efficiency of these enterprises could be greatly increased through reorganization. For a time, the present directors, and their key staff, would remain as the entrepreneurial "hub" of these enterprises, but distinct production and distribution divisions within each enterprise should be restructured as subsidiaries, with the most competent manager in question appointed as an associate director. In time, the subsidiaries should become independent enterprises and the associate directors promoted to the rank of director. While there appears to be a substantial number of managers capable of undertaking this task, a serious shortage of trained and experienced managers will long prevail. The importance of continuity in maintaining already established management-training facilities and, indeed, of their expansion has failed to receive adequate attention by both the Chinese authorities and by their Western sponsors. The major thrust of the recommendations in this section, however, are based on the view that, whatever their ownership--be it socialist or capitalist--enterprises will respond to market forces and to the pressures of competition only if their "owners" and managers are truly held responsible for the financial results of their decisions. [29]

(7) Since the assumptions of neo-classical market analysis are in many respects not relevant to the process of transformation toward a market economy, reforms are required to reduce failures and to mitigate injurious effects of transition. The universal, specialized, and cooperative banks of China must be put on a solid commercial basis. They have had no choice but to make many loans on political considerations, inevitably resulting in extremely weak balance sheets. Such loans should be taken over by a government agency and, wherever necessary, they should be rescheduled. Thereafter, the banks should be held responsible for making their decisions strictly on economic grounds. It is extremely important that the rate of interest be increasingly determined by market forces: for, otherwise, the allocation of funds among regions and enterprises will continue to be rationed, with non-economic factors distorting the decision-making process.

(8) The transition toward a market economy requires new legislation on monopoly practices, patent law, commercial and corporate law, insurance, and the settlement of national and international commercial disputes. While substantial progress has already been made, an enlarged investment in education and training in these fields is now indispensable.[30]

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(9) The establishment of a safety net for the labor force in non-agricultural employment in the form of legislation covering unemployment insurance, health insurance, and retirement pensions is essential. Economic fluctuations have been, and will continue to be, an inherent aspect of a market economy. According to official estimates, approximately 75 percent of sales in China are at present conducted via "market forces." The further reduction of price controls and other market impediments are likely to continue; the process has reached a momentum too costly to reverse. Experience has shown, however, that the negative aspects of market forces--especially mass unemployment--can bring about disillusionment and serious hardship. If these are to be reduced, and the transition to a freer market system accelerated, legislation for the preceding safety net must be implemented not only on humanitarian grounds but also to render it possible for the state-owned enterprises, in particular, to improve their productivity growth. This follows from the fact that inefficiency of the large state-owned enterprises is now primarily the result of their inability to fire incompetent workers. They will be unable to overcome this dilemma unless the requisite insurance schemes are put into effect. This kind of legislation is long overdue.

(10) Another safety net is required with respect to bankruptcy. The present procedures are ineffective either to impel endemic money-losing enterprises from being shut down, or to protect occasional unprofitable enterprises from unwarranted destruction. Strengthened and enforced bankruptcy legislation could play a significant role in the restructuring and modernizing of a substantial number of viable state-owned enterprises.

(11) A market-oriented economy cannot function satisfactorily with an inconvertible currency. Formidable as this task is in practice, there are at least the following reasons why step-by-step measures should be taken as expeditiously as possible in moving toward commercial convertibility, then to balance-of-payments convertibility, and finally to full convertibility for all transactions for people and enterprises. In a world of reasonable price stability, as may be expected for the 1990s, a convertible currency that would remain quite stable over time would serve the purpose of integrating China's domestic price level and relative price structures of tradable goods with those of the international economy. No better price signals exist for China's economy. Further, movement toward greater degrees of convertibility is a trial and error process, a result of which is the interdependent determination of a country's dynamic comparative advantage. The greater the permissible retention of foreign exchange by exporters, and by domestic firms earning foreign exchange, the larger the degree to which imports would enter the country on comparative efficiency grounds. No less important, as the recent experience of the European Monetary System has shown, is that maintenanc of a quite stable, convertible currency has the byproduct of enforcing budgetary and monetary discipline, thereby keeping in check excessive fluctuations in the trade balance as a percent of GNP. For similar reasons, it helps to improve a country's international competitiveness. A convertible renminbi would play a key role in promoting the establishment of foreign firms in China. Even with the progress already made toward commercial convertibility--under the regulations governing operations of the approximately 100 swap centers located throughout the country--foreign firms are still inhibited from

