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Whither China?

Recent turmoil in China has riveted world attention. Both the scope and the passion of the popular protest have surprised observers. Even a casual visitor to the country would agree that economic reform in China during the last ten years has brought about striking improvements in the standard of living. So why has there been so much apparent popular disenchantment, despite these impressive economic successes?

This *Letter* seeks to throw light on this question by examining the accomplishments and defects of the economic reform in China over the past decade. Although not all political upheavals have economic roots, in this case, economic factors seem to have played a central role.

At the macroeconomic level, accelerating inflation in recent years reflects a lack of effective monetary and fiscal policies, which in turn, can be attributed to some basic defects in the present institutional framework. On a microeconomic level, the widespread corruption, which both the government and the populace recognize as an unacceptable social evil, is a symptom of structural deficiencies in the nation's distributive system.

No matter how the current political turmoil is settled, China will have to face up to the fundamental defects of the economic reform that lie at the root of the turmoil. At this juncture, the policymakers in China can choose either to preserve the nation's present institutional framework and revert to the tightly-controlled command economy of pre-reform days, or institute sweeping structural reforms that will regain the forward momentum of economic reform which has bestowed considerable benefits on China in the past ten years.

Accomplishments of economic reform

Broadly speaking, China's economic reform has proceeded in two stages. During the first stage, from 1979 to 1984, reform focused on the rural area, where 80 percent of the population resided. By leasing land to farmers and letting farmers decide what to grow, and by increasing the official purchase prices of farm products, the reform released productive initiative and energy formerly dammed up in the rural communes. Farm output increased so rapidly that for a few years, until consumption caught up, granaries were bulging with surplus grains. Even more remarkably, rural industrial development caught on like wild fire, producing a wide range of light industrial and consumer products. Rural industries soon became the most dynamic sector of the Chinese economy.

In 1984, the leaders began a comprehensive program of urban industrial reform to reduce the scope of economic planning, grant enterprises substantial autonomy in managing their businesses, and open the economy to foreign trade and foreign investment. Where the state had taken all the profits and covered all the losses before, the reform allowed enterprises to retain after-tax profits and held them responsible for their losses. Where capital investments had been financed by the state treasury before, the reform forced enterprises to seek bank loans and pay interest. Where workers had been paid fixed wages regardless of enterprise profitability, the reform allowed enterprises to pay workers bonuses out of retained earnings.

Overall, reform in China has achieved impressive results. Since 1980, national income has grown at an average 10 percent annual rate. The standard of living has risen markedly, as the quantity, variety, and quality of consumer goods have all improved. Goods such as refrigerators, color televisions, and washing machines, previously considered luxury items, are now available and accessible to many households.

Defects in reform program

Economic reform has brought mixed blessings, however. Foremost among the problems it has created is rampant inflation. Economic reform has enriched the countryside and enabled urban enterprises to give workers lavish bonuses and undertake extravagant investment projects. This rise in spending power has led to rising expectations about living standards. But, because it has been fueled by unrestrained bank lending to enterprises and rapid growth of the money supply, the reform has given more spending power to people than the growth in output could support. (See this *Letter*, November 4, 1988.)

Coupled with the easing of price controls, this rapid growth in spending power has caused inflation to accelerate. According to official data, retail prices rose 6 percent in 1986, 7 percent in 1987, 18 percent in 1988, and during the first four months of 1989, retail prices were 27 percent above their level a year ago. These inflation rates are not high by other developing countries' standards. However, China's per capita income still is relatively low, and certain structural features peculiar to China have made inflation harder to tolerate than in other countries.

In the first place, wage rigidity is much more pervasive in China than elsewhere. The government accounts for a far larger proportion of total employment. Strapped by budget deficits year after year, the government has not been able to raise the pay of civil servants, school teachers, hospital workers, and retired persons fast enough to keep up with the pace of inflation. Moreover, despite economic reform, enterprises' "wage funds" are tightly regulated by the government. When the authorities decided last September to clamp down on bank credit and enterprise spending in a strong bid to keep inflation under control, even the bonuses of workers in profitable enterprises began to dry up.

Compounding the problems caused by wage rigidity is an almost total lack of labor mobility. Workers, whether in government or enterprise employment, cannot change jobs without their employers' consent. This generates deep frustration and resentment in those who are caught between rising prices and slowly-adjusting wages, with little freedom to change jobs.

Another popular complaint has been widespread corruption. The government not only recognizes the problem, but also has in recent years instituted vigorous measures to stamp out corruption, including setting up channels for citizens to identify corrupt officials anonymously. Thus far, however, the measures have not been effective.

