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# FRBSF WEEKLY LETTER

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## China on the Fast Track

1992 was a banner year for the Chinese economy. With relatively little world media attention, China achieved a spectacular 12.8 percent output growth rate and laid the ground for an ambitious economic reform program. These achievements were especially notable in view of the general doldrums in the world economy and the immense difficulties encountered by the formerly socialist economies in Eastern Europe and the former Soviet Union. Impressed by this outstanding performance, some observers predict that China will be a world economic superpower in the next century.

This *Letter* reviews China's rapid growth and rededication to economic reform in 1992 and assesses both the short-run and the long-run prospects of its economy. In brief, while the outlook is generally optimistic, China also faces some major challenges. China's successful takeoff to sustainable economic growth into the next century will depend critically on whether it will be able to overcome existing structural weaknesses in its economy.

### **Flying high**

China's strong economic performance in 1992 was broad-based. Real agricultural output rose 4 percent, and the grain harvest was the second highest on record. Industrial output rose 20 percent, on top of a 14 percent increase in 1991. Most remarkable was the phenomenal 60 percent output growth of rural and township industries, which in 1992 employed a total of 100 million workers and accounted for about 17 percent of the nation's total labor force. Foreign trade also grew rapidly: Exports rose by 18 percent and imports increased by 27 percent. Attracted by a booming economy and availability of low-cost labor and land, foreign direct investment reached \$11 billion, more than double the volume in 1991. In addition, amidst this rapid expansion inflation remained moderate: Retail prices increased 5.3 percent, up from 4.0 percent the year before.

The boom in 1992 was an acceleration of recovery from a prolonged recession in 1989–1990. The recession was brought on by a severe austerity program launched in September 1988 in

order to fight inflation. The program was remarkably successful in achieving its goal: The retail price inflation rate fell from 27 percent in 1988 to 6 percent in 1989 and to near zero in the second half of 1990. In 1991, the authorities cautiously eased up controls; the economy responded quickly, with output rising 7 percent, up from 4 and 5 percent in 1989 and 1990. Then in 1992, the authorities pulled out all the stops: Investment expenditures rose a whopping 33 percent, while the broad money (M2) growth rate reached an 8-year high of 30 percent. Under these strong stimuli, output growth accelerated to 12.8 percent, second only to the historical high of 14.6 percent in 1984.

### **Economic reform**

1992 is also notable because it marks the start of the third stage of China's economic reform—the first two began in 1979 and 1984, respectively. The year opened with a clarion call by Deng Xiaoping to accelerate the pace of economic reform. In his celebrated "Speech after the Southern Tour," Deng strongly berated the "obstructionists" who wished to cling to the old system, and called for bold, across-the-board economic reform in order to let market forces play a greater role in a "socialist economy with Chinese characteristics." The speech signaled a major change in the direction of the country's economic policy.

Between 1989 and 1991, reform was put on hold in the name of combatting inflation. Since the only policy instrument available to the authorities for fighting inflation was direct controls through the old planning framework, the seat of power in policymaking shifted markedly back to the central planning authorities. In that environment, planning control was king, and mere talk of economic reform was taboo.

Deng's speech changed all that. Immediately after the speech, a carefully orchestrated nationwide movement was launched to study the speech, and senior officials and researchers were directed to prepare a comprehensive program for the implementation of the ideas it contained. Suddenly, the atmosphere changed. Reform came back into

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vogue, and officials at all levels and in all regions began pushing for reform.

Some interpret this abrupt change as another demonstration of Deng's powerful leadership in China. Without disputing the obvious, it also may be interpreted as an inevitable response to mounting political pressure from local government authorities. As most of the Chinese economy languished under the stringent spending controls during 1989-1990, certain regions in the south—Guangdong Province and three Special Economic Zones along its coast—experienced rapid growth and prosperity. The difference was that local authorities in these regions had special latitude to accommodate both foreign and domestic investors, and they seemingly invested and extended credit as much as they saw fit. In any case, some attribute this special latitude to local officials' connections with Beijing; it is just as plausible, however, to assume that it reflected the central authorities' recognition of the region's special role in attracting much needed capital and technology from Taiwan and neighboring Hong Kong. The result was that the rapid economic growth and prosperity in these regions turned into a giant magnet for a large and rising volume of capital and skilled labor from the rest of the country. It appears likely that clamors from the local authorities in the rest of the country to share in the same rapid growth and prosperity enjoyed by the southern regions prompted the central authorities to lift tight spending controls and institute nationwide economic reforms.

Indeed, one of the first policy changes was to grant local authorities across the country permission to establish "special development zones" with a virtually free hand to offer incentives for attracting domestic or foreign capital to develop local industries. The local authorities wasted no time seizing this opportunity. The number of such zones jumped from 117 at the end of 1991 to more than 2,000 at the end of 1992. Conceivably, a substantial portion of the 33 percent increase in investment expenditures in 1992 was due to the local governments and the businesses they established.