establishing and expanding their operations in China unless they can be assured of a greater degree of foreign exchange transfers. In many cases, the enlargement of such domestic sales is a necessary condition for foreign firms to expand investments in plant and equipment in China. ¶ There is probably no single factor in international economics that can play a greater role in raising the quality of manufactures in China, as well as its more general modernization, than foreign investment which is carefully conceived, planned, and executed. These arguments, moreover, apply powerfully to increasing convertibility of the renminbi for the expansion of joint projects. These projects have the additional advantage of expanding "property rights" for foreign enterprises engaged in specified activities in China, which the authorities have recently encouraged. Hence, this would serve the purpose of extending "property rights" under China law. The more successful China's economic development, and the higher the growth in per capita income, the larger will be its foreign trade and investment. The enhanced opening of China to world trade and finance is bound to entail an expansion in official, business, and private travel, as well as public and private investment abroad. Hence, for the longer term, a combination of full convertibility and freer commercial and investment policies is most likely to accelerate China's per capita economic growth and welfare. However, a sequential expansion of convertibility can only be established successfully on the foundation of improved budgetary and monetary stability. The task is great, but not greater than the need: for the requisite budgetary and monetary policies could be established within an approximate period of three years; and with sufficient cooperation between China and the IMF, the achievement of "full convertibility" during a period of three to five years -- with surveillance and, if need be, control of capital movements -- is not an unreasonable goal.

VI. Conclusions

These recommendations do not appear to be inconsistent with the present economic objectives of the government of China. If implemented, their effects would be immensely enhanced by a reasonably assured international economic environment of equality of treatment, based on the most-favored-nation clause. There is no need to belabor the point, however, that this condition will increasingly depend on political as well as economic factors in China and in the world economy.

The distribution of China's foreign trade is widely dispersed.[31] China's strong export performance in recent years has been significantly associated with the growth of domestic production and exports of foreign owned and/or joint-venture enterprises, which have been established in the special economic zones and areas.[32] Indeed, China is planning to develop impressive new economic and technological zones that are to be constructed over a span of 30-40 years, with a multi-billion dollar infrastructure projected to be financed by the central government, domestic bank loans, and foreign capital. This initiative is part of a new policy, under the Eighth Development Plan, to diversify geographically the process of economic development by pursuing more concentrated regional development programs in the 1990s.

Clearly, the success of this policy will be impossible in isolation from the outside world. Recent experience in Japan, the European Community, and the United States indicates that their assistance via freer commercial and investment policies toward China will be dependent upon China's further progress toward a market-oriented economy and, particularly, upon freer political developments at home. Current geopolitical events in the world economy would appear to render such developments in China most appropriate. However, a growing conflict of interest among nations to obtain capital from abroad may develop into a stark fact of the 1990s. On a world scale, the propensity to invest more than to save will probably be intensified by the increased demand for capital to restructure eastern Germany, to assist in the momentous transformations of Eastern Europe and of the U.S.S.R., and to reconstruct Kuwait and Iraq. These factors, especially in conjunction with China's expressed interest in participating to a larger degree in world financial, investment, and trading institutions manifestly should increase her interest in further developing a compatible and freer market-oriented economy.

The consistency of the arguments presented in this article, however, may depend, indirectly, on the validity of a view expressed by Wu Jinglian, who wrote: "The principle 'no one is above the law' in civil law is based on the equality established in the commodity market."[33] A long view regarding China's transformation toward a full-fledged market economy favors this outlook. But whether a communist economy, such as that of China, is reformable under legislative processes into a market economy with democratic pluralistic institutions is a seriously questionable issue. Nonetheless, if the arguments and recommendations presented herein are reasonably correct, the conclusions would appear to be consistent with either legislative or revolutionary change: for the requisite reforms and a freer market would serve not only as a means to economic efficiency and modernization, but also as definitive long-term goals of democracy.

NOTES

1. For a select bibliography of books, articles, and documents I found useful in preparing this paper, see Bibliography, pp.40-44.

2. See Leonid Hurwicz, "The Price Mechanism, Decentralization, and Incentives,"

3. Ibid.

4. The issue here discussed applies in many forms to the organization of state enterprises during the transition to a market system. To my knowledge, every country has experienced these serious phenomena. For a recent extended discussion, see Janos Kornai, <u>The Road to a Free Economy: Shifting From a Socialist System, The Example of Hungary</u> (New York: W. W. Norton, 1991), pp. 34-101, and sources cited on pp. 213-217. Cf. also Kornai's <u>Contradictions and Dilemmas: Studies on the Socialist Economy and Society</u> (Cambridge, MA: MIT Press, 1986); David Lipton and Jeffrey Sachs, "Creating a Market Economy in Eastern Europe: The Case of Poland," 1990 <u>Brookings Papers on Economic Activity</u>, vol. 1, pp. 75-133.

