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MACROECONOMIC DEVELOPMENT OF CHINA:

"OVERHEATING" IN 1984-1987 AND PROBLEMS FOR REFORM

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ABSTRACT

After the Chinese Communist Party had embarked on economic reform in 1978 China's macroeconomic performance had been quite satisfactory until the autumn of 1984, but since then the Chinese economy ran into "economic overheating", with rapid inflation and large trade deficits, which is nothing but a typical case of demand-pull inflation. Its two major causes are high rates of increase in money supply caused by rapidly increasing bank lending and of increase in wage payments, both accompanied by some mismanagement in the process of economic reform. A third cause is too high an increase in government expenditures financed by the central bank credit. Chinese leaders seemed to believe "economic overheating" coming under control in 1986, but it appears that appeasement was only temporary and that "overheating" was still going on throughout 1987. Through this "economic overheating" in 1984 through 1987 China's net international assets-liabilities position deteriorated severely: by 12.5% of China's GNP in 1986. China's present macroeconomic management is deficient in several ways and needs to be improved. Money-supply must be firmly controlled through a two-tier quota system with quotas set for each quarter, both for central bank lending to each of non-central banks and for the latter's lending to their customers. Both non-central banks and non-financial enterprises should be transformed into a full-fledged independent enterprise operating on a commercial basis, free from political and nepotistical influences. China's present balance of payments management also needs to be improved in several ways. Imports should be controlled on a centralized basis under a "foreign-exchange budget," while the competitive price mechanism should be fully used in promoting export and directive planning as well as the complicated foreign exchange retention system currently in force should be abolished. The dependence on foreign borrowing should be lowered by promoting export and restricting import more efficiently. China's annual investment ratio to GNP is still too high, and should be lowered, and the efficiency of investment raised.

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INTRODUCTION

From 1978, when China took the first step of the economic reforms aiming at modernization of the Chinese economy and the policy of "opening up the country" China's macroeconomic development had been quite satisfactory until 1984. Since the fall of 1984, however, after the declaration of the basic principles of the second stage of the economic reform centered on urban and industrial development, and continuing through 1987, the Chinese economy has been "overheated", with rapid inflation and large trade deficits. This article first describes the process of economic overheating in China during the period from 1984 to 1987 and attempts to analyze its cases, and then, based upon this analysis, points out shortcomings of China's macroeconomic management and indicates the basic directions for improvement and a number of concrete measures to be taken. Section I provides an outline of the "economic overheating" phenomenon, particularly development of inflation and the trade deficit, since the fall of 1984. Section II explains that this phenomenon of "economic overheating" is nothing but typical demand-pull inflation, and points out that there exists an important perception gap between the general understanding among the Chinese leaders and myself. Section III analyzes how a sudden increase in total demand arose, which was the basic cause of the demand-pull inflation. The following two sections discuss what China's present macroeconomic goals should be (Section IV) and what basic principles and

concrete measures are necessary for such goals to be achieved (Section V). Finally, Section VI is a summary of the major conclusions.

1. THE PROCESS OF "ECONOMIC OVERHEATING": 1984-1987

With the fall of the Gang of Four in 1976 the Great Proletariat Cultural Revolution, a long period of suffering for the Chinese people, came to an end. Following the adoption of new policies towards economic reform by the Third Plenary Session of the Eleventh Central Committee of the Chinese Communist Party (CCP), China entered a new period of steady and rapid economic growth until the middle of 1984. During this period, the Chinese economy managed to escape from its prior stagnant state and proceeded to achieve remarkable results in terms of macroeconomic indices. Those who are interested in economic growth of developing countries and countries with planned economies then looked at China with great interest.

The Favorable Macroeconomic Performance of China: 1978-1983 China entered a new period of rapid economic growth from 1978 to 1983 with a growth in real GNP of 5 to 10% for each year. It appeared that China entered a period of "High Economic Growth" such as one Japan went through from 1955 to 1970. Moreover, economic growth was more or less well balanced between sectors of the economy¹⁾ such as agriculture and industry, and light and heavy industries (See Figure 1). Growth of agricultural production was particularly remarkable, and development of industrial and other nonagricultural production in rural areas was noteworthy.

China had had an excess of grain imports over exports for many years, and especially for 1978 through 1982 imported a large amount of wheat, which was then one of the largest items of imports. Since 1985, however, grain exports exceeded grain imports, reflecting favorable condition of the Chinese agriculture²⁾ (Figure 2). As a result of a substantial increase in domestic

production, imports of raw cotton, which had amounted to a considerable sum in the past, steadily decreased, in spite of the fact that exports of cotton textile products increased rapidly. By 1985 raw cotton no longer had to be imported, and it even became an export item.³⁾

The above-mentioned improvement in the trade of agricultural products contributed substantially to the balance of payments, and the balance of payments remained more or less balanced for most years from 1976 to 1983. The value of exports in terms of U.S. dollars increased fourfold, and with the invisible account showing a small surplus the current account maintained an approximate equilibrium. Also, there were inflows of long-term capital, and by the fall of 1984 foreign exchange reserves had increased substantially (Figures 3 & 4).

Furthermore, the rate of inflation remained quite low: for most years it was kept below 2 to 3%, and the government budget maintained an approximate balance (Figures 5 & 6).⁴⁾ In 1979 and 1980, however, the government instituted a general increase in its purchase prices of farm products and at the same time an increase in the amounts of grants-in-aid to urban residents for the supplement of living costs. This caused an increase in the rate of inflation and a deficit in the government budget in 1979 and 1980 (13.4% and 10.5%, respectively, of the total expenditures). Aside from these two years, however, the rate of price increase remained low and the government budget was more or less balanced.

These excellent macroeconomic and growth records of the Chinese economy resulting from the economic reform since 1979 seems to have instilled Chinese leaders with the new confidence to pursue further epoch-making reforms in the Third Plenary Session of the Twelfth Central Committee of the CCP in 1984.⁵⁾

Following this Third Plenary Session of the Twelfth Central Committee, however, China's macroeconomic conditions appears to have deteriorated much and, indeed, gone out of hand. The economy was overheated, with prices increasing

rapidly and trade deficits reaching unprecedented levels for three consecutive years. An outline of this "economic overheating" phenomenon is now presented.

Trends in Inflation Foreign observers like myself cannot know which price indices are the best indicator of inflation in China or how reliable they are. We can get an approximate idea of the inflationary trend, however, by looking at several official statistics such as Workers' Cost of Living Index or the Retail Price Index (Figure 7).

From 1978 to 1984 the annual rate of price increase remained at a level under 2 to 3% for most years, with only a few exceptions, such as 1980. In 1984 however, price levels increased steadily, and by the beginning of 1985 both Workers' Cost of Living Index and Retail Price Index were more than 10% higher than the same months of the previous year. The national average rates of inflation reached then 11 to 12%. This nationwide inflation was particularly severe with regard to the prices of "subsidiary (non-staple) foods" sold in the free markets in large cities. The common people felt, Japanese newspaper reported, that the actual inflation rate was much higher than that recorded in official statistics.⁶⁾ Beginning in early 1986, the rate of inflation started to slacken and, by the middle of the year, it leveled off to between 2 and 4% (Figure 7).

Nevertheless, inflation was rekindled from the autumn of 1986 on, and the rate of inflation again reached over 6% from late 1986 to April 1987. In May 1987, the cost of living and retail price indices were both over 9% (compared with the same month of the previous year). In particular, the rate of price increase for free market consumer goods was 22.0% in January 1987 and 14.2% in April. In 1987 the rate of price increase was especially high in big cities throughout the country, and Beijing, Shanghai, Guangzhou, and Shenyang all faced double digit inflation. City residents again were quoted to have attested that the actual inflation rate was much higher than published statistics showed. The inflation process that began in 1984 and leveled off in the middle of 1986

does not seem to have ended at the time of writing this article.