In the meantime, a comprehensive reform program was drawn up by the State Commission on Restructuring the Economic System. The program was approved and promulgated by the State Council in March this year. As promised, the program was truly bold, aimed at clearing away nearly all

the remnants of the old economic structure that continue to impede the working of market forces, in areas ranging from state enterprises, price controls, commodity markets, foreign trade, investment restrictions, government budget and revenue sharing, banking and financial markets, wages, unemployment insurance, housing, and medical care. Reports from China indicate that parts of the program have already been implemented, such as laying off idle workers in a few state enterprises.

## **Near-term prospects**

The near-term prospects of China's economic growth depend crucially on the authorities' assessment of the risk of inflation currently in the economy. Over the past year, a debate has been raging in China over whether the economy has become "overheated." Those who are not concerned argue that the rapid growth in 1992 was a natural acceleration of a rebound from the 1989-1990 recession, that the high money and investment growth was to meet pent-up demand, and that in fact the inflation rate measured by retail prices was quite moderate. Those who are concerned point to the more than 11 percent rise in the cost of living index for residents of 35 major cities, the 13 percent rise in the prices of capital goods, and within that index the 16 percent rise of electric machinery prices and the 18 percent rise in cement prices. In addition, they claim, the nation's transportation capacities were already severely strained, meeting only 60 percent of demand. They fear that sooner rather than later the strains felt in the production sectors in 1992 will spill over to affect consumer prices this year.

Recently released data indicate that rapid growth continued into the first quarter of 1993, with output at a level 14 percent higher than the same period last year, industrial output 22 percent higher, investment by state enterprises an astounding 70 percent higher, and that by local governments 80 percent higher. At the same time, signs of accelerating inflation have appeared. Retail prices in major cities were 15 percent higher, and those in the countryside more than 8 percent higher, than last year. The \$1.2 billion trade surplus during the first quarter of 1992 turned into a \$1.2 billion deficit this year.

Under these conditions, actions reportedly have already been taken to restrain inflation: Orders have gone out to banks over the country not to exceed allocated credit limits, and many investment projects have been canceled or postponed. If these measures are carried out, an explosive boom-and-bust might be avoided. One would then expect a significant slowdown of output growth from its rapid pace last year, to perhaps

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8 percent as in the official forecast. However, in view of the signs of inflationary pressures that have already surfaced, retail prices are likely to rise more than 10 percent for the year, rather than the 6 percent envisaged in the official forecast.

### **Long-term prospects**

During the decade of the 1980s, China achieved a remarkably high average growth rate of 9 percent a year. The achievement was attributable to the economic reform since 1979, which has released abundant productive initiative, talents, and energy to seek opportunities for an improved standard of living. Given the nation's renewed commitment to economic reform, its high savings rate, its large pool of underutilized labor, its low level of technology, and the wide areas of structural adjustments yet to be explored, there is every reason to be optimistic about China's long-run growth prospects.

This optimism, however, is predicated on the nation's long-term commitment to economic reform and on the soundness of the reform program. Although economic reform has benefited the vast majority of the people, commitment to reform is a political decision. In every reform there are always winners and losers, and there is no guarantee that the will of the minority losers would not dominate over that of the majority winners—especially in a country like China, where the direction of political winds is particularly hard to predict.

As to the soundness of the reform program, since only its broad outline was made public recently, it is obviously premature to attempt any serious assessment. Nevertheless, from the scope and general thrust of the announced program one does gain an impression of a readiness to depart from the *piecemeal* approach to reform in the past and replace it with a *systems* approach that takes into consideration the interlocking relationships of the various parts of the reform program.

For instance, the perennially loss-making state enterprises have been a millstone that has weighed down government finance and at the same time obstructed reform of the financial system; reform of the inefficient state enterprises in turn has been impeded by not having a "safety net" to provide housing, medical care and other types of adjustment assistance to workers laid off from these enterprises; and yet to provide this safety net would require funding which the government can ill afford, given the poor state of its finance. Whether the newly announced comprehensive reform program can break this gridlock remains to be seen.

### **Conclusion**

Reform of centrally planned economies is uncharted territory. Using a piecemeal, experimental approach since 1979, China has attained remarkable success in casting off many of the shackles that had deprived its people of the fruits of modern economic growth, as enjoyed by the peoples of the industrial countries and the newly industrialized economies in the Pacific Basin region. China's growth performance since reform began, and especially in 1992, has been impressive. In the short run, its ability to achieve sustained rapid growth will depend on its success in defusing the current threat of inflation without another recession. In the long run, despite reform, the shackles that remain continue to restrain the nation from exploiting its full growth potential. The authorities in China appear to have recognized the limitations of the piecemeal approach and now have adopted a bold and broad reform program. The world waits with great interest to see its implementation.

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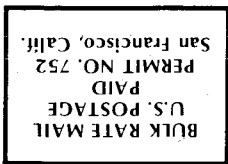
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