5. In the United States, for the postwar period, the time has been approximately one year.

6. Regarding the difficult experience of Germany's reunification, the Bundesbank has noted: "The abrupt change in the system brought to light underlying structural shortcomings in performance and competitive weaknesses of the old regime on a scale that had not generally been expected." See "Promoting Economic Activity in the New Länder," Monthly Report of the Deutsche Bundesbank, vol. 43, no. 3 (March 1991), p. 15; Helmut Schlesinger, "European Monetary Restructuring and its Implications for Interest Rate and Exchange Rate Policies," contained in this Symposium; and Wilhelm Nölling, <u>Geld und die deutsche Vereinigung</u> (Hamburg, Juli 1991). See also George A. Akerlof, Andrew K. Rose, Janet L. Yellen, and Helga Hessenius, "East Germany in From the Cold: The Economic Aftermath of Currency Reform,"

Brookings Papers on Economic Activity, vol. 1, 1991, pp. 1-87; for a critical appraisal of the policy recommendations, however, see the "Comments" by Rudiger Dornbusch, pp. 88-92; Manuel Guitian, pp. 92-98; and the "General Discussions," pp. 98-101. Useful references to the English and German literature are provided on pp. 102-105.

7. See Theodore W. Schultz, Investing in People: The Economics of Population Quality (Berkeley: University of California Press, 1981), especially chapters 2, 3, 6, and 7; and the related discussions consistent with these views in Restoring Economic Equilibrium: Human Capital and the Modernizing Economy (New York: Basil Blackwell, 1990), chapters 8 and 16.

For an incisive review of the recent literature on economic development, containing complementary arguements to those in the text, see Albert Fishlow, "Review of Handbook of Development Economics," Journal of Economic Literature (forthcoming, December 1991).

8. The locus classicus of the new international trade theory is Elhanan Helpman and Paul Krugman, Market Structure and Foreign Trade: Increasing Returns, Imperfect Competition, and the International Economy (Cambridge, MA: MIT Press, 1985). For formal contributions on issues ranging from gains-from-trade theories with increasing returns to scale to economic growth and terms of trade under imperfect competition, as well as welfare analysis of factor movements and of protection under such conditions, see the papers in Monopolistic Competition and International Trade, edited by Henryk Kierzkowski (Oxford: Clarendon Press, 1984). Recent research on the causal relations between industrial organization and international trade is reviewed by Paul Krugman, "Imperfect Competition, Increasing Returns, and Differentiated Products in International Trade," in John M. Letiche, ed., International Economic Policies and Their Theoretical Foundations (New York: Academic Press, 2nd edition, 1991), chapter 27.

9. People's Bank of China.

10. State Statistical Bureau and data provided by the Chinese authorities.

11. This is the percent of change in constant dollar imports divided by the percent of change in real GNP.

12. State Administration of Exchange Control.

13. Ibid.

14. For a discussion and sources on this issue, see D. Gale Johnson, The People's Republic of China: 1978-1990 (San Francisco: International Center for Economic Growth, 1990), pp. 97-100.

15. For a careful, extended discussion, see M. I. Blejer and Gyorgy Szapary, "The Evolving Role of Fiscal Policy in Centrally Planned Economies Under Reform: The Case of China," IMF Working Paper No. WP/89/26; M. I. Blejer, D. Burton, S. Dunaway, and G. Szapary, "China: Economic Reform and Macroeconomic Management," IMF Occasional Paper (forthcoming), 1991; "China: Macroeconomic Stability and Industrial Growth Under Decentralized Socialism," IMF Report No. 7483 (3 vols.), 1989.

16. Barry Naughton, "False Starts and Second Wind: Financial Reforms in China's Industrial Systems," in The Political Economy of Reform in Post-Mao China, ed. Elizabeth J. Perry and Christine Wong (Cambridge, MA: Council on East Asian Studies of Harvard University, 1985), p. 229.

17. As a percent of total government expenditures, China's total subsidy schemes have grown extremely large, constituting 27.9 percent of the total government expenditures in 1990. According to the Budget Data, in 1990 the total subsidies comprised 6.4 percent of China's GNP: subsidies on daily living necessities equalled 2.4 percent of GNP, and those covering operating losses of enterprises, 3.9 percent. Data provided by Ministry of Finance and State Statistical Bureau.