In 1983 and 1984, China's economic policy-makers stated that correction of the skewed price structure was one of the most urgent tasks on the reform agenda. They believed that in order to carry out such a reform, prices of industrial raw materials, energy prices, train fares, and prices of living necessities, such as food, clothing, and matches, which had previously been artificially suppressed, would have to be raised. They said that keeping the rate of inflation under 2 to 3% would be a matter of great importance, although in order to correct the price structure increases in the price level would be inevitable. But a high rate of inflation must be avoided, they said, since it could lead to unrest among masses. Within one or two years after these sayings, however, inflation was in the shocking double digits.

Large Trade Deficits Prior to 1978, China made it a policy not to obtain loans from foreign countries nor to invite foreign direct investment as a way to cover the deficit in the balance of trade. In order to adhere to this policy of "developing by one's own efforts and means" ("zili gengsheng"), the Chinese government kept total imports at a low level compatible with export earnings. Thus, the trade account was carefully kept balanced or to show a small surplus. In China, for the most years the balances of invisibles and of transfer payments have usually showed slight surpluses. Their sizes are small, however, compared with the trade balance. So it is safe to assume that the trade balance accounts for most of the balance of payments on current account.

Beginning in 1978, with China's adoption of a policy of "opening up the country", the government took the initiative in encouraging inward direct investment and in obtaining loans from foreign countries. This did not, however, change the general conditions of the balance of trade until the middle of 1984 (Figures 3 and 8). During the three years between 1978 and 1980, the government proceeded to borrow long-term funds from foreign countries in order to import machinery, plants and other producers' goods. This gave rise

to a sharp increase in imports, which afterwards led to cancellation of contracts, inviting complaints and criticisms from foreign countries. Yet the trade deficits for these three years were at 12.8% (1978), 14.7% (1979), and 7.0% (1980), respectively, of the total exports. In 1982 and 1983 together, due to an impressive increase in exports, a surplus exceeding the total deficits in 1978 through 1980 was recorded, and, in July 1984, foreign exchange reserves reached a record high of 17 billion dollars, which is equal to more than eight months' imports in 1983 (Figures 3 & 4).

In the autumn of 1984, however, subsequent to the declarations of new economic reform policy adopted by the Third Plenary Session of the Twelfth Central Committee of CCP, the trade surplus switched to a trade deficit, and the deficit thereafter continued to grow rapidly, and foreign exchange reserves decreased drastically (Figures 4 & 8⁷⁾). The trade balance remained in this deteriorated state for more than three years. In the fourth quarter of 1984, imports increased 44.9% over the same quarter in 1983, and in 1985 as a whole 54.2% over 1984. In the same periods, exports increased only 11.3% and 4.7% respectively over the previous year's levels. The trade deficit in 1985 reached an overwhelming 14.9 billion dollars (54.4% of exports). In the beginning of 1986, imports remained at the peak level but gradually leveled off, and for 1986 as a whole it showed only a 1.6% increase over the previous year. Exports increased by 13.1% in 1986 over the previous year, but the trade deficit still amounted in 11.9 billion dollars, or 38.3% of exports, because the trade deficit in the previous year was so large. 8)

Through 1987, the trade deficit seems to have been decreasing towards an acceptable level, and in October 1987 and January 1988 the trade account showed a slight surplus for the first time from the summer of 1984 (Figure 8).

In Figure 8 large amounts of imports and trade deficits in December 1985 and 1986 are most noticeable. This is due to what is called the "Merchandise Huilung" policy, which aimed at holding down the rate of price increase during the Chinese New Year period by absorbing some of the "excessive liquidity", 9)

that is currency in circulation among the public, resulting from the extraordinarily large amount of cash currency issued earlier. With the Chinese New Year at hand, the government used its foreign exchange reserves to import consumers' durables such as home appliances, electronics products and passenger cars which people, villages and small enterprises wish to buy. Through the sale of these products, the government attempted to absorb some of the "excessive liquidity".

The Size of the Accumulated Trade Deficits Although the large trade deficits which persisted more than three years from the autumn 1984 at last seems to have come to an end at the end of 1987, the accumulated trade deficits over the three year and five months' period from August 1984 to December 1987 amounted to 31.5 billion U.S. dollars. Within three years China's net foreign asset-liability (or lending-borrowing) position (including direct investment and shareholding) had greatly deteriorated. The deterioration amounted to an enormous sum: it nearly amounts to China's average annual exports in 1985 through 1987, which is 32.6 billion dollars; or to 12.5% of China's GNP in 1986, converted to the dollar value at the year-end exchange rate¹⁰⁾ (252.2 billion dollars). Such a severe worsening in net foreign asset-liability position constitutes an onerous burden for the Chinese economy and people.

In the case of the Japanese economy, even during periods of severe external disturbances, such as the two oil crises in 1973-1974 and 1979-1980, the total current account deficits amounted only to about 1.3% (first oil crisis) and 1.9% (second oil crisis), respectively, of the annual GNP at the time. Compared with China, Japan is a much more open economy with respect to international trade and finance. In the case of China during the 1984-1987 period, moreover, there were no major exogenous shocks comparable to the oil crisis mentioned above. A sharp decline the 1986 drop in oil prices in 1986 might be mentioned, but it reduced China's export value at most by about 4

billion dollars.

The Chinese economy is called a "socialist planned economy," an economy in which centralized economic planning is essential.¹¹⁾ If this is the case, why did exports and imports fluctuate so drastically between 1984 and 1987, in an utterly unplanned manner? Furthermore, why are there no planning targets for exports and imports publicly announced in any of the documents presented to the People's National Congress, while a number of economic planning targets are given in the Report on the National Economic and Social Development Plans presented there?

In Japan in the 1950s and the first half of the 1960s, when the balance of payments constituted a major constraint on economic growth, a "foreign exchange budget" for exports, imports and invisibles was compiled every three to six months. Problems regarding exports were discussed at length in "Export Councils" (Central Export Council and Sectoral [Industrial] Export Councils for each industry) where government officials and representatives of industries were present, and concerted efforts were made to restrain imports and to achieve export targets.¹²⁾ A comparison of the economies of contemporary China and Japan in the 1950s and the early 1960s gives an impression that, at least in the area of international trade and the balance of payments, the contemporary Chinese economy is much less well planned than the Japanese economy in the 1950' and early 1960'.

II. THE BASIC CHARACTERISTICS OF "ECONOMIC OVERHEATING"

It should be now obvious and perhaps accepted by most Chinese economists that excessive overall demand caused the phenomenon of "economic overheating", in China in 1984 through 1987 characterized by high rates of inflation and huge trade deficits.

Demand-Pull Inflation The macroeconomic condition of the Chinese economy between 1984 and 1987, particularly in the first half of 1985, exemplifies a situation of pure demand-pull inflation, in which the total demand for goods and services surpasses the total supply in a national economy. The basic nature of China's "economic overheating" is nothing but a case of pure demand-pull inflation.

It is evident, even from the statistics readily available to foreigners, that after the fall of 1984, the increase in total purchasing power exceeded substantially that in the supply capacity of the Chinese economy. As a result, first, production increased sharply (Figure 9). Second, the excess demand pulled up all or most prices, and the price level of goods and services rose sharply. Third, in areas where supplies were limited, a bottleneck situation emerged. Where prices were not regulated there, prices increased sharply creating "bottleneck inflation". In areas with price controls (including certain basic materials, electric power, and transportation) either shortage of goods, supply restrictions, or forced waiting occurred. Typical examples included a limited supply of electric power causing factories to stop production one or two days a week and ships moored in seaports a number of days before unloading cargo. The latter situation was bound to create a bottleneck situation in the next stage. Fourth, the trade balance turned into a deficit since there was a large increase in the import of those goods which were usually imported or had to be then imported because of the domestic supply shortage. These are all typical symptoms of demand-pull inflation.

