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China's Choices

In December 1978, China's leaders adopted a program of economic reform designed to stimulate production and economic growth by encouraging the development of "free" markets for much of the country's goods and services. The results of this reform have been very impressive. Since 1980, China's output has increased about 10 percent a year. In 1986, incomes in the agricultural areas have doubled and urban residents' incomes have increased 50.5 percent over 1978.

However, the transition from a planned economy, in which virtually all prices were administratively controlled, to one in which many prices are determined in markets has not been an easy one. In recent years, inflation has become a serious problem, threatening to undo all that reform has accomplished to date. Although many factors have contributed to this problem, the fundamental weakness in the reform program has been insufficient control of the growth of money and credit in the economy. Thus, China is now faced with the need to reduce aggregate inflation pressures, and, as circumstances permit, accomplish price reform. This *Letter* evaluates China's options.

Four approaches

The guiding principle behind China's economic reform program is "the state regulates markets, and markets motivate enterprises." The market is the link between macroeconomic goals and the realization of those goals on the microeconomic level. But the market cannot exist without relaxation of price controls. The question before policymakers, thus, is how to coordinate price reform and monetary policy in such a way that markets are allowed to function effectively and inflation is brought under control.

To help clarify China's choices, it is instructive to examine how other countries have implemented monetary and price policies. Historical evidence suggests that, within the context of countries that have socialist or at the least heavily-regulated economies, there are four approaches to the simultaneous control of both relative prices and the aggregate level of prices. The first approach might be characterized as "loose money and relaxed price control." The second is "loose money and tight price control," while the third is "tight money and tight price control." Finally, the fourth is "tight money and relaxed price control."

Loose money, relaxed price control

The combination of loose monetary control and relaxed price control best characterizes the approach followed by Yugoslavia, particularly between 1950 and 1964. During that period, Yugoslavia abandoned the Soviet-style planning apparatus, with its formal system of centralized administrative management, and adopted a more decentralized system that granted producers the right to determine output levels and products. The fixed price system was eliminated, leaving prices to be determined by market forces. Partly in response to this decentralization of economic decision-making, output increased, and real income doubled between 1952 and 1959.

During the same period, however, Yugoslavia followed a monetary policy that allowed the money supply to increase by more than 250 percent. Moreover, short-term bank credit expanded rapidly, doubling in volume between 1952 and 1958, and nearly tripling by 1961. This expansion of money and credit, together with the elimination of the country's fixed price system, led to rapid inflation. In the ten years between 1954 and 1964 the price level doubled. Inflation remains a problem today in Yugoslavia; from 1965 to 1986 inflation averaged 28 percent a year and in 1987 the annual inflation rate reached 221 percent.

Yugoslavia's experience suggests that relaxing price controls in an environment of loose monetary control is unwise. In fact, such a combination has led to galloping inflation, which in recent months has increased the conflicts among the different national republics, leading to civil disturbances, according to a number of Yugoslavian officials.

Loose money, tight price control

Between 1930 and 1937, the Soviet Union followed a policy of rapid money supply growth in conjunction with tight control over prices. During this period, currency in circulation increased more than 260 percent, compared to an increase in nominal gross national product of around 200 percent. To a large extent, the rapid growth in currency helped to finance the large increase in defense expenditures, which increased as a proportion of total government spending from 5.6 percent in 1931 to 17.4 percent in 1937.

Ordinarily, such an increase in the money supply could be expected to cause the price level to rise; however, prices were rigidly controlled during this period. As a result, official statistics show that the retail price index was stable. Nonetheless, there were widespread shortages and long lines outside shops. Moreover, the prices of goods on the "curb market" apparently were nearly 3½ times higher than in the state stores.

As the Soviet Union's experience suggests, official prices can be kept from rising through administrative controls, but alternative, unofficial markets develop and the allocation of goods and resources becomes distorted. Social tension also increases.

Tight money, tight price control

In the 26 years prior to the implementation of economic reform, China pursued policies that involved tight control over the growth in the money supply and rigid control over the prices of goods and services in the economy. Between 1952 and 1978, the rate of growth in China's gross social production (gross material products produced chiefly by industry, agriculture and building sectors) averaged 10.8 percent a year, while the average rate of growth in its bank-money supply (all deposits plus cash) was 10.5 percent per year. At the same time, all prices were administratively-controlled, either at the national level or the local level. Consumer prices, in particular, remained virtually frozen for most of this period. However, rationing was necessary to allocate goods among consumers.