18. China Statistical Yearbook, 1989; The People's Bank of China; and data provided by the Chinese authorities.

19. The framework and historical background have incisively been presented by Wu Jinglian; see National Technical Information Service, Department of Commerce, Springfield, VA, Daily Report: China, FBIS-CHI-88-221, 16 November 1988, pp. 45-49.

20. Ibid., p. 46.

21. Ibid., p. 45

22. Ibid., p. 47.

23. Near the end of 1984, Wu Jinglian writes, abnormal conditions appeared, "There were enormous money supplies in all four quarters of the year and extremely unstable price levels. The conclusions drawn in early 1985 were: loss of macrocontrol, total amount control, and investment and consumption control. February saw the strengthening of macrocontrol to dampen the heat." Ibid., p. 46.

24. One objective was to keep bank deposits of state enterprises frozen, and thereby prevent inflation.

25. This conclusion is consistent with statistical tests for "Granger Causality" conducted by M. Bell, H. Khor, B. Stuart, and F. Montes-Negret of the IMF and IBRD, as well as with the work done by David Burton and Jiming Ha, "Economic Reform and the Demand for Money in China," IMF Working Paper No. WP/90/42, 1990.

26. Janos Kornai, The Road to A Free Economy: Shifting From a Socialist System, The Example of Hungary (New York: W.W. Norton, 1990), p. 195; see also pp. 159, 178.

27. Ibid., p. 33.

28. For relevant experience of foreign countries, see Daphne A. Kenyon and John Kincaid, Competition Among States and Federal Governments (Washington, D.C.: The Urban Institute, forthcoming 1991); George F. Break, Financing Government in a Federal System (Washington, D.C.: Brookings Institution, 1980); and Richard M. Bird, Financing Canadian Government (Toronto: Canadian Tax Foundation, 1979) vol. 1, and Federal Finance in Comparative Perspective, vol. 5, 1986. (Includes studies on Austria, Australia, Germany, Switzerland, and the United States.)

29. The practical details, of course, can be adapted to the environment of the country. Shares of stock, for example, could be issued to the holding company representing the government, to banks, and to employees of the enterprise on a 50 percent, 25 percent, and 25 percent basis, respectively. For a discussion of these issues, see the study by the managing director of the IMF, the president of the I.B.R.D., the secretary general of the OECD, and the designated president of the E.B.R.D., in the International Monetary Fund publication, The Economy of the U.S.S.R.: Summary and Recommendations (December 19, 1990), esp. p. 28; David Lipton and Jeffrey Sachs, "Privatization in Eastern Europe: The Case of Poland," Brookings papers on Economic Activity, vol. 2, 1990, esp. the discussion on "The Debate Over the Pace of Privatization" and on "A Strategy for Privatization," pp. 296-327, and the Comments by Lawrence H. Summers, who wrote: ". . . the whole privatization area is fraught with uncertainty. At least from an economic standpoint there is little to be gained and much that could be lost by the state giving up its ownership claims too quickly." p. 337.

30. For expert papers on these issues, see the study prepared by Eileen Feibus for the New York Stock Exchange, U.S.S.R./NYSE Seminar, Moscow, October 8-10, 1990.

31. See Appendix Table 1 and Table 2., where it is shown that, in 1989, 35.1 percent of China's exports was directed to industrial countries, of which 15.8 percent was sold to Japan, 8.3 percent to the European Community, and 7.7 percent to the United States. China's exports to the developing countries constituted 58.1 percent of its total exports, of which 42.5 percent went to Hong Kong. As regards China's imports, 50.9 percent came from the industrial countries; 17.3 percent from Japan, 12.8 percent from the European Community, and 11.9 percent from the United States. China imported 40.6 percent of its total imports form the developing countries: 33 percent from Asia, of which 23.7 percent came from Hong Kong, with the remainder dispersed throughout the world.

32. In the first half of 1990, exports of foreign enterprises rose by over 100 percent, accounting for 50 percent of the overall growth in China's exports (based on discussions with Chinese government authorities).

33. Daily Report: China, National Technical Information Service, Department of Commerce, Springfield, VA, SBIS-CHI-88-221, 16 November 1988, p. 48.