Factors in Cost-Push Inflation It appears that China's 1984-1987 inflation was caused not so much by cost-push forces as by demand-pull ones. The following three factors could be thought to have caused cost-push inflationary pressure.

(1) Dismantling of Price Controls and Revision of Controlled Prices The

first possible cost-push factor would be the rationalization and liberalization of prices which had been controlled up to that time and kept low for a long time in line with policy considerations. As part of the economic reform prices of both staple foods and non-staple foods (vegetables, meat, eggs and fish) were raised, or controls on them abolished. On the side of producers' goods, revisions of the price system for basic materials and capital goods were carried out and a new system of negotiation pricing and floating prices (within a range) were introduced. Price controls were abolished in many other areas as well. In addition, railroad transportation, fares were raised. Such measures created cost-push inflationary forces. It is inevitable that the "relative" prices of such goods and services as mentioned just now increase somewhat during economic development, but inflation can be avoided if changes in the relative price structure are effectuated in such a way that some prices increase and others decline. Nevertheless, in most countries there are various restraints and limitations on price decline: that is, what is called downward rigidities of most prices. Hence "relative" prices can increase only by raising the "absolute" prices, and changes in the relative price structure can be effectuated only through an increase in the general price level. Therefore, changes in relative prices, particularly those changes which result from the relaxation of price controls, generally create inflation. Because China's pricing structure generally lacks flexibility, rationalization of the price structure and liberalization of price controls tend to result in an increase in the general price level.

(2) Exchange Depreciation A second possible factor in cost-push inflation is the depreciation of the exchange rate of the Chinese currency (the Renminbi yuan, RMB). This cause can be included in the same conceptual category as the first one. In less-developed and centralized planning economies such as China, the use of a floating exchange rate is perhaps out of question. Hence, it is necessary to regard the exchange rate as an artificially controlled

macroeconomic variable rather than a price determined by the demand and supply forces. Based on this interpretation, the depreciation of the RMB yuan should have acted as a significant cost-push force in the inflationary process.

At the beginning of 1981 China adopted a dual exchange rate system. For foreign transactions other than trade an official exchanges rate of 1.53 yuan (RMB) to the U.S. dollars was used. However, for transactions between China's governmental interantional trade corporations or agencies on the one hand, and manufacturing and wholesale enterprises on the other, a "domestic" or "internal" exchange rate of 2.8 yuan to the dollar was used. This nearly amounts a use of a dual exchange rate system under which the 2.8 yuan rate is used for merchandise trade and the 1.53 yuan rate for any other transactions. Thereafter, the official exchange rate depreciated but the "internal" (merchandize trade) rate was kept at 2.8 yuan. In 1985 the dual exchange rate system was abolished as a result of a complaint from the United States and the official rate of 2.8 yuan to the dollar was adopted, which was thereafter gradually depreciated. By October 30th of the same year, the official rate had been depreciated to 3.2 yuan to the dollar and by July 5th 1986, it had dropped further to 3.7 yuan to the dollar. Since then the yuan has fluctuated around the 3.7 yuan per U.S. dollar (Figure 10).

Looking at only trade transactions, the yuan (RMB) depreciated 12.5% against the dollara over the one year period between September 1984, when great inflation started, and October 1985. Furthermore, the yuan depreciated another 13.5% against the dollar until July 1986. The total depreciation of the yuan against the dollar in about two years amounted to 24.4%. Since September 1984 the dollar has fallen substantially against the Japanese yen and major European currencies. This means that China's effective exchange rate has dropped by something like 35 to 40% between 1984 and the end of 1987. Such a large depreciation of the yuan must inevitably have had a cost-push effect on the domestic price of goods. Looking at from a macroeconomic point of view, however, the depreciation of the exchange rate is more a result, than a cause,

of inflation. The exchange rate was adjusted as a policy means to cope with
13)
large and increasing trade deficits, and declining foreign exchange reserves.

Moreover, the Chinese economy is not a highly open one, as there exist various barriers which separate the domestic price structure from the international one. Especially there are no strong ties between consumer goods and imports. Thus, cost-push pressure on the domestic price level, especially on the retail prices of consumer goods and workers' cost of living, resulting from the exchange depreciation are likely to be weak.

Third, cost-push inflation in the West European and North American countries is strongly influenced by the process of wage determination through collective bargaining. In contrast there is no collective bargaining in China, and hence no inflationary pressure originates from the wage determination process.

It can be concluded from the above that cost-push factors were weak in the 1984-1987 inflation in China.

Perception Gaps: When Did the "Economic Overheating" End? Examination of a variety of Chinese literature on "economic overheating" after 1984, including principal documents presented to the annual People's National Congress, government announcements, official statements made by China's leaders, and writings by Chinese economists, suggests that my view of the "economic overheating" basically accords with the predominant view in China. Yet there seem to exist gaps in perception, especially with regards to two points.

The first gap is concerned with the question when and whether the "economic overheating" cooled down. Judging from several writings and statements, Chinese leaders appear to believe that the "economic overheating", or demand-pull inflation in macroeconomic terminology, occurred between the end of 1984 and the beginning of 1985. They seem to believe that by the middle of 1986 the situation had cooled down and
14)
the problem of high inflation had been largely overcome.

A cursory inspection of newspaper reports and statistics reveals that the severe inflation between 1984 and 1985 was checked by the strong measures to control inflation implemented in 1985. Some of such measures were contradictory to the reform of the economic system. It appears that by the end of 1985 the upsurge of inflation had begun to subside, and by the middle of 1986 inflationary pressures had been considerably reduced. Industrial production between October 1985 and April 1986 was below the levels in the same months of the previous year (Figure 9), and the rate of inflation also fell substantially (Figure 7).

Inflationary pressure seems to have increased thereafter, however. The rate of inflation was at its low between June and August 1986, but then rose again. This trend toward the resurgence of "economic overheating" is apparent from various data, including price indices (Figure 7), industrial production (Figure 9) and the money supply (Figures 11 & 12). Various reports in 1987 reports suggest that the trend toward "economic overheating" was far from over then. For example, from January to August 1987, industrial production increased 15.4% (the target in the official plan was 7%) over the previous year's level. In the first half of 1987, "basic capital construction" investment increased 19.3% over the previous year's level, in spite of the declared policy to suppress the level of "basis capital construction" investment below the level in 1986. This is far above the level given in the 7th Five-Year Plan. In the first quarter of 1987, the total employees' wages showed a 16.7% increase over the previous year's level. In particular, the total amount of bonuses increased 42.6%.

As stated previously the national average inflation rate in 1987 was over 9%, and in large cities the inflation rate reached double digits. Based on such statistics, it cannot be concluded that inflation "had been suppressed in principle."

Macroeconomic Interpretation of the Trade Balance A second perception gap

between the Chinese leaders and myself is that they do not seem to perceive nationwide rapid inflation and large trade deficits as coming from the "same roots", or caused by the same basic factor, namely an excessive overall demand relative to the supply capacity.

From a macroeconomic point of view a country's trade deficit is interpreted as follows. In a closed economy, when the country's total demand (or its rate of increase) exceeds the total supply, real purchasing power, which is the basis of aggregate demand, has to be reduced to the level where the aggregate demand is equal to the level that suppliers are able to provide, thereby restoring the equilibrium between the aggregate demand and supply. This is achieved by the rise in prices of goods and services, that is, by inflation. If the rate of increase in the aggregate demand continues to exceed that of the aggregate of supply over several years, sooner or later prices will rise. In contrast to this situation, if demand exceeds supply in a relatively small country under a fixed exchange rate system and with large foreign exchange reserves its imports will increase to fill the gap between the aggregate demand and the country's supply capacity. Thus a trade deficit develops, which is equal to the excess amount of demand over supply. Prices do not rise but the foreign exchange reserve decreases, so that, in effect, excessive demand is absorbed through the sale of foreign exchange by the monetary authorities to the public.