Tight control over the money supply coupled with rigid price control can guarantee a stable price level, as China's experience shows. However, price controls do not allow for shifts in relative prices of commodities. As a result, the allocation of goods becomes distorted and economic growth is stifled.

Tight money, relaxed price control

After World War II, a number of countries faced the need to make a transition from wartime rationing and price controls to free-market determination of relative prices without igniting inflation. West Germany and Japan followed similar strategies in this transition. To control expansive aggregate demand, the West German government released broad categories of commodities from wartime price controls at the same time that it implemented a currency conversion, which had the effect of reducing the value of the currency in circulation from Reichs Mark 150 billion prior to the reform to Deutsche Mark 12 billion after the reform. Such a drastic reduction in the money supply led to stabilization in the price level, even as prices for individual commodities were decontrolled.

In Japan, the Reconstruction Bank and the Bank of Japan sought to stimulate postwar production by investing large amounts of funds in industrial enterprises. The immediate result of this policy was to stimulate inflation. Even after the enactment of the Emergency Financial Measures, inflation on the black market and in the rural areas continued to soar. In February 1949, Joseph Dodge, the financial adviser to the Supreme Commander of the Allied Powers, advanced the so-called "Dodge Plan," which called for suspending new lending by the Reconstruction Bank, tight monetary policy, and an "overbalanced" government budget (that is, one that generated fiscal surpluses) to redeem bonds prior to maturity. This plan was adopted and price controls were lifted. In time, the price level was stabilized.

The experiences of West Germany and Japan suggest that it is possible to decontrol prices and at the same time stabilize the price level. This approach, then, provides a useful economic framework for China during its transition from controlled prices to market-determined prices.

The current situation

Undertaking such an approach will not be easy, however. In recent years, China has followed policies that entail rapid money supply growth and gradual relaxation of price controls. The government's policy of gradual price reform, instituted in the second half of 1984, has increased the proportion of retail prices determined by the market from 2.5 percent in 1978 to 16 percent in 1984 and 50 percent in 1988.

At the same time, the government has pursued expansionary monetary policy. Between 1984 and 1987, the growth rate of the aggregate money supply averaged 23 percent a year, while that of national income averaged only 10.4 percent a year. Likewise, in the first half of 1988, industrial output rose 17 percent over its year-earlier level, but the money supply shot up 30 percent.

This expansionary policy and the relaxation of price controls over a significant proportion of commodities have resulted in a rapid rise in the overall price level. Retail prices rose at the rates of 8.8 percent, 6 percent, and 7.2 percent in 1985, 1986, and 1987, respectively. In 1988, the annual inflation rate is expected to register at least 25 percent. This situation has become untenable, and the government has responded by suspending further price reform for one year and reinstating certain spending controls.

A difficult choice

A return to price controls is not a good long-run solution to the problem of inflation because it undermines the goals and achievements of economic reform. Instead, China might adopt a tighter monetary policy along the lines adopted by West Germany and Japan in the postwar transition period. But such a decision should be made only after the costs of doing so and the need to adapt the policy to China's special circumstances are considered.

Carrying out a tight monetary policy means that China would have to "pay the piper." Many countries have had to suffer increasing unemployment and declining real production while overcoming inflation. Moreover, experience shows that the longer the duration of the inflationary process, and the faster the rise in prices, the more a society will suffer in overcoming inflation. For this reason, halting inflation has become a matter of crucial importance in China now. Short-term recession brought on by a tight monetary policy may be a necessary sacrifice if China is to control inflation and foster long-run economic development.

But a policy aimed at slowing money supply growth and decontrolling prices must take China's own national characteristics into account. The economies of West Germany and Japan are based on private ownership of enterprise. Once a suitable monetary environment was created in those two countries and price controls were relaxed, the transition occurred relatively quickly. Because China's economic system is different, a few more steps in this transition process may be necessary. First, China should try to turn its banks and enterprises into truly independent entities responsible for their own profits and losses, even though they are not privately owned. As a next step, then, China could privatize much more of its economy, granting the right of private ownership in many enterprises. These steps, pursued in the context of appropriate monetary policy, should enable China to join the ranks of the "Newly Industrialized Countries" before the end of this century.

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