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TABLE 1. China: Direction of Trade, 1985-1989

(*In percent of total*)

	1985	1986	1987	1988	1989
Exports					
Industrial countries	41.8	40.2	37.0	36.7	35.1
Of which: United States	8.5	8.4	7.7	7.1	7.7
Canada	0.9	1.0	1.0	0.8	0.7
Japan	22.3	16.2	16.2	16.9	15.8
France	0.8	1.0	1.1	1.1	1.0
(Former) Germany, Fed. Rep. of	2.7	3.2	3.1	3.1	3.0
Netherlands	1.2	1.5	1.5	1.6	1.4
Italy	1.1	1.2	1.4	1.6	1.3
United Kingdom	1.3	4.6	1.3	1.4	1.2
Switzerland	0.6	0.6	0.5	0.4	0.4
Developing countries and areas	51.7	53.1	57.3	57.3	58.1
Africa	1.5	1.8	3.1	3.4	1.1
Asia	39.2	40.2	43.6	46.9	51.9
Of which: Hong Kong	26.2	31.2	34.9	38.3	42.5
Macao	0.9	1.0	1.1	0.9	0.9
Singapore	7.5	3.9	3.4	3.1	3.2
Europe	2.7	3.2	2.9	2.1	1.9
Of which: Romania	1.0	0.8	1.0	0.7	0.5
Middle East	6.5	6.7	6.7	4.4	2.6
Of which: Jordan	3.6	3.3	3.4	1.5	0.6
Western Hemisphere	1.8	1.2	1.0	0.5	0.6
Of which: Brazil	1.6	0.8	0.6	0.2	0.1
Countries other than IMF members	6.5	6.7	5.6	5.8	5.9
Of which: Korea, Dem. People's Rep.	0.9	0.8	0.7	0.7	0.7
U.S.S.R.	3.8	3.9	3.2	3.1	3.3
Memorandum item:					
Oil exporting countries	2.6	2.4	2.5	2.6	2.2
Imports					
Industrial countries	70.4	66.9	61.3	55.2	50.9
Of which: United States	12.2	10.9	11.2	12.0	11.9
Canada	2.7	2.3	3.2	3.4	1.6
Australia	2.6	3.2	3.1	2.0	2.3
Japan	35.7	28.8	23.3	20.0	17.3
France	1.7	1.7	2.1	1.8	2.4
(Former) Germany, Fed. Rep. of	5.8	8.4	7.2	6.2	5.6
Italy	2.1	2.6	2.9	2.8	3.0
United Kingdom	1.8	2.4	2.1	1.6	1.8
Switzerland	0.7	1.2	1.2	0.9	0.8
Developing countries and areas	25.0	27.1	32.1	36.0	40.6
Africa	0.7	0.6	0.4	0.4	0.6
Asia	16.7	19.0	25.3	28.4	33.3
Of which: Hong Kong	11.2	12.9	19.5	21.7	23.7
Singapore	0.6	1.3	1.4	1.8	2.4
Europe	2.8	3.7	3.1	2.7	2.5
Of which: Romania	1.4	1.3	1.0	1.0	0.7
Middle East	0.5	0.3	0.6	1.0	0.9
Western Hemisphere	4.3	3.6	2.7	3.5	3.3
Of which: Brazil	2.3	1.6	1.0	1.4	1.4
Argentina	0.8	0.8	0.8	0.7	0.9
Countries other than IMF members	4.5	5.9	5.4	6.0	5.7
Of which: Korea, Dem. People's Rep.	0.6	0.6	0.5	0.4	0.3
U.S.S.R.	2.4	3.4	3.0	3.3	3.3
Memorandum item:					
Oil exporting countries	1.4	1.2	2.0	2.2	1.8

Source: International Monetary Fund, *Direction of Trade Statistics* (various issues).

TABLE 2. China: Imports by SITC Group, 1986-90[1]

(in percent of total)

Primary products	13	16	18	20	54	56
Foodstuffs	4	6	6	7	19	21
Of which: cereals	(2)	(4)	(3)	(5)	(13)	(15)
Beverages	0	1	1	0	1	1
Nonfood items	7	8	9	8	24	21
Mineral fuels	1	1	1	3	6	8
Edible oils and fats	0	1	1	1	3	5
Manufactures	78	72	69	68	209	193
Chemicals	9	12	17	13	41	38
Products classified by material	26	22	19	21	66	51
Machinery	39	34	30	31	92	92
Miscellaneous manufactures	4	4	4	4	10	11
Unidentified items	8	12	13	12	37	51

Source: General Administration of Customs.

1/ Data are on a c.i.f. basis.

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