The situation in most countries falls somewhere between these two extreme cases. When there is an excessive overall demand in a country, the domestic prices of goods and services rise, and in the international economic relations
15) the country runs a trade (or current account) deficit. Hence the increased purchasing power is partly absorbed by the increase in prices and partly by the decrease in the foreign exchange reserves (or borrowing from abroad). In effect, a trade deficit mitigates the extent of the price increase (the rate of
16) inflation) in proportion to its size.

The Main Cause of the Trade Deficit According to the macroeconomic interpretation of the trade balance explained above, it is apparent that of "economic overheating" in China caused by the excessive demand from the middle 1984 until at least the first half of 1987, and that the excessive demand for goods and services relative to the supply capacity resulted in domestic price increases on the one hand, and trade deficits on the other. This is the basic cause of China's large trade deficits in 1984 through 1987.

Secondary causes of the trade deficits would include the following: 1) a decrease in earnings from oil exports caused by the fall in oil prices in 1986; 2) an increase in imports accompanying foreign direct investment and loans; 3) mismanagement in the administration of import and foreign exchange controls which arose in the process of reforming the import and export systems; 4) the "Merchandise Huilung" policy by which it was intended to reduce price increases in April of 1985, in late 1985, and in late 1986. Also, in the earlier stages the economic policy authorities seem to have adopted 5) a policy to increase imports and reduce foreign exchange reserves, which by the middle of 1984 reached an unprecedented high level. These and some other factors would have contributed more or less to suppressing exports and increasing imports, and contributed to trade deficits. In my view, however, the previously mentioned basic macroeconomic factor, namely the relationship between aggregate demand and aggregate supply, was the main cause for the trade deficits.

From a macroeconomic viewpoint, it is apparent that imports increase when total domestic demand exceeds total domestic supply. Also, exports stagnate, or even decrease under such conditions. In fact, in 1985 China's imports increased by 54.1% and exports stagnated at only 4.7% above the previous year's level. Under domestic conditions favorable to the producers, it is no wonder that exports stagnate. It was reported that Chinese enterprises could then sell their products without much difficulties in domestic markets, so that many firms choose to sell their products domestically rather than

export them to foreign markets where conditions regarding specifications, quality, design, and delivery time are stricter and more cumbersome to fulfill.

China's economic literature seems to lack the understanding that inflation and trade deficit are both a macroeconomic phenomenon. It is my impression that in China these two phenomena are interpreted as unrelated results of different causes.¹⁶⁾

The lack of macroeconomic understanding on the part of China is especially apparent in the Chinese view on the trade imbalance between China and Japan. For example, regarding an increasing bilateral trade deficit with Japan, the most reputable Chinese newspaper on economic affairs Jingji Ribao (Economic Daily), July 16, 1985, warned against a sharp increase in imports from Japan, particularly a large increase in durable consumer goods. It stated that "A close, cooperative effort by business and academic circles in both China and Japan to solve the China-Japan trade imbalance is necessary, but there is not an enough effort on the part of Japan." Chinese leaders reiterated such misplaced views and statements throughout 1985 and 1986.¹⁷⁾

III. SOURCES OF THE INCREASE IN THE AGGREGATE DEMAND

What were the causes of the sudden upsurge in the aggregate demand from the fall of 1984, which brought about rapid inflation, and the severe deterioration of the trade balance? Have the conditions for rapid demand-pull inflation and large trade deficits been removed? What should be the targets of macroeconomic management in present day China? Further, are the institutional arrangements and measures currently used for macroeconomic management sufficient for achieving the macroeconomic targets? Are there any rooms for improvement, and if there are, in which directions? In order to correctly address these questions, detailed information is needed concerning the various

economic institutions in China, the progress of economic reforms, macroeconomic developments since 1984, and the measures of macroeconomic management adopted to cope with these situations. A foreigner like myself has naturally only limited information. But there may be an advantage to a foreigner who looks at these problems as a distant, third party observer. What follows is a foreign-slanted, bird's-eye view of China's macroeconomic policy situations.

First, the sources of the sudden increase in the aggregate demand beginning from the Autumn of 1984 are considered.

Causes of the Sudden Increase in the Aggregate Demand 1984-1985:

(1) Sudden Increase in Bank Lending The March 1985 "Political Activities Report" by Zhao Ziyang, who was then Prime Minister and is now CCP's General Secretary, quite frankly explained the causes of the sudden expansion of the aggregate demand which began in the fall of 1984 and continued throughout the first half of 1985.¹⁸⁾ From this report and other newspaper and magazine reports and articles, the causes of the sudden increase in the aggregate demand and the economic overheating during this period can be broadly understood as follows.

First, in the fourth quarter of 1984, there was a sudden increase in the total amount of bank lending to enterprises. This situation seems to have occurred because of the mismanagement in the process of economic reform through which the financing of "basic capital construction" investment was changed from the provision of government (public finance) funds to bank lending.¹⁹⁾ In relation to the reform of the financial sector in 1985, it was announced in the fall of 1984 that the limit or quota for lending by each bank and each of its branches from January 1985 on would be assessed and determined according to the actual level of lending at the end of 1984. Because of this, banks such as the China Industrial and Commerce Bank, China Agricultural Bank, etc. and their branches, in an attempt to obtain a higher limit or a larger

quota, rushed to increase lending to enterprises during the fourth quarter of 1984. In competition with each other they increased lending enormously, without examining the business conditions of customers and their investment plans. Thus towards the end of 1984 a disorderly, uncontrolled state of a sudden increase in bank lending appeared (Figure 12).

The defects in the system of each bank's control of its provincial branches appears to have been also responsible for the confusion at this time. At least at this time in 1984, China's various banks and their provincial branches bore little resemblance to independent enterprises and their regional constituent parts. Most of them were more a receipt and disbursement window of the central or local (provincial) government, than an independent enterprise in banking or its branch. This may be a primary cause of the forfeiture of monetary control in 1984-1985.

From what I heard in China in 1986, from November to December of 1984, provincial and special-city governments were vigorously encouraging branches of the China Industrial and Commercial Bank and other banks in areas under their jurisdiction to increase, as much as possible, lending to enterprises under their direct control as well as to other enterprises in the provinces or the special cities. At the same time these enterprises were urged by the local governments to borrow as much as possible from banks. It was said that those branches of People's Bank of China (PBC), China Industrial and Commercial Bank, China Agricultural Bank, China People's Bank for Construction, and China People's Insurance Companies, which were located in each province, were all urged by the provincial government to go to their head offices in Beijing and to acquire as much funds as possible. It was said that the head offices of various banks in Beijing and PBC could not get hold of the exact figures of their respective total lending for the country as a whole for several months.

At that time, and perhaps even now, the branches of PBC as well as other banks located in the each province or special-city were supervised from both their respective head offices in Beijing and the provincial or special-

city government. It appears that the deficiencies of this ambiguous two-tier management system, in which supervising responsibility lies in two bosses, that is, the Beijing head office of each bank and the respective provincial governments, and at the critical time probably more strongly in the latter, were exposed. I heard a rumor that the head of a certain provincial branch of PBC, caught between the head office in Beijing and the provincial government, bearing a tremendous burden, committed suicide in 1985.

To cope with the sudden increase in bank lending, from the spring of 1985, strongly restrictive measures were implemented, and reflecting this the rate of increase in money supply temporarily went down. From mid-1986, however, in spite of the large trade deficits, the money supply shifted again toward a rapidly rising trend (Figure 11). It can be conjectured, therefore, that the proper conditions to control bank lending had not yet been established.