The roots of corruption in China are no different than in any other country in which economic activity is regulated by government officials. The greater the scarcity of resources and the more rigid the price controls, the greater is the potential for corruption. And in China, despite the proclaimed goal of taking the government out of business decisions, essentially the same economic planning structure as before regulates prices, restricts labor mobility, approves bank credits, and decides who gets what and how much essential, scarce inputs, such as energy, transport, raw materials, parts, and components.

Prior to reform, under conditions of generalized poverty, corruption was virtually non-existent. Ostentatious living was too easily detected and generally frowned upon. In contrast, economic reform has shifted emphasis to material work incentives and made display of wealth acceptable and even fashionable. This change in values has combined with increased access to consumer goods and continued bureaucratic control over economic activity to reinforce a tendency for corruption.

Roots of the defects

Both inflation and corruption are symptoms. Their roots lie deep in a tentative, piecemeal approach to reform that has characterized China's economic reform from its very beginning. Granted, the scope of China's economic reform has been unprecedented among socialist countries, and its purported transformation from a Soviet-type command economy to one in which market forces play a crucial role involves far more drastic changes than any other economy has attempted in so short a time. In a fundamental sense, China has been trying to break new ground, and its cautious step-by-step approach is entirely understandable. Nevertheless, the result has been reform without a blueprint to ensure internal consistency. Moreover, as the experiences of other countries have shown, partial reform often creates more problems than it solves.

In China's case, economic reform was meant simultaneously to increase economic efficiency and to preserve social stability. However, in China's institutional structure, "social stability" has a special meaning that is absent in market economies. Workers in China are dependent on the enterprises and government units that employ them, not only for their salaries and wages, but also for the provision of housing and medical care. Under these circumstances, allowing an unprofitable enterprise to fail or a redundant government unit to be closed entails serious social disruption beyond the lost jobs. The authorities thus have been driven to minimize structural changes in government and enterprise management. Although government agencies have been converted into government corporations, and greater autonomy has been given to enterprises, their management style has not broken away from the lackadaisical approach which characterized government and enterprise management prior to reform.

The inability or reluctance to let enterprises fail has had serious implications for the conduct of fiscal and monetary policies. Fiscal policy has been hampered by the need to prop up failing enterprises through tax reductions and direct subsidies, and monetary policy has been weakened by the need to support unprofitable enterprises through bank loans.

Prior to reform, responsibility for macroeconomic stabilization rested with the fiscal authorities. Through tight budget control over all spending units, aggregate demand was adjusted to balance aggregate supply. Banks were subservient to the planning (fiscal) authorities, carrying out purely "cashier" functions. Economic reform eased budgetary controls on enterprises, and transferred the responsibility for enterprise financing, and ultimately, macroeconomic stabilization, to the banking system. The banking system, however, has not had the staff nor the authority to carry out an effective monetary policy in the new environment. As a result, inflation has become a serious problem.

Moreover, fear of accelerating inflation has increased the government's reluctance to relax price controls. These price controls may, to some extent, keep a lid on price increases arising from excessive demand pressures, but they also prevent necessary relative price adjustments. In an attempt to ensure the supply of "essential" goods and services to consumers at "tolerable" prices, needed price reform has been held back. As a result, the supply of these "essential" goods and services has become more scarce than would have been the case if their prices had been allowed to rise, providing incentives to increase production of these goods and services.

Alternative scenarios

Thus, despite its many outstanding achievements, economic reform in China has a number of serious defects, the roots of which can be traced to the lack of an overall, integrated blueprint that could simultaneously ensure social stability and improve economic efficiency. The result has been a partial economic reform that has satisfied neither goal. The choice before the authorities is, therefore, either return to rigid control of the command economy that existed prior to reform, or institute further reform that would ensure price stability and allow market signals fully to determine the allocation of scarce resources.

The perils of restoring rigid controls are clear from China's own past experience as well as those of other socialist economies. Economic incentives would sag, and economic stagnation return. At the same time, foreign trade and foreign investment would decline precipitously, which means that technological progress, on which China's modernization has depended, would be retarded.

However, the alternative course of fundamental reform is not an easy one, either. Obviously, it is much easier to identify defects than to recommend remedies. Nevertheless, it seems safe to say that any such reform must permit enterprises to fail and allow workers to change jobs, without jeopardizing access to housing and medical care. It also should ensure that effective monetary and fiscal policies are implemented to restrain inflationary pressures, and that price reforms are undertaken to ease scarcities that arise from a distorted price structure.

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