

Towards a System of Modernized Macroeconomic Control in China?

Tsang Shu-ki
Department of Economics
Hong Kong Baptist College

Abstract

In order for a "socialist market economy" to function smoothly, a modernized macroeconomic control mechanism needs to be put in place in China. In the 1980s, failure to ensure macro-stabilization was attributable to, among other factors, the continued non-separation of politics and economics, the lack of real progress in the enterprise reform, irrationality in the price system, as well as questionable attempts at reforming the fiscal and monetary systems. After more than a decade of changes, favourable circumstances have emerged: (1) there is now a greater determination to extricate the economic sphere from political interference; (2) the enterprise reform has entered a new phase; (3) the price reform is almost near completion; and (4) opinions about the short-term and medium-term reform strategies for the fiscal and monetary systems seem to be converging and major rationalizing actions are being taken.

However, serious constraints remain obvious. Because of China's peculiar mode of decentralization reforms in a fairly rigid political setting, the conflicts of interests among the central government, the local authorities, the enterprises, and the consumers have resulted in a complicated web of entangled but unstable relations. Factors such as historical legacy and regional diversity are also obstacles to sweeping rationalization. Only a drawn-out give-and-take process that skillfully arbitrates the interests of various parties, vested or newly formed, stands a realistic chance of success in instituting a macroeconomic authority with sufficient legitimacy and adequate means in effectively managing an economy undergoing great transformation. A key question is whether such an authority would be forthcoming, given all the frustrations and temptations of the Chinese reform. In so far as "muddling-through" is a painful process, a "big bang" of some sort may be tempting, although the chance of its success is unlikely to be high, despite the "foundation" of 15 years of gradualist reforms.

Towards a System of Modernized Macroeconomic Control in China?

Tsang Shu-ki¹
Department of Economics
Hong Kong Baptist College

1. Introduction

This is a strange time to write about the modernization of macroeconomic control in China. Yet again, only five years after 1988, and four from the June 4 tragedy, the Chinese economy became so overheated that the central government has been forced to step hard on the brake. Top officials have repeatedly emphasized that the avoidance of a "hard landing" is given top priority. Nevertheless, there is little doubt that a good deal of administrative measures, quite alien to western economies, has been and needs to be applied. Of the sixteen points in the austerity package unveiled in early July 1993, more than eight could be regarded as non-market-oriented, bureaucratically interventionist, in nature.² The replacement of the President of the People's Bank of China, Li Guixian, by Vice Premier Zhu Rongji was on the other hand quite in line with the conventional wisdom among western economists of engineering a change in inflationary expectations.

History is of course not repeating itself mechanically. The situation in 1993 differs in a

¹An earlier version of this paper was presented in a panel session of the 34th ICANAS (International Congress of Asian and North African Studies) Meeting held in Hong Kong on August 22-28, 1993.

²See *Sunday Morning Post*, Hong Kong, July 4, 1993. According to the report, the sixteen points were: (1) Call in loans diverted to speculative schemes; (2) Force workers within two weeks to buy all government bonds that had failed to sell; (3) Raise interest rates; (4) Force non-financial institutions to repay funds borrowed from financial institutions; (5) Impose a 20% cut in government spending and a ban on new imports of cars; (6) Suspend price reform measures; (7) Forbid the issuing of new IOUs to peasants; (8) End dubious fund-raising schemes; (9) Control real estate fever in development zones; (10) Reduce the scale of infrastructure projects; (11) Control how companies list shares on the stock market; (12) Reform the export financing system; (13) Force banks to control the ways they approve loans; (14) Strengthen the central bank; (15) Clear transport bottlenecks that keep goods piling up; and (16) Send inspection teams to ensure provinces obey orders.

number of ways from that in 1988.³ The market mechanism is now more entrenched, thanks to the remarkable progress in price liberalization and the installation of market hardware and software in the past few years. Supply and demand seem to have become more price-elastic, partly as a result of a more efficient flow of information and changes in enterprise and consumer behaviour. Nevertheless, the fact that administrative measures are still heavily resorted to in a major clampdown shows that much remains to be desired in the institution of an effective macroeconomic control mechanism in China.

In order for a "socialist market economy" to function smoothly, there is little doubt that a modernized macroeconomic control system needs to be put in place in China. This paper reviews the problems encountered in the 1980s and looks at the prospect towards the year 2000. Section 2 probes into the first decade of reform and identifies major difficulties in the transition from a command structure to a flexi-mode of macroeconomic fine-tuning. Favourable factors for the 1990s are discussed in Section 3, while the crux of the remaining problems is dissected in Section 4. Section 5 offers some speculative remarks on the showdown that appears to be unfolding between the "gradualists" and the "rapidists" in China.

2. Sources of Instability in the 1980s

The relative success of the Chinese economic reform in the 1980s is undeniable, and well documented.⁴ However, the macroeconomic fluctuations in that short time span were also quite extraordinary. Overheating occurred in 1980-1981, 1984-85, and 1987-88. In response, recession had to be engineered in 1982, 1985-86, and 1989. We are now apparently at another cyclical peak. Various factors can be cited for these ups and downs in the economy: supply-push, demand-pull, structural, behavioural, and policy mistakes etc. However, the high frequency of these cycles enjoins one to look for more compelling and comprehensive explanations.

In a way, failure to ensure macro-stabilization in the 1980s was attributable to the fact the economic reform was far from completed. First, the continued non-separation of politics and economics posed a great constraint on effective macroeconomic control. On the one hand, decision making power was being decentralized. On the other, fiscal and credit allocations were still based on political considerations, and units with political clout could exert pressure to gain funding for

³Indeed, I think that the unfolding events in 1993 show more similarities with those in 1985 than in 1988. See below.

⁴See for example Perkins (1988) and Chen, Jefferson and Singh (1992).

ambitious projects. The situation was therefore theoretically worse than the pre-reform monolithic situation, as *multiple* centres of power vied for resources.⁵

Second, the lack of real progress in the enterprise reform weakened the microeconomic foundation of effective macro-control. Given a higher degree of autonomy, the enterprises were however still dependent on the Treasury and the banking system for their ultimate economic viability. This gave rise to an *asymmetrical* form of behaviour: the enterprises were keen to push any economic boom to its limit in an effort to gain more resources and welfare for their employees, but had a rather distant sense of responsibility. They knew that even in the worst case, the paternalistic State would still be around to save them.

Third, the irrationality in the price system was another obstacle to macro-stability. Profits and losses were as much a result of policy as that of actual efficiency and performance because of the arbitrary nature of relative prices. It would therefore be difficult to enforce real discipline on the enterprises. The double-track pricing system, introduced as a transitional measure, could on the other hand be *de-stabilizing* in some cases because of the possibility of plan evasion, hoarding and profiteering activities.⁶

Fourth, the attempts at reforming the Chinese fiscal and monetary systems in the 1980s turned out to be half-hearted and questionable. The fiscal reform degenerated into the *baogan* system, in the context of both state-enterprise and central-local relations, which had serious macroeconomic as well as industrial repercussions.⁷ The monetary reform, on the other hand, failed to establish a central bank with sufficient clout and a truly "commercial" banking system. A key problem was that of balance-sheet fragility in the specialized banks, as evidenced by the following table for the Industrial and Commercial Bank of China (ICBC)--the largest among the four.

⁵Fang Gang et al. (1990) have called such a situation the "multiple-sovereignty mechanism" under which direct competition between subunits ("brotherly competition") becomes rife.

⁶See Cheng, Tsang and Chan (1993) for a theoretical analysis of the problems of the double-track pricing system for Chinese agriculture; and Tsang (1991) for the overall implications for monetary policy. Wu (1986) and Wu and Zhao (1987) provide earlier analyses at a more concrete level.

⁷See Ping (1992) for a macroeconomic critique from the principal-agent perspective, and Wong (1992) for an industrial diagnosis.

Table 1
Sources and Uses of Funds of the Industrial and Commercial Bank
Year-end, 1987

		Unit: Rmb 100 million	
<u>Sources</u>		<u>Uses</u>	
Deposits	3172.38 (64.24)	Loans	4448.17 (90.07)
Capital funds	184.35 (3.73)	Res. dep. at PBC	363.72 (7.36)
Borrowing from PBC	1157.69 (23.44)	Dep. at PBC	98.23 (1.99)
Other items	424.24 (8.59)	Vault Cash	28.54 (0.58)
<hr/>		<hr/>	
Total	4938.66 (100.0)	Total	4938.66 (100.0)

Source: *Almanac of China's Finance and Banking*, 1988, p.67.

Note: Numbers in brackets are percentages. PBC--People's Bank of China; Res. dep.--reserve deposits; dep.--deposits.

As the table shows, the ICBC was heavily dependent on the PBC for funding: net liabilities to the Central Bank amounted to Rmb 69.574 billion, or 14.09% of its total assets, and formed an important source to support the huge loan-deposit gap. Moreover, unlike its commercial counterparts in the West, 90% of the ICBC's funds were lent out as loans, rather than diversified into a portfolio of assets with different degrees of liquidity, risk, and rates of returns. This is not to mention the fact that a substantial portion of the loans was "policy loans" with very low liquidity and, if any, returns---a problem to which we will later return.

Confronted with such a fragile financial structure of the banking system, it would be very difficult to implement effective monetary control. The evolution from the initial "gap control" to the later system of reserve requirement and relending did little to change the situation. Any tightening by the PBC would, given this kind of lopsided balance sheet, have drastic impact on the banks as there was very little liquid assets out of which they could switch. To restore balance, they had few

alternatives other than limiting new lending and demanding enterprises to repay outstanding loans. This would generate severe knock-on effects in the economy as a whole and was one of the key reasons why the PBC was usually reluctant to reign in unless things were really out of control.⁸

3. Emerging Hopes for 1990s

After more than a decade of changes, some favourable circumstances are emerging in the 1990s. There is now a greater determination, at least at the central and provincial levels, to extricate the economic sphere from political interference. In his report to the 14th Party Congress of the CCP in October 1992,⁹ Party General Secretary Jiang Zemin propounded the basic concepts and strategy of building a socialist market economy in China. He stressed the importance of four interrelated tasks:

- (1) The transformation of the operation mechanism of large and medium-sized state-owned enterprises, the pillar of China's socialism. A key method is to enforce the separation of government and enterprise functions.
- (2) Speed up the development of the market mechanism and the pace of the price reform.
- (3) Deepen the reform in the distribution system and the social security system.
- (4) Speed up the transformation of the functions of the government. The decentralization of authority and power to the enterprises will be consolidated by legislation and regulations. Bureaucratic intervention is to be avoided.

The enterprise reform has, on the other hand, entered a new phase. The cumulative effect of the past decade seems to be bearing fruit on the behaviour of the enterprises in terms of independence, rationality, as well as efficiency. Rawski (1992) argues that even without privatization, the Chinese reform has turned on sufficient competitive and financial pressure on the state enterprises that change their behaviour fundamentally. Jefferson, Rawski and Zheng (1992) even find tantalizing scraps of evidence indicating the prevalence of "market-like forces", e.g. "the marginal revenue product of materials is virtually identical in state and collective industry through the period of 1980-88" (1992, p.255-356). Our empirical research (Tsang and Cheng, 1993), based on a set of

⁸See Tsang (1990b) for a more detailed analysis of the dilemma confronting the Chinese monetary authority.

⁹A full version of the report in Chinese was published on October 26, 1992 on *Ta Kung Pao*, Hong Kong.

panel data for 1984-88, suggests that unlike in the pre-reform period, the remunerations given to workers by state industrial enterprises were constrained by their own profits. Although these findings are open to scrutiny and further refinement,¹⁰ they do suggest that the reform is beginning to show some beneficial effect on the behaviour of the enterprises.

Institutionally, the Chinese government seems to be practicing the strategy of what I would call *parallelism*, in the sense that non-state-owned sectors are allowed to grow faster than the state sector, but a drastic shake-up of the latter, in the style of a "big bang", is to be avoided in order to reduce social costs.¹¹ The share of state-owned enterprises in industrial production, for example, dropped from 77.6% in 1978 to 48.4% in 1992.¹² Many economists in China are forecasting that the contribution of the state sector to GNP will fall to less than 25% by the year 2000. Such a "parallel" development will be similar to Taiwan's process, in which the public sector's share fell from 80% to 20% in more than three decades. The increasing importance of the non-state sectors is likely to produce profound changes in the way economic agents react to macroeconomic signals and policies, making the latter more effective. On top of these developments, one has of course to pay attention to the expansion of the stock system introduced to the state sector, and the plan of a large-scale selling-off of small-sized state enterprises.

The development of the enterprise reform has been buttressed by the most encouraging aspect of the Chinese experiment: the price reform. Taking advantage of the relative supply-demand balance in the aftermath of 1989, the achievement in price liberalization in the past few years has been truly remarkable. The prices of most consumer goods are now determined by supply and demand. As for means of production, the September 1992 reform further reduced the number of items under administrative control to 89, from that of 737 at the end of 1991. Of the 89 items, only 34 were actually under direct planning, the rest being targets of guidance. Many economists in the country are also predicting that the double-track system in agriculture can be unified within one or two years. A recent report puts the latest shares of goods whose prices are determined by supply and demand as follows: 95% of the retail prices of social commodities, 90% of the procurement prices of agricultural and related goods, and 85% of the sales prices of means of production. The report asserts that China's "openness" in price formation has surpassed the West, because even in

¹⁰Stepanek (1991) obviously thought that nothing much had changed for the better in China's state factories.

¹¹I have given a critique of the rapid privatization programme and other related shock-therapy measures proposed for the economic transition in Tsang (1992a).

¹²The 1992 ratio is calculated from *A Statistical Survey of China 1993*, p.70.

the developed countries, 20% of prices are controlled or regulated by the government.¹³ As to the exchange rate, the Government has made a pledge to unify the multiple exchange rates within a time span of five years, in an effort to speed up its re-entry to GATT.¹⁴

The combined effects of enterprise and price reforms appear to have led to some interesting outcomes. There are signs that the price elasticities of supply and demand, at least in some sectors, are on the increase. An example is the movement of the prices of construction materials in 1992-93. Driven by the boom in the housing and real estate markets, prices went up significantly in 1992. However, supplies were surprisingly forthcoming in an unprecedented way, and by the end of 1992, prices actually fell back and a stockpile emerged in Southern China.¹⁵ This could only be good news to any Finance Minister or President of Central Bank, since the economy has become more self-adjusting.

Last but not least, opinions about the short-term and medium-term reform strategies for the reform of the fiscal and monetary systems seem to be converging. A series of reports by the World Bank (The World Bank, 1990a, 1990b, 1992) on options of fiscal and monetary reforms are well echoed, consciously or otherwise, by treatises and actions in China. Fiscally, the consensus is to move away from the dependence on circulation-based taxes (within which the dominance of the product tax should give way to VAT) towards performance-based taxes, to unify individual income taxes and enterprise income taxes (the latter at the level of 33%), and to rationalize central-local relations by some kind of sharing scheme on the basis of tax types or tax bases on the other.¹⁶ As for the monetary system, a popular view is to rectify the balance-sheet fragility and non-independence of the specialized banks by transferring their "policy-loan" components to newly established long-term credit, import/export, and agricultural development banks, or at least by preparing two separate balance sheets for the two types of loans extended by the Bank.¹⁷

¹³*Wen Wei Po*, 17 September, 1993, p.6.

¹⁴There have been some recent changes to ideas about the pace of exchange rate liberalization in China. See below and Tsang (1993c).

¹⁵Private communication by the author with informed sources in Guangdong.

¹⁶See the World Bank (1990a) and Ping (1992). There have been many press reports on plans along these lines. The latest one was *Ta Kung Pao*, Hong Kong, July 8, 1993, p.2.

¹⁷See the World Bank (1990b) for the latter, less ambitious proposal. Top leaders, however, seem to be in favour of the more radical approach of setting up "policy banks". See *Financial News*, March 21, 1993, p.1. Resistance to such a proposal still remains. See below.

Released of the burdens of loans of low viability and returns, the "commercialized" banks will then behave more rationally, while the "policy banks" can carry on with their strategic functions, befitting a socialist market economy. The effectiveness of the central bank should no doubt be strengthened through the introduction of more monetary instruments, the liberalization of interest rates, and the enhancement of its status in the political hierarchy.

Major rationalizing actions along these lines have already been taking place. A "Leading Committee on Reforms in the Fiscal, Taxation and Financial Systems" was reportedly formed by the State Council recently, under the chairmanship of Vice Premier Zhu Rongji.¹⁸ The unification of enterprise income taxes was launched in Tianjin for experimentation on July 1, 1993.¹⁹ As for monetary reform, it appears that the Chinese has decided to set up a "government development bank" (*zhengfu kaifa yinhang*), on the basis of the six large investment companies of the State Planning Commission. Its sources of funds will include fiscal allocations for capital construction, postal savings deposits, social security balances, and State-guaranteed bonds, while its major task will be the financing of key investments on capital construction and infrastructure development of the government.²⁰ This will pave the way for the specialized banks to relinquish their policy loans for capital construction. An import-export bank and an agricultural development bank are also in the pipeline. A "Temporary Regulation on the Management of PBC Monetary Bonds", on the other hand, was issued²¹ and a trading system was launched in July 1993. The monetary bonds (*rong zi juan*) are of 3-month, 6-month, and 9-month maturities. They are traded between the PBC and the banks and financial institutions in nine major financial centres in the country, namely, Beijing, Tianjin, Shanghai, Wuhan, Shenyang, Chongqing, Xian, Guangzhou, and Shenzhen.²² It is a major step towards the development of the open market operation of the central bank, so that it could have a more flexible and effective means to influence the reserve position of the financial sector.

4. Transition Muddle: Conflicts of Interests and Macroeconomic Authority

Despite these encouraging developments, the establishment of an effective, Western-type,

¹⁸*Ming Pao*, Hong Kong, June 17, 1993, p.9.

¹⁹*Ta Kung Pao*, July 8, 1993, p.2.

²⁰*Capital Economic Information News*, May 7, 1993, p.1.

²¹*Ming Pao*, Hong Kong, June 18, 1993, p.7.

²²*Securities News (Financial News)*, February 21, 1993, p.1.

macroeconomic control mechanism in China may not be plain sailing in the coming years. The fact that another round of overheating needs to be rectified by "a mixture of economic and administrative means" shows how much still remains to be done to achieve that goal.

Technically, the monetary reform seems easier than the fiscal reform as it involves less conflicts of interests. However, serious problems still exist even for it. The separation of policy banks and commercial banks, for example, is a task that would "require several years or an even longer period", according to Premier Li Peng.²³ A key issue is to ensure adequate capital base for both types of banks after the re-structuring. As much as one-third of the total assets of the specialized banks was regarded as "risky assets" because they were "doubtful" policy and commercial loans.²⁴ The loading of the policy loans to policy banks may ease the burden of the specialized banks, but not entirely. The problem for the policy banks to be financially viable will be even greater. A gradual programme of separation is necessary, and the current thinking is to establish cross-shareholding between the two types of banks, so that they could share the costs and benefits of the transition. Even that may not solve the problem of capital adequacy, and some economists are now advocating a massive sales of small-sized state enterprises to raise funds for the required capital injection.²⁵ In any case, a recent press report said that the working conference on finance held from late June to early July failed to endorse the separation proposal because of resistance from conservatives.²⁶

This points to the fact that *the reform of macroeconomic mechanism involves a complicated process of bargaining over the distribution of costs and benefits*. Its complexity is only greater for the reform of the fiscal and taxation system. It is one thing to unify the income tax rates for enterprises, another to settle properly the relations among the central government, the local authorities, and the enterprises. A key problem is how to un-tie the local government-enterprise nexus, the crux of Christine Wong's (1992) dysfunction hypothesis. Related questions are: How to turn both local governments and enterprises financially independent in a situation of fiscal decline? How to avoid forced expansion by revenue-starved local governments?²⁷ And how to widen the tax

²³As reported in "Separating Policy and Commercial Functions", *Financial News*, January 15, 1993, p.1.

²⁴See Tsang (1993a).

²⁵In private discussions with the author in a visit to Beijing in early July, 1993.

²⁶*Hong Kong Economic Times*, July 9, 1993, p.2.

²⁷Ping (1992, chapter 13) provides a critique of such behaviour of the local authorities.

base from its industry-concentration? The revenue-expenditure distributive relationship between the central and the local governments is, on the other hand, particularly explosive, in the era of "economic warlordism" (*zhuhou jingji*).²⁸ In a system as complicated and unstable as China's, it would be very difficult, if not impossible, to use the tax rates (and there are many of them) as a tool for macroeconomic adjustment.

With hindsight, one could argue that macro-instability in China, since the launching of the economic reform and including the present overheating, has been the result of a more fundamental contradiction: the *lagged* development of a new mode of macroeconomic control under a situation of rapid systemic changes, which in turn is attributable to the basic philosophy and strategy of the Chinese reform. This actually has long-term implications for the prospect of the institution of effective macroeconomic control in the country.

Deng Xiaoping's pragmatism, epitomized in the famous dictum of "cats", or that of "crossing the river with a boulder in one's hands", is no doubt a crucial factor in ensuring short term success and avoiding blunders. However, it also runs the risk of unintentionally making long-term mistakes, which would be quite difficult to correct.

Deng's sequential tactic of "allowing some people to become rich first" is laudable from the perspective of generating demonstration effects and incentives. Nevertheless, the lack of a long-term strategy and effective re-distributive mechanisms (in the form of taxation and resource-allocation systems) has led to another result: "different people taking turn to get rich". Moreover, the well-being of different parties appears to be a function of the preferential treatment given by the central government. Once other parties receive similar favourable terms, however, positions of relative superiority would change and former beneficiaries might become disadvantaged. This has happened across different population sectors and geographical regions. The predicament of the Chinese farmers is a classic case in point. They were the major beneficiaries of the first stage of the economic reform in 1979-84. When the reform spread to the cities, their relative comfort declined, and now, in the third stage of reform (with the development of socialist market economy formally proclaimed a national goal), they have become the victims. In terms of per capita income, the urban-rural ratio

²⁸The World Bank (1990a) has outlined three options for reforming China's central-local fiscal arrangements: (1) limited tax sharing; (2) balanced tax-sharing; and (3) base-sharing model. Pragmatically, it favours the less radical "base-sharing" model as a medium-term goal. The discussions within China have been rather vague on this issue, reflecting its difficult nature. Even the latest pronouncement by the central authority was imprecise on the reform plan. See *Ta Kung Pao*, July 8, 1993, p.2.

was 2.37:1 in 1978, 1.72:1 in 1985, and 2.33:1 in 1992.²⁹ In other words, their relative income share is now back to the same level as that on the eve of the economic reform. The turn of fortunes has been rather dramatic.

I have argued elsewhere (Tsang, 1993b) that such a process of "different people taking turn to get rich (or poor)" creates a general climate of dissatisfaction as relative incomes twist and turn. Moreover, because the fortunes of any party are seen largely as a result of "delegating power and relinquishing revenues" (*fongquan rangli*) by the central government, any sense of gratitude is easily overwhelmed by that of favouritism, or the lack of it. Hence, the central government finds itself caught in a political paradox: it fails to score points for any achievement, as its only contribution is perceived to be letting go its power, but is blamed for misfortune. In the extreme, it could be viewed merely as an obstacle.

Under such a situation, different parties have competed for obtaining more autonomy and authority from the central government, which, because of the absence of an overall long-term strategy, could only pacify these parties in turn by further decentralization. Moreover, as political reform has moved at a snail's pace, the central government has not re-constituted its authority by claiming a more popular mandate and therefore lacks the legitimacy and credibility to enforce drastic actions, unless the situation turns into near-crisis, like the present one, or outright disaster, as in 1988, when even the local governments and enterprises themselves feel a sense of guilt for pushing things too far.

From another angle, the dilemma is also the consequence of the wrong sequence of economic reform. Wong (1992) has discussed the issue with regard to local finance and industrialization. The problem is of course more pervasive, as I would argue (Tsang, 1993). The poverty of Deng's pragmatism is clear from this perspective. Wu and Reynolds (1988) have pointed to the problems of failing to set up a system of indirect but effective macroeconomic management before groups of interest, vested or newly formed, become powerful. In the traditional command system, local authorities and enterprises were passive agents with little self-interest. Therefore, there should have been enough time in the early stages of the reform to revamp the macroeconomic mechanism in a modernized fashion, with the agents offering too much resistance. Most economic proposals on the transition have stressed the necessity of changing the fiscal and monetary systems before the enterprise reform (e.g. Fei and Reynolds, 1988; McKinnon, 1991).³⁰

²⁹Computed from the *Statistical Yearbook of China*, 1992 and *A Statistical Survey of China*, 1993.

³⁰Even the Big Bang theorists such as Kornai and Sachs emphasize the importance of one-stroke "macroeconomic surgery" as a pre-requisite to rapid and massive privatization of

The reason why the Chinese government did not choose that sequence is an issue that requires more elaborate space to discuss. Here I would only offer a speculative comment. Tsang (1990a) has pointed out that the paramount objective of the CCP in launching the economic reform was to survive and revive after the disasters of the Cultural Revolution. It understood how badly the population had suffered, and how shaky its own legitimacy was. The top leaders, particularly Deng Xiaoping, viewed the economic reform as a way to compensate and pacify the masses, and to regain credibility for the Party. Hence they looked for quick, and observable, results: "letting some people get rich first" was a reflection of that mentality. Nothing would be more encouraging to the people, and the party, when supplies were abundant and when farmers and urban residents ate and dressed better.

The establishment of macroeconomic control mechanism, in contrast, is time- and resource-consuming but tangible results are not easy to observe. No one would attach much value to an effective Finance Ministry or central banking system, or the lack of them, except when the economy is severely overheated or contracted, i.e. they get their worthy attention by default. Hence the relative neglect of that aspect of the economic reform (Tsang, 1993b).

5. Muddling-through versus Big Bang

Serious constraints and obstacles remain in China's march towards a modern market economy with an effective macro-control mechanism. Because of China's peculiar mode of decentralization reforms in a fairly rigid political setting, the conflicts of interests among the central government, the local authorities, the enterprises, and the consumers have resulted in a complicated web of entangled but unstable relations, which is the focus of an endless process of bargaining. The problematic sequencing of the reform, caused by historical-political as well as economic factors, means that the institution of a modernized macroeconomic authority will meet a great deal of resistance from various parties which have a much strong sense of self-interest and are prepared to do everything to defend it. Factors such as historical legacy and regional diversity in a big country with long tradition also hinder sweeping rationalization based on idealistic formulas.

Experience in 1989-92 shows that the central government could still muster enough strength to overcome opposition and force through major price reforms. Some economists would argue, however, that the price reform is easier to implement in the sense that it is more general in nature and

state assets. See Tsang (1992a).

hence intrudes less into specific interests (Lal, 1990). Reforms of the monetary and fiscal systems, particularly of central-local fiscal relations, are unlikely to be so smooth.

It appears that only a drawn-out give-and-take process that skillfully arbitrates the interests of various parties, vested or newly formed, stands a *realistic* chance of success in establishing a macroeconomic authority in China with sufficient legitimacy and adequate means in effectively managing an economy undergoing great transformation, while avoiding traditional crude methods which are showing diminishing marginal returns. A key question is whether such an authority would be forthcoming, given all the frustrations and temptations of the Chinese reform.

However, There is apparently a growing number of commentators as well as decision makers who think that instead of continuing the muddling-through China should attempt something drastic. A big bang after 15 years of gradualist reforms seems worthy of at least a try. Of all arguments against a "big bang", the cost to pay as a result of the macroeconomic surgery and the unemployment effect of privatization is a key issue. Some would say that China's situation now is much better than that in Russia and Eastern Europe, and therefore the cost is likely to be substantially lower (see Tsang, 1993c).

A "big push" in China can also be motivated by frustration rather than by confidence or far-sight. Indeed, China's "gradualist" reforms have been punctuated by adventurist moves from time to time, when the top leadership grew impatient or felt at a loss in dealing with the complicated mess of reality. Outstanding examples include the ill-fated attempts of radical liberalization of 1985 and 1988 (Tsang, 1990a). In the latter case, top leaders including Deng Xiaoping and Zhou Ziyang actually wanted to gate-rush in the price reform, but were held back in the last minute because the macroeconomic situation was too bad. In 1993, China seems to have entered a new deadlock as the macroeconomic control mechanism fails to catch up with the free-wheeling developments in major sectors of the economy, particularly the property, financial and services sectors.

As I analyzed above, it is now even more difficult than in the past to work through the complicated web of rapidly emerging and entrenched interests. This observation may, ironically, lead to the opposite conclusion: that the government should try something drastic, say rapidly changing the fiscal and monetary systems and freeing the Renminbi by fiat and then force every party of vested interests and non-interests to adjust behaviourally to the new circumstances. It is essentially a *coup* intended to enable the central authority to rise above the increasingly dirty mess of local powers. The freeing of the swap rates for Renminbi in June 1993, which was reversed soon after the launching of the austerity programme, might be the tip of the iceberg as an expression of the inclination and the power of the "rapidists". More decision-makers could lose their patience, or their

nerve, in the near future.³¹ The possibility that China might take a gamble, not just in foreign exchange liberalization, cannot be ruled out. In August-September 1993, there were many signs that the top leaders were drafting a comprehensive reform package on macro-control. Premier Li Peng, in his speech on the eve of the 44th Anniversary of the PRC, said that "big reform steps" will be taken shortly in the spheres of public finance, taxation, money and banking, trade and investment management (*Wen Wei Po*, October 1, 1993).

It remains to be seen how big and comprehensive these reform initiatives would turn out to be, and whether they would constitute a "big bang" in any sense. Nevertheless, to talk about reform so loudly at the initial stage of a macroeconomic adjustment programme is to me a strange tactic. As analyzed above, various vested interests would harbour a certain sense of guilt for the excesses in the economy around a cyclical peak, so the balance of (bargaining) power would swing in favour of the central authority. That is the basis for any austerity package involving a good deal of administrative measures. However, it is one thing to ask these parties to comply to the tightening in credit, the clampdown on investment and the anti-corruption drive. After all, they should not have over-expanded and got corrupt in the first place. It is quite another to demand them to go along with drastic reform steps involving the whole macroeconomic system, and to adjust rapidly to the new rules of behaviour. The cyclical power of the central government may not be enough to sustain it through a reform process of the "big bang" type, whose costs may be very high and very unevenly distributed.

The talk about reforms could, on the other hand, send out the wrong signals to the local governments and enterprises if they do not take it seriously. They may interpret it as a way for the central authority to climb down because of the difficulties in forcing through the austerity programme this time. The assertion, made by many high-ranking officials including Zhu Rongji and Li Peng, that "preliminary success" has been achieved in macroeconomic readjustment would only add to such a belief. While it is certainly true that without further reform the effectiveness of China's

³¹ For example, the liberalization of the foreign exchange system has become a battle ground for radical reformers and the gradualists. Recently, China's Vice Minister of Finance, Mr. Jin Renqing, allegedly revealed that the official and the market exchange rates will be unified *next* year (*Ta Kung Pao*, September 16, 1993, p.4). This is a dramatic shift from the previously stated time frame of five years, and an official from the SAEC said that he was "not aware of a change of policy" (*SCMP*, September 17, 1993, Business 2). Unfortunately, Mr. Jin did not specify to what scope of transactions the unified rate would apply. In other words, he did not define the degree of convertibility that would accompany the unification of the exchange rates (Tsang, 1993c). Interestingly, Hongkong's Financial Secretary Hamish Macleod said after an IMF meeting in Washington that it would take five to ten years for China to complete "the unification of the swap market, black market and official rates" (*Hong Kong Standard*, October 1, 1993).

macroeconomic control would remain very low, cyclical contraction and macroeconomic reform are two very different animals. To argue that macroeconomic contraction can be achieved through reform is quite absurd. It is just like a doctor who attends to a patient suffering from high fever and discovers that because of a lack of exercise the latter is weak and gets sick easily. He then tells the patient: "Giving you medicine to cool you down is no real solution. Now would you get up and do 50 laps outside. Afterwards, go swimming. Sport helps to strengthen your body and you won't be ill so easily." If you were the unfortunate patient struggling with a temperature of 103 degree Fahrenheit, how would you respond to such advice? The Chinese experience of 1989-92 clearly points to the wisdom of a proper sequential approach. Major reform initiatives were not taken until the inflationary pressure in the economy really subsided. Any responsible doctor should undoubtedly insist that the patient do more exercise, after he is cured!

There is a chance that 1993 would turn out to be like 1985. Overheating then led to readjustment, which was aborted in the second half of 1986 as Zhou Ziyang turned soft in face of protests from the local authorities. As the root problems of imbalances had not been solved, they accumulated, worsened, and in 1988 finally exploded. In trying to lure parties of vested interests to participate in a comprehensive reform process, the central government may have to loosen the rein again this time. Indeed, there are already signs that credit is being relaxed, to alleviate the problems of "triangular debts",³² if not for any other consideration.³³ Macroeconomic relaxation could be traded for reform compliance. The trouble is: unless the macroeconomic reforms so very successful that the underlying inflationary is eradicated at the same time, the loosening designed as an incentive could brew further problems down the road. We might see a "second leg" of the present cycle and dangers could lie ahead in 1995-96.

As to a possible big bang for China in 1994, I remain a sceptic about its real chance of

³²In the last macroeconomic cycle, "triangular debts" emerged largely as a result of the readjustment programme launched in late 1988. This time round, the issue became serious in the first half of 1993, even before the clampdown. The proliferation of "white slips", "green slips", "red slips" etc. was a clear sign of the serious shortage of funds and the over-expansion of investment and excessive commitments of working and fixed capitals. The "new three heats" (*xin san rue*)--euphoria over economic development zones, the housing and the stock markets-- focussed on investments that required funds of long maturity and therefore contributed to the monetary draught and, because the principle of economic viability was not observed in the circuit of lending and borrowing, the debt trap.

³³For a more comprehensive discussion of the possible factors resulting in a half-way abortion of the austerity programme and some counter-arguments, see my interview as reported in *Hong Kong Economic Times*, September 24, 1993.

success. A big bang after 15 years of gradualism is of course different from a big bang in Year zero, and I would support any move that aims at achieving a breakthrough, particularly in establishing effective macroeconomic control. However, as I analyzed above, 15 years of improperly sequenced gradualism have brought both hopes and *obstacles*. These obstacles are no less, if not more, difficult to overcome than those in Year zero. Any grand blue-print could easily be watered down beyond recognition in the practical reality of hard bargaining among so many parties of different interests in a country as big as China (one fifth of mankind).

References

- Chai, Joseph C.H. (1991), "Incentive and Profit Sharing in Chinese Industry 1979-1989", *Hong Kong Economic Papers*, No.21.
- Chen, K., Jefferson, Gary H. and Singh, I. (1992), "Lessons from China's Economic Reform", *Journal of Comparative Economics*, vol.16, no.2.
- Cheng, Yuk-shing, Tsang, Shu-ki, and Chan, Man-hung (1993), "Price Responsiveness of Chinese Agricultural Production under the Economic Reform", *Jingji Yanjiu*, January (in Chinese).
- Fei, John and Reynolds, Bruce (1987), "A Tentative Plan for the Rational Sequencing of Overall Reform in China's Economic system", *Journal of Comparative Economics*, Vol.11, No.3.
- Fang, Gang et al. (1990), *Macroeconomics of Public Ownership*, Joint Publishers, Shanghai (in Chinese).
- Jefferson, Gary H., Rawski, Thomas G., and Zheng Yuxin (1992), "Growth, Efficiency and Convergence in Chinese Industry: A Comparative Evaluation of the State and Collective Sectors", *Economic Development and Cultural Change*, Vol.40, No.2.
- Lal, Deepak (1990), "The Fable of the Three Envelopes: The Analytics and Political Economy of Reform of Chinese State Owned Enterprises", *European Economic Review*, Vol.34, September.
- McKinnon, Ronald I. (1991), *The Order of Economic Liberalization*, John Hopkins University Press.
- Ping, Xin-qiao (1992), *Fiscal Principles and Comparative Fiscal Systems*, Joint Publishers, Shanghai (in Chinese).
- Perkins, Dwight (1988), "Reforming China's Economic System", *Journal of Economic Literature*, June.
- Rawski, Thomas G. (1992), "Progress without Privatization: The Reform of China's State Industries", Mimeograph, Department of Economics, University of Pittsburg.

Stepanek, James B. (1991), "China's Enduring State Factories: Why Ten Years of Reform have Left China's Big State Factories Unchanged?" in U.S. Congress Joint Economic Committee, *China's Economic Dilemmas of the 1990s: Problems of Reforms, Modernization and Interdependence*, Washington: US Government Printing Office.

Tsang, Shu-ki (1990a), "The Nightmare of the Cultural Revolution and the Experience of the Chinese Economic Reform", in C. H. Ng et al. (eds), *Exploration of Democracy in China*, Hong Kong: Meeting Point Ltd., January (in Chinese).

Tsang, Shu-ki (1990b), "Controlling Money during Socialist Economic Reform: the Chinese Experience", *Economy and Society*, Vol.19, No.2.

Tsang, Shu-ki (1991), "Monetary Policies under the Double-Track System: Some Theoretical Considerations for China", *BRC Working Paper Series CS91011*, Hong Kong Baptist College, July.

Tsang, Shu-ki (1992a), "Against Big Bang: Theoretical and Practical Arguments", *BRC Working Paper Series ES91020*, Hong Kong Baptist College, March.

Tsang, Shu-ki (1992b), "Emerging Trends in the Chinese Economy after the 14th Party Congress", *Wide Angle*, Hong Kong, December (in Chinese).

Tsang, Shu-ki (1993a), "Recent Developments in China's Financial Sector", paper presented in a seminar organized by CERD Consultants Ltd., Hong Kong, June 15 (in Chinese).

Tsang, Shu-ki (1993b), "Loss of Control in China?", *Wide Angle*, Hong Kong, July (in Chinese).

Tsang, Shu-ki (1993c), "The Foreign Exchange System in China: Review and Outlook", paper presented in the Symposium *Strategies for Foreign Exchange Operations in PRC*, organized by Streeter Communications, September 23, Hong Kong.

Tsang, Shu-ki and Cheng, Yuk-shing (1993), "Workers' Remunerations and Enterprise Autonomy under the Chinese Economic Reform: A Panel Data Analysis", *BRC Working Paper Series CS92027*, Hong Kong Baptist College, July.

Woo, Tun-oy and Tsang, Shu-ki (1988), "Comparative Advantages and Trade Liberalization in China", *Economy and Society*, Vol.17, No.1.

The World Bank (1990a), *China: Revenue Mobilization and Tax Policy*.

The World Bank (1990b), *China: Financial Sector Policies and Institutional Development*.

The World Bank (1992), *China: Reform and the Role of the Plan in the 1990s*.

The World Bank (1993), *China: The Achievement and Challenge of Price Reform*.

Wong, Christine P.W. (1992), "Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China", *Modern China*, Vol.18, No.2.

Wu, Jinglian and Zhao, Renwei (1987), "The Dual Price System in China's Industry", *Journal of Comparative Economics*, Vol.11, No.3.

Wu, Jinglian and Reynolds, Bruce (1988) "Choosing a Strategy for China's Economic Reform", *American Economic Review*, Papers and Proceedings, May.

Zheng, Jia-heng et al. (1992), *The Fluctuations and Adjustments of the Chinese Economy*, China Statistical Publishing House (in Chinese).