(2) Increase in Wage and Bonus Payments A second cause of the sudden increase in the aggregate demand was the rapid rise in the overall wage bills (including bonus payments). In China in the past, at all public agencies and enterprises, a uniform, bureaucratic wage system, very similar to the compensation system for state employees in Japan, had been used. In the process of reforming this system, increasing the autonomy of the enterprise as a decision-making unit, and introducing a new wage system under which wages and bonuses to be paid are determined taking into account the performance of both the enterprises and individual workers, it was announced in the late 1984 that the total wage bills (including bonus payments) allowed to each enterprise in 1985 and later years would be assessed according to the level of actual payments in 1984. As a result at the end of 1984, various enterprises rushed to implement salary raises, promotions, and a variety of bonus payments, increasing greatly the overall amount of wages and bonuses. In December of 1984 the national total of wage bills (including a bonus payments) was 75.4% higher than in the previous December. Both nominal and real per capita wages showed almost the same sudden increase as total wages. Until

the third quarter of 1985, nominal wages continued to increase at a double digit annual rate (Figure 13).

The trend in the yearly rate of increase of labor productivity in China's industrial sector (or the urban sector) has been, on the average, probably around 5%, and at most 6 to 8%. Hence, if a major increase in wages, say an increase of 40% or any double digit increase were to occur in one year, so long as that there is no counteracting large reduction in other items making up the aggregate demand, it is inevitable that the aggregate demand will become excessive.

There were two important results of this economically irrational large wage increases which occurred from the end of 1984. The first is a sudden increase in consumers' demand. Although the increase in overall wage bills resulted in a considerable increase in household savings (bank deposits and purchases of government bonds), as the marginal propensity to save of the urban households was still low in China, and as there was no personal income tax on Chinese wage- and salary-earners, a major portion of the increased wage incomes was channeled into rapidly increasing consumers' demand, overflowing the markets for goods and services. It was naturally accompanied by a multiplier effect and led to a rapid increase in the aggregate demand.

The second result is an increase in enterprises with operating losses. Together with the implementation of the tightening policy since the spring of 1985 as well as revisions in distortions of the relative prices, between 1985 and the end of 1987 a remarkably large, increasing number of public enterprises ran into operating losses. It was repeatedly reported that the total amount of such deficits was also increasing. In 1986, twenty percent of all the public enterprises were running losses, and the number increased still more in 1987.²²⁾ The reckless increase in wages and bonuses must have been one of the main causes of the increase in enterprises falling into losses.

(3) Increase in Government Expenditures The third cause of the increase in

the aggregate demand is the increase in government expenditures. However, unlike the first two major causes, the increase in government expenditures was not as concentrated to the period from the end of 1984 through 1985. (Figure 6).

Since 1976, the size of the government expenditures first increased suddenly but temporarily in 1978 and 1979: thereafter it was restrained and registered either a decline or only a small increase in each year until 1982. After 1983 the tendency toward increases reappeared, and in the three year period between 1984 and 1986, the annual rate of increase was 20% or more in nominal terms. In real terms too, an annual double-digit rate of increase has continued since 1983 (Figure 14). Earlier, funds for both "basic capital construction" investment and "technological improvement" investment in enterprises were supplied from the government budget, but from 1979 on these were gradually converted to bank lending. The conversion was basically completed in 1985.²³⁾ Considering this fact, it is apparent that the government expenditures were increasing at a considerably faster pace than the statistics indicates, and therefore that the expansion of the government expenditures exceeded the "real capability" of the Chinese Economy (Figure 1).

Consequently, as a first approximation, the expansion of government expenditures can be considered as one of the main causes of the sudden increase in the aggregate demand.

However, as a source of the sudden increase in the aggregate demand, the increase in government expenditures does not have the same importance as the above-mentioned (1) increase in bank lending and (2) increase in wages and bonus payments, in my view.

First, government expenditures increased sharply in both 1978 and 1979, and during these two years, "economic overheating" somewhat similar to the recent one but on a much smaller scale occurred. From 1978 to 1985, however, the relative importance of government expenditures to the national income were declining: that is, the ratio of government expenditures to the national

income decreased from 36.9% in 1978 to 27.5% in 1984, and to 27.0% in 1985.

Second, when considered from a macroeconomic point of view, even if government expenditures increase significantly, if there is an increase in tax revenues sufficient to finance increased expenditures, the effect on the aggregate demand will remain relatively small.²⁴⁾ Furthermore even in a situation where tax revenues are not sufficiently increased to cope with the increase in government expenditures, if the latter are financed through government bond issues, and if they are willingly purchased by households, enterprises, and banks (excluding, however, the central bank), then there will be the so-called "crowding out" effect on investment in the enterprise sector,²⁵⁾ and the resulting expansion in the aggregate demand will be a limited one.

Considered in this light, attention must be paid from a macroeconomic management point of view to the amount of government deficit financing by the central bank, rather than the size of the government expenditures or its rate of increase, as an important indicator of the strength expanding the aggregate demand coming from the government sector. It must be pointed out here, however, that the concepts of the government revenue and budget balance in China differ considerably from those common in Western market economies. Specifically, China's government revenue includes: 1) the proceeds from government bond issues (domestic bonds, treasury bills) and 2) loans from foreign governments and international organizations and proceeds from foreign bond issues. On the side of government expenditures, 3) both redemption of bonds and 4) interest payments on bonds and debt are included. Consequently, what is called the budget deficit seems to be equal to government treasury's borrowing (overdrafts) from People's Bank of China. For example, in a report on the execution of the 1985 national government budget, presented to People's National Congress on March 26, 1986, Finance Minister Wan Bingqian stated that while it had been difficult in recent years to achieve a balance in the government budget, the execution of the government budget for the 1985 fiscal year yielded a surplus of 2.8 billion yuan, and that this was a most desirable change. The government

revenue for 1985 included, however, proceeds from national treasury bills (6.0 billion) and new foreign loans (2.5 billion). Although some amount of repayments of debt, bills and bonds would have been included in the "expenditures related to government liabilities" (4.0 billion), in terms of the common Western usage, China's government budget in 1985 was still clearly
26)
in deficit.

It is difficult to estimate the strength of inflationary pressure produced by the government sector in the process of "economic overheating" in 1984-1987. Yet my general impression is that while it is clearly a mistake to ignore it, it was far less important as the primary causes of overheating than the increases in bank lending and in overall wage bills discussed above.

Major Causes of Demand Expansion since 1986 According to the statements of China's leaders they seem to believe that a condition of "economic overheating" from the end of 1984 through 1985 was by and large overcome in 1986. As stated above, that is contrary to my understanding. Inflation seems to have been rekindled in the latter part of 1986.

A glance at available statistical series indicates that the sources of the resurgence in the excessive aggregate demand from the latter part of 1986 were basically the same as those prominent from the end of 1984 through 1985. That is, in 1986 the pace of bank lending to the enterprise sector became quite high again, as it did in 1984 and 1985, or perhaps even higher (Figure 12), and supported by this development, the annual rate of increase in the money supply again surged to more than 40% (Figure 11). In addition, while in the latter half of 1985 the overall wage bills were restrained, they rapidly rose again from the first quarter of 1986 and remained in the double-digit level from the second quarter of 1986 (figure 13). The rate of increase in government expenditures, especially the real rate of increase, was also restrained somewhat in 1985, but in 1986 it rose again, and the nominal rate of increase reached as high as 24.2% over the previous year (Figure 14).

The Problem of Non-Budgetary Funds After the development of the "economicoverheating" phenomenon, Chinese documents frequently emphasized the necessity of controlling and reducing fixed asset investment financed by "non-budgetary funds", or of controlling "non-planned investment", as one of the main objectives of the policy for controlling the aggregate demand. For example, the first provision of the "Sanya Sanbao" (three reductions and three supports) policy announced in the beginning of 1987 stated that "planned construction is to be upheld, and non-planned construction reduced."

