
FRBSF WEEKLY LETTER

January 18, 1985

China: A Visitor's Report

During the last four years, I twice visited China. The first time was in the Summer of 1980, and the second, last Fall. Between the two visits, China undertook some dramatic basic economic reforms. In this *Letter*, I present my impressions of the changes I witnessed and discuss the problems still confronting China's economy.

Modernization, 1980

The 1980 visit took place shortly after China launched its "Modernization" program. As reported in the *Letter* of October 24, 1980, China completely transformed itself from a private enterprise to a socialist-planned economy after the 1949 Revolution. By 1958, private enterprise had been completely eliminated in the industrial and commercial sectors, and agriculture was either nationalized or collectivized. The twenty years that followed were marked by turmoil and calamity as the nation suffered through the "Great Leap Forward" in the late 1950s and, after four years of recovery, the Cultural Revolution of 1966-76. China emerged from the late 1970s with outdated technology, low worker morale, a stagnant economy insulated from the rest of the world, and a greatly swollen population.

After Chairman Mao's death in 1976, the new leadership made a landmark decision in December 1978 to begin a shift from the completely collectivized, egalitarian, Soviet-type command economy toward an economy in which the market mechanism would be allowed to play a large role in allocating resources within a socialist framework.

From the start, the reformers realized the enormity of their task. Instead of following a preconceived blueprint, they adopted a pragmatic, experimental approach toward reaching the ultimate goals of economic reform. Nevertheless, the general direction of the reform was clear. First, they resolutely turned away from a preoccupation with capital investment towards a greater emphasis on meeting consumer needs. Second, the reformers decided to remove stifling, direct bureaucratic control over economic activities to give enterprises greater autonomy. Third, they emphasized opening the economy to foreign trade and foreign investment.

The task was gargantuan and the obstacles to reform were numerous. History is not replete with cases of huge, clumsy bureaucracies rejuvenating themselves by relinquishing tight controls on a national economy. China's case was made even more difficult by a decade of self-destruction during the Cultural Revolution, when all schools were shut down and a whole generation lost the opportunity for education. Ideology superseded technical expertise, and slogans substituted for knowledge. Although impressed by the reformers' obvious determination and fervor, I nevertheless felt that the prospects for the reform's success were bleak.

Observations, 1984

It was thus with considerable surprise that I found on the 1984 return trip a new dynamism and confidence in the country's future. There was pervasive evidence, absent four years ago, of a nation on the verge of "economic take-off." In Beijing, in particular, many modern highrises had altered the city's skyline. People were better dressed in a wider variety of colors and styles. Where there had been sparsely stocked stores in 1980, there was now an abundance of meats, vegetables, fruits, and consumer goods. Streets still crowded with bicycles were now also clogged during peak rush hours with automobiles and trucks, many imported. Moreover, the quality of city living as represented by its cleanliness and attractiveness seemed greatly improved. In Beijing, many trees, shrubs and lawns now front apartment houses where four years ago there was only bare ground.

Even more impressive were the improvements in the rural areas, where eighty percent of the population reside. On visits to the countryside, one could not help noticing the handsome two-story houses that the farmers had themselves built during the last two or three years. There were clearly more consumer goods available in the rural area as well, as evidenced by the large number of bicycles, radios, and even television sets in farm households. Particularly interesting were the many small tractors driven by farmers on rural roads; these tractors plowed the fields but also served as a means of rural transportation.

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Government officials invariably attributed this dramatic improvement in rural living conditions to the recently introduced "household responsibility" policy. This policy distributed land to farmers through long-term leases according to the number of persons in each farm household. In return, a household must turn a fixed amount of produce (set by a negotiated contract between the farmer and the authorities) over to the state, but can keep any surplus for its own consumption or for sale in the open market. In effect, this policy represents a dramatic land reform that has largely reversed the earlier collectivist policy. It has replaced the nationwide agricultural communes and collectives with a land-tenure system similar to sharecropping — except that the farmers are obligated to turn in a fixed amount, rather than a fixed percentage, of their annual produce. The fixed amount provides a great incentive for a farmer to increase production to earn the surplus.

The new land-tenure system plus the high official purchase prices of farm products have combined to fuel a surge of productive effort and creativity in the farm sector. In many regions, the authorities had stopped buying grains from farmers because they had run short of storage space. I was repeatedly told that there are now many "10,000-yuan households," meaning that there were now many households with annual incomes exceeding 10,000 yuan (about \$4,000) in rural areas all over the country. This income compares well to the annual income of about 4,000 yuan for a cabinet minister, 1,000 yuan for a school teacher, and 700 yuan for a factory laborer. These 10,000-yuan households have made their fortunes not only through agriculture but also by raising pigs, chickens and ducks, by stocking fish ponds, and by selling handicrafts.

The authorities are making a showcase of all those who have become wealthy through innovative individual entrepreneurship, although there is evidence that the agricultural reforms had other purposes as well. For example, they also seem aimed at reducing the pressures on urban development. The historical imbalance between farm incomes and those of urban occupations has encouraged a strong trend of migration from farms to cities.

The apparent success of rural economic reform has led Chinese officials to extend the principles of the household responsibility policy to urban industrial and commercial enterprises. In October

1984, the Party's Central Committee adopted a plan intended to subject city enterprises to the discipline of the market, letting them prosper or fail according to their success in meeting market demand. To many, the decision means the start of Phase Two of the "Second Socialist Revolution" launched six years ago.

Remaining challenges

The 1984 visit left little doubt that the great majority of the people, especially those in the countryside, are living much better today than they did a mere four years ago. The removal of rigid controls over economic activities has led to a veritable explosion of creative energy. The subsequent improvement in living conditions and adroit management of resources have been impressive and even startling in view of the short time that has elapsed.

Yet, to applaud the progress is not to say that China's Modernization is no longer fraught with difficult unresolved problems. Perhaps the biggest problem today is reform of the domestic price structure which is seriously out of line with the relative costs of production and world prices. Without a reasonable pricing system, it makes little sense to talk about letting market incentives help direct the allocation of resources. The problem was obvious to Chinese policymakers four years ago, but the price structure remains rigid. Thus far, no major price adjustments have been made although officials are acutely aware of the obvious under-pricing of coal, staple foods, public transportation, and housing. Reportedly, subsidies on these goods and services account for more than one-half of the central government's budget expenditures. Such long inaction testifies to the enormous political risk involved in making basic changes in the price structure.

The problem of a rigid domestic price structure has also exacerbated China's difficulty in formulating a sensible exchange rate policy. Since 1981, China has had what is generally regarded as a dual exchange rate system. Under this system, tourist expenditures, inward remittances, and foreign diplomatic spending have all been conducted at the official rate — which up to about nine months ago, was stable at around 2 yuans per U.S. dollar — while all import and export transactions between the state trading corporations and domestic residents have been at a fixed "internal settlement rate" of 2.8 yuans per dollar.

This dual exchange rate system has caused much confusion and misunderstanding. U.S. industries, for example, have demanded countervailing duties against textile imports from China, alleging that the differential between the Chinese internal settlement rate and the official rate constitutes an export subsidy. The system also has been responsible for extensive black market activities that have caused the government to lose foreign exchange receipts. Partly in response to these concerns, the authorities have allowed the official exchange rate to float gradually upward during the past nine months; it reached a high of 2.62 yuans during the author's visit.

Another major problem facing China's Modernization program is the country's ponderous bureaucracy. Despite the reforms that have been implemented, the bureaucracy continues to make all major economic decisions and to dominate all large enterprises. Government industrial bureaus have been renamed corporations with new plaques decorating their front doors and former bureau heads are now called presidents. However, with no real system of internal responsibility or external discipline imposed by market competition, the newly formed corporations still operate like the old bureaucracies.

Combined with the effects of unchanged prices, which place essential inputs (such as raw materials, fuel, transportation, and finance) in perpetually short supply, a large part of Chinese entrepreneurship consists of acquiring and using the political clout needed to secure scarce but essential supplies. For instance, because of the acute shortage of transportation equipment, a license to import a truck was said to be worth at least as much as its import price. Without an open

bidding system, the import licensing authorities obviously hold a great deal of economic power.

A similar situation exists in the labor market. Because wages too are frozen, managers, technicians and skilled workers who are highly valued in their places of employment are rarely granted the permission to leave in search of higher wages. The reduced labor mobility limits productivity. In short, bureaucracy continues to hold sway over a large part of China's economic life despite the progress wrought by very significant economic reforms.

Conclusion

No visitor to China today can help but be impressed by the prevailing spirit of enterprise and confidence. Surprisingly large progress has been made in living conditions in the last four years. While the progress has bolstered hope for continued improvements, there is reason to believe that serious obstacles still lie ahead. Basically, the reformers have yet to decide on the extent to which they will yield direct administrative control to the workings of the market system. In other words, they have yet to settle on an appropriate mix of market principles within a socialist economy.

The Chinese economic reform is undoubtedly the world's largest controlled economic experiment of this century, involving one-quarter of the human race. It is like turning a gigantic ship around, with one billion passengers aboard, in largely uncharted waters. The world holds its breath in watching the maneuver. Although the direction of reform has been spelled out in the October 1984 declaration of the Party's Central Committee, the true test still lies ahead — in its implementation.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount	Change	Change from 12/28/83	
	Outstanding 12/26/84	from 12/19/84	Dollar	Percent ⁷
Large Commercial Banks				
Loans, Leases and Investments ^{1 2}	189,644	— 63	13,619	7.5
Loans and Leases ^{1 6}	171,304	— 51	15,949	10.0
Commercial and Industrial	53,136	— 250	7,173	15.3
Real estate	61,972	— 67	3,073	5.1
Loans to Individuals	32,259	259	5,608	20.6
Leases	5,118	39	55	1.0
U.S. Treasury and Agency Securities ²	11,198	— 67	— 1,309	— 10.2
Other Securities ²	7,142	55	— 1,021	— 12.2
Total Deposits	200,606	5,144	9,609	4.9
Demand Deposits	51,178	4,289	1,941	3.8
Demand Deposits Adjusted ³	33,178	1,477	1,847	5.7
Other Transaction Balances ⁴	13,317	683	542	4.1
Total Non-Transaction Balances ⁶	136,112	173	7,127	5.4
Money Market Deposit Accounts—Total	42,051	627	2,454	6.0
Time Deposits in Amounts of \$100,000 or more	40,299	— 918	2,134	5.4
Other Liabilities for Borrowed Money ⁵	21,685	936	— 1,322	— 5.6
Two Week Averages of Daily Figures	Period ended 12/17/84	Period ended 12/03/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	75	40		
Borrowings	30	44		
Net free reserves (+)/Net borrowed(—)	45	— 3		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change