In recent years, the amount of non-budgetary funds has been rapidly increasing. It was reported that in 1985 the total amount was 140 billion yuan, reaching 81% of the budgetary revenue, and that in 1986 it amounted to 167 billion yuan, having nearly tripled in six years. Further, in the financing of basic capital construction investment, formerly, budgetary funds provided more than 80% of the total, but today its relative importance has dropped to 30%. Consequently, it is often asserted that the control of non-budgetary funds and non-planned investment is very important for controlling the aggregate demand and inflation.

27)

A cursory reading of available explanations concerning "non-budgetary funds" suggests, however, that these so-called "non-budgetary funds" do not have the characteristics to cause strong inflationary pressure. Looking at items which are explained to constitute "non-budgetary funds", first, "additional" taxes such as "additional" industrial and commercial tax, etc. ("additional" here means local government taxes in addition to the central government taxes of the same title, "additional" receipts, public utilities fares, revenue from local governments' enterprises, maintenance costs for roads and waterways, production, services, and miscellaneous revenue of schools and other units, environmental protection and sanitation charges in cities, incomes from marketplaces and buildings, all of which are included in the revenue of local governments, cannot constitute the sources of strong inflationary pressure, no

matter how large their sizes become, so long as the increases in expenditures are limited within the increases in revenue. Whether they are used for investment in fixed assets or for expenditures of consumptive nature they cannot be considered as a cause of the increase in the aggregate demand which accelerates inflation.

Second, from among the items originally classified as "non-budgetary funds", if I try to pick up items which could possibly become sources of inflation, enterprises' internal funds such as depreciation reserves, funds for major repairs, and retained earnings after profit taxes might be such candidates. However, these items are very small amounts compared with those of Japanese enterprises. For example, the yearly amount of depreciation charges has been very small, since the length of the life of fixed assets for the depreciation purpose in China has been generally quite long, 30 years earlier and perhaps still over 20-25 years. Furthermore, a large proportion of depreciation reserves and funds for major repairs was used to be absorbed into government revenue by the central or local governments supervising them. Also, a predominant part of enterprise profits has been transferred to the government or paid to the government as taxes. Although recently the autonomy of the enterprise has been gradually increasing, the proportion of profits left in the hand of the enterprises was on the average perhaps still less than a quarter or at most a third of the total profits in 1984 through 1987. Moreover, if the amounts of these internal funds of enterprises were to increase in a short time, it would have been a result of "economic overheating" rather than its major cause.

It has often been pointed out and deplored in Chinese literature that a considerable portion of investments financed by "non-budgetary funds" or "non-planned investments" were investments in unproductive facilities which did not contribute much to production, and that many were investments of very small amounts (which in themselves cannot be thought undesirable) having questionable productive consequences. Also, the wasteful use of "non-budgetary funds" for

non-investment group consumption expenditures by government organizations, enterprises and cooperative groups has often been criticized from the standpoint of economic efficiency.

Certainly, in Japan too, from the standpoint of efficiency, there are numerous problems concerning the way public money is spent, not only by the central and local governments but also by the public sector in general. For China in the process of reforming its economic system, it is not difficult to imagine that there are many problems related to the efficient use of "non-budgetary funds." Apart from questions of economic efficiency, however, but from the standpoint of macroeconomic management under the present situation in China, if we exclude those investments by enterprises and investments or other expenditures of local governments and other governmental organizations which are financed by borrowing from banks or elsewhere, "non-budgetary funds" and "non-planned investments" do not seem to be a major source of inflationary pressure. In other words, except for the control of investment and other expenditures financed by borrowing from banks or elsewhere, the control of "non-budgetary funds" and "non-planned investment" should not constitute a priority target in China's macroeconomic management.²⁸⁾

IV. TARGETS OF MACROECONOMIC MANAGEMENT

What should be considered the main targets of macroeconomic management in China today? For example, if the growth rate of GNP, or of industrial and agricultural production, or of real per capita income and wages is sufficiently high, would it be all right even if the inflation rate is quite high, as it happened over the past several years? Or if a high growth of the domestic economy is maintained, would it not a problem even if large trade deficits persist? Questions such as these regarding macroeconomic targets are considered below.

Four Main Targets of Macroeconomic Management Broadly speaking, the principal targets of macroeconomic management in China today, in my view, are: (1) price stability; (2) maintenance of full employment and a reasonably high rate of economic growth; (3) a proper degree of the balance of trade. In addition, in a centrally-planned economy such as China, perhaps (4) a proper balance of consumption and investment should also be regarded as one of the main targets of macroeconomic management.

Each of these four targets is discussed below.

(1) Price Stability As a concrete target of price stability in China, it would be desirable that the annual rate of increase of the Consumer Price Index (CPI: for the time being the "index of urban workers' living costs" may be taken to represent this) should be kept below 3% if possible, and below 4-5% at most. Correlating this to the experience of Japan during the "high growth" period in the late 1950's and 1960's, it would imply that the annual rate of increase of the Wholesale Price Index (WPI: no appropriate statistical series for this is published in China) has to be kept below 1-2%.

As the rate of inflation goes up, that level tends to become unstable and fluctuate over from year to year, making rational economic calculations difficult. Moreover, high inflation hurts people's trust in the country's currency and the financial system. In turn, their confidence in the government will also be damaged. With the advance of unanticipated inflation, people whose rate of increase in income does not equal the rate of inflation because of long-term contracts or price (and wage) controls are exploited. Also there will be people who earn large profits through speculation and other unproductive activities. Thus the acceleration of unanticipated inflation leads to discontent among the general public about inequitable income distribution and causes social instability.

Also, in China today, it is important to mobilize the savings of the

general public as a source of investment funds, so that the real rate of interest when the public save in the form of financial assets (term deposits, government bonds) should be kept above 2-3%. From this point of view, the rate of increase in the CPI would have to be kept within the above-mentioned limit.²⁹⁾

In any economy like today's China, which is undergoing rapid development and an extensive economic reform the relative prices are bound to change quickly. Considering the existing price rigidities, an annual increase in price levels is inevitable. It is desirable to keep this price increase within a moderate range as mentioned above.

(2) Full Employment and Economic Growth The second requirement of China's macroeconomic management is the full utilization of domestic factors of production such as the labor force and productive facilities. Further it is important to draw into the market economy the potential productive resources that exist in various places of the Chinese economy but not fully utilized hitherto. For these purposes, it is necessary to maintain a moderately high level of the aggregate demand and a fairly high but stable rate of economic growth.

The 7.5% growth rate in GNP (probably real GNP) as proclaimed in the 7th Five-Year Plan (1986-90) is perhaps a reasonable benchmark. If macroeconomic management is carried out appropriately it would not be difficult for the Chinese economy, I believe, to achieve such a growth rate.

In order to achieve targets (1) and (2), the greatest task for China's macroeconomic management today is to control the level of the aggregate demand and supply so that they are commensurate with each other.

(3) Equilibrium in the Balance of Trade A reasonable degree of equilibrium in the balance of trade, or more precisely speaking the balance of international payments on current account, as a target of macroeconomic management, in the context of present China, would reduce to the following

two questions. First, to what extent could an average annual deficit in the trade balance or on current account be viewed as tolerable over a 5-10 year period? Second, to what degree are fluctuations in the payments deficits and/or surpluses tolerable?

First, if there are secular current account deficits, the net international asset-liability (investment and indebtedness) position deteriorates accordingly. If the initial amount of net external assets was small, accumulated liabilities will increase. As a result, the burden (interest and dividend payments and principal repayments) for future generations will grow steadily.³⁰⁾

From the point of view of financial prudence (or cautiousness in financial affairs), I believe that the best policy is to maintain near balance of receipts and payments on current account. With this kind of policy the problem of foreign debt burdens in the future can be avoided. A slightly more lax standard would be that net international indebtedness may temporarily increase, but the ratio of net international indebtedness to GNP or to the annual export converge to a relatively low level and that later the above ratio be held constant and that accumulated net foreign liabilities increase at most at the same annual rate of growth as GNP or export.³¹⁾

For example, if the export of goods and services is 10% of GNP and the growth rate of GNP is 7.5%, with an annual current account deficit of 10% of the exports (1% of GNP) the ratio of accumulated foreign liabilities to GNP will converge to 13.3% of GNP, in the long run. In a future steady state, if the average interest rate is 5%, interest payments is only 0.67% of GNP, which is less than the current account deficit (1.0% of GNP). If the interest rate is 7.5%, then all the current account deficit must be used for interest payments.

Why is "financial prudence" to be emphasized? Briefly stated, as far as today's China is concerned, it is wise to avoid taking even just one step further toward the difficult situation of heavy international indebtedness into which some developing countries have fallen, and are now experiencing great

hardship in reducing the burdens, not to speak of getting out of it.

Fortunately for China, severe balance of trade deficits in 1984-1987 and the accompanying sudden and large deterioration of the net international investment/indebtedness position occurred when the latter had not worsened yet.³²⁾

The Chinese authorities are said to have set as a tentative goal a debt service ratio (DSR) of 15-20%. But this seems too high in my view: a much lower DSR³²⁾ be preferable.

There is another reason why it is advisable to keep the dependence on foreign debt low. For China it would not be too difficult to improve the trade balance by controlling imports and increasing exports. China's exports amount only to 1.5% of the total world exports, thus approximating the present condition of China to that of the so-called "small country" in the theory of international trade. When considered in light of the past experience of Japan and the Asian NIES, as a newly industrializing nation it would not be too difficult for China to expand exports fairly rapidly. Further, as will be mentioned later, in China at present the ratio of investment to GNP is very high, and it does not seem necessary to import a large amount of capital every year through turning the balance of payments on current account into a deficit.

Moving to the second question, to what degree should the annual current account balance be permitted to fluctuate from the secular target level? For the sake of simplicity, it is now assumed that the secular target level of the current account deficit is zero.

The extent to which the current account balance, namely the deficit or surplus of the balance of payment on current account fluctuates from year to year depends on the degree of the dependence on trade of the national economy, the composition of imports and exports, and the degree of liberalization of import trade, foreign exchange controls, the easiness of foreign borrowing, and so on.

Except for the U.S., which is the key currency country, or other advanced industrialized countries with very high credit standing, a criterion for

developing and semi-developed countries would be that the total deficits over a period of continued large deficits should be restrained within the size of foreign exchange reserves at normal times. For example, in the case of China, if the normal level of the foreign exchange reserves is equal to 3-4 month's imports, and if the annual level of imports of goods and services, which is approximately equal to that of the exports under normal conditions, is about 10 to 12% of GNP, then the current account deficits which unexpected circumstances have given rise to should be rectified by appropriate macroeconomic measures before the amount of accumulated deficits exceeds the initial, normal level of the foreign exchange reserves. The latter would be somewhere between 2.5 and 4.0%, and nowhere around 10, 12 or 15%, of GNP. Basically the use of long term capital imports should be to finance secular, planned deficits over a long-run.

Again talking about the Japanese economy in the latter half of the 1950s and the early years of the 1960s, when the Japanese government and the Bank of Japan had much difficulties in maintaining the international payments and receipts in balance, the amount of the foreign exchange reserves at normal times was roughly equal to 3-4 months' imports, and macroeconomic management and balance of payments measures were aiming at keeping the yearly size of the current account deficit within 2-3% of GNP at a maximum. When current account balance clearly turned into deficit and the aggregate domestic demand became excessive, tight monetary and fiscal policies were implemented so as to turn the current account into a surplus within half a year to a year.

As compared to the experience of Japan in the early postwar period, the scale (in terms of ratio to GNP or exports) of China's trade deficits from the end of 1984 to 1987 were enormous, as stated earlier, and the period of trade deficits continued much longer. As China cannot afford to fall into a period of such large trade deficits again, it is imperative to improve macroeconomic and balance of payments management.

As stated earlier, both inflation and the trade deficit come from the same roots of "economic overheating". If the aggregate demand management is properly

implemented, neither a high rate of inflation nor a large trade deficit will occur. Consequently, macroeconomic management to control the aggregate demand assumes great importance not only for targets (1) and (2), but also for (3).

Once the conditions of "economic overheating" occur, however, there is a trade-off relationship between price increases and an adverse balance of trade. If the trade deficit increases, the rise in prices will be mitigated. The "Merchandise Huilung" policy with the use of foreign exchange reserves is a good example. When the trade balance is improved by tighter control of import, the rise in domestic prices will be accelerated. This trade-off relationship seems to be observed in China in the middle of 1987, when the trade deficit was reduced but inflation seems to have been accelerated. Acceleration of inflation may, to a certain degree, a result of the depreciation in the RMB exchange rate in 1986.

(4) A Proper Balance between Consumption and Investment

In a "socialist" planned economies such as China, great importance should be attached to the proportions of consumption (household consumption plus social consumption) and investment (capital accumulation) to the total production or national income as one of the determining factors of economic growth. In China prior to 1978, a low-wage, high-accumulation policy was pursued in which wages and the government purchase prices of agricultural products from farmers were kept as low as possible, in order to raise the rate of accumulation (investment), develop heavy manufacturing industries, and increase the growth rate.

As well known, without capital imports from foreign countries, in a simple model of economic growth, there is a relationship between the ratio of accumulation (proportion of income saved and invested) "s" and the rate of economic growth "g": namely,

$$gc = s$$

where "c" is the (marginal) capital coefficient, representing the amount of

necesssary capital (physical production facilities, inventories, and social "infrastructure" capital) for each unit of additional output. The low-wage, high-accumulation policy intends, in short, to raise the value of "s", and at the same time increase the relative importance of industries producing capital goods and producers' goods sacrificing consumption and consumer goods industries within the national economy, in order to increase "g".

Following the Third Plenary Session of the Eleventh Central Committee of CCP in 1978, the previous policy of enforcing high-accumulation was reexamined and a new policy of stressing the need for steady improvement of national living standards was adopted. As a result, the government purchase prices of agricultural products from farmers were raised and wages for urban workers were increased. Also the policy of promoting heavy industries at the expense of light industries was revised, and since then the Chinese government expressly stated that it would aim at balanced growth among agriculture, light and heavy industries.

This policy line switch notwithstanding, however, the overall ratio of accumulation (proportion of capital accumulation in national income) remained quite high as before, and in fact recently has gone up. After the implementation of the 1978 policy line switch, the accumulation ratio declined from the 1978 level of 36.1% to 28.3% in 1981, but through the process of "economic overheating" it was once again on the rise, returning to a level of 33.7% in 1985, which is close to the 1978 level (Figure 15).

Although there are differences in the concepts of national income and capital accumulation between China and Western countries, my general impression about capital accumulation in China is the following:

(i) Until today since the 1950's, China's accumulation ratio has been remarkably high from an international point of view. Perhaps it is quite high, even if one takes into account the difference in the rate of economic growth, among countries. To state it another way, China's marginal capital coefficient has been very high.

(ii) The reason for this remarkably high capital coefficient and a high capital accumulation ratio in China, in spite of the fact that real national income per capita and the growth rate are rather low, would be low efficiency of investment (low contribution of investment to productive purposes).³⁴⁾

(iii) One of the major factors behind the high accumulation ratio and low efficiency of investment, and also behind recurrent, sharp increases in investment, a phenomenon called "a malady of hunger for investment" would be the "socialist" policy of not charging a price for the use of capital. Investment involves the use of capital in the sense of control of general purchasing power over a given period of time. Because of an obvious ideological reason the capital in this sense has long been free of charge for investors in "socialist" countries.³⁵⁾

If the above impressions are correct, by charging proper "user fees" from investors, or from the users of facilities constructed by the investment project, investment efficiency in China could improve, and the accumulation ratio could go down without lowering the rate of economic growth. In fact, since 1978, despite the fact that the accumulation ratio was nearly the same as before if not somewhat lower, the rate of economic growth increased substantially.³⁶⁾ If investment efficiency improves still further, the accumulation ratio as high as 30% would not be necessary in order to attain a rate of economic growth of 7.5%.

Through the recent economic reforms, the price for the use of capital has been introduced in various forms. The source of the supply of funds for investment in enterprises was converted from allocation of funds from the government budget to bank lending, and interests are now collected. The length of life of durable plant and equipment for the depreciation purpose was shortened, and, in addition, a major part of the depreciation allowances are now retained within the enterprises. One of the new taxes ("ligai-shui") replacing the old system of enterprises delivering all the profits to the supervising authorities, the "adjustment tax" can be thought of as representing

a sort of price for the use of capital. Through these reforms investment efficiency is likely to increase steadily.

Based upon these considerations, as a target of future macroeconomic management, it would be advisable to continue to improve investment efficiency on the one hand, and gradually decrease the accumulation ratio on the other, lowering at the same time the relative weight of heavy industries and raising the weight of light industries accordingly.

V. MEASURES FOR IMPROVING MACROECONOMIC MANAGEMENT

The Chinese economy is now in a process of rapid economic development, and its economic organizations are undergoing extensive reforms. In this process groping with trial and error is unavoidable. Compared with the advanced industrialized economies with well-established institutions for economic policies and highly developed markets of all sorts, it is a matter of course the weight of light industries accordingly. policies and highly developed markets of all sorts, it is a matter of course that macroeconomic management will prove to be far more difficult under the current Chinese conditions.

Failure of Economic Policy and Principles for Improvements When looking at the course of "economic overheating" between 1984 and 1987 from a distant point in a foreign country, I cannot help but have an intuitive feeling that this "overheating" phenomenon occurred through a series of failures on the part of the economic policy (or planning) authorities as has been discussed.

What measures can be taken to improve China's macroeconomic management, in order to eradicate inflation as quickly as possible, and to prevent the future recurrence of "economic overheating"?

Before considering concrete measures for improvement, three basic

principles which I consider important for China's macroeconomic management today are discussed.

(A) Controlling the Sources of the Aggregate Demand Since China is now in the process of rapid economic development the main macroeconomic problem is likely to be one in which the aggregate demand exceeds the overall supply. In his Report on Political Activities to the National Congress in March 1987 Prime Minister (then) Zhao Ziyang states "The troubles we are recently encountering are occurring amidst the continual improvement of people's life through vigorous productive activities, and not in a declining economic conditions with falling incomes". The Chinese economy is now vigorously advancing, as the economic and technological gaps vis-a-vis developed countries are quite large. Enterprises, individuals, and banks are apt to use whatever available funds for spending. Therefore, for those responsible for the macroeconomic policy it is extremely important to control within appropriate limits the aggregate demand, which is prone to become excessive. For this reason the control of the very "sources" of the excessive aggregate demand is a task of utmost importance for China's macroeconomic management.

(B) The Necessity for Direct Quantitative Controls In the case of the government-run enterprise (factory) as found in China today, although its autonomy appears to be increasing, the managers of enterprise (especially the head of the factory) are far from being endowed with the full responsibility for the profits and losses of the enterprise. The intervention of the supervising government organizations in enterprise operations is quite extensive, and as ever before this is perhaps still necessary. What is called an enterprise in China is mostly similar to no more than a factory of a company, rather than a company itself, in the Western, market-economy countries. The marketplace environment is still not sufficiently developed: enterprises cannot act independently and astutely without assistance and supervision from the upper

organizations. On the part of the enterprise, managers at each level are not much concerned with the performance of the enterprise, nor the incentives for mobilizing efforts of the managers and employees to improve the enterprise's performance well arranged. As ever before, large distortions remain in the price system and attempts to establish the legal system of bankruptcies and an unemployment insurance system are still only in the beginning stages.

A point which needs to be stressed is that the banks are still far from³⁸⁾ having characteristics of an entity which can be called an enterprise. So long as the banks lending funds to enterprises have not become a full-fledged enterprise, it would be difficult to make non-bank enterprises receiving these loans a full-fledged enterprise operating on a profit maximizing, commercial basis. Under conditions where banks make loans without expecting to recover them from the borrower or do not try hard to choose most promising enterprises as their customers, and where borrowers cannot go bankrupt, full-scale functioning of price mechanisms would be impossible. Under these conditions, for the purpose of macroeconomic management, it is impossible to depend largely on price adjustment measures through market mechanisms, which is called "economic leverages" in recent China. For the purpose of macroeconomic adjustment of finance, wages, and imports, direct, quantitative control measures need to be used as primary policy means.

In short, in the Chinese economy at the present stage, for the purpose of macroeconomic management, a "quota" system for individual enterprises must be widely used. Chinese policy officials must be already very much knowledgeable about various difficulties accompanying a quota system, but for the time being there would be no other way but to use a series of quota systems, in a manner that is as efficient, equitable and transparent as possible.

(C) The Use of Price as Adjustment Measure What has just been stated does not imply, however, that measures of price adjustment are not important for the purpose of China's macroeconomic management. Rather, to make direct quantitative

controls work smoothly the price adjustment measures should be used as much as possible along with the quota system, and their role should be increased gradually in the future. Concrete examples of this point will be given below.

Concrete Measures for Improvements in Macroeconomic Management Based upon the analysis of the causes of "economic overheating" between 1984 and 1987, and on my limited knowledge of the Chinese economy, the various measures I consider most appropriate for improving China's macroeconomic management are stated below.

Control of Bank Lending and Money Supply As the central bank of China, People's Bank of China (PBC) should set a target for the rate of increase (or a range for that rate) in the money supply on a monthly or quarterly basis, and pursue monetary policy so as to achieve such a target.

Demand-pull inflation arises from an excessive level of the aggregate demand, namely from an excessive increase in the purchasing power throughout the whole economy. The most important source creating this excessive purchasing power is the central bank credit, namely the central bank lending to various banks, and the central bank's financing of the government expenditures. This source of the excessive expansion of the aggregate demand must be firmly controlled.

On policies for economic stabilization, Prime Minister (then) Zhao Ziyang very frankly stated in March 1987: "We have not yet established effective institutions and mechanisms for guiding effectively the funds in the society in rational directions" (Ibid., Political Activities Report). For the purpose of macroeconomic management, however, before talking about the rational sectoral allocation of government funds, it is necessary to control firmly the very size of total funds in the society, which is the source of the increase in the aggregate demand.

For this purpose, it is necessary to determine and control: (1) the amount

of lending from PBC to the various major banks, and perhaps also the allocation of funds to their respective provincial branches; and (2) the amount of lending by the major banks, and perhaps also by their respective provincial branches, to enterprises.

Whether to establish each of these two phases of direct controls only at the level of the Beijing head office of each major bank or on a more detailed basis across the level of each provincial branch depends on what degree of autonomy the provincial branches of respective banks have. I would think it is necessary to establish lending limits (quotas) at the level of provincial branches.

When these non-central banks or their provincial branches extend loans and other forms of credit to customers (mainly enterprises) in excess of the quota, and when they need to borrow from PBC in excess of the limits as determined in (1), a high penalty rate of interest should be charged on such excess portions of borrowing from PBC.³⁹⁾

In addition, the total amount of (1) must be determined by taking into account PBC's financing of the government budget deficit. If the government budget deficit financed by PBC becomes larger, the total amount of lending from PBC to banks must be reduced correspondingly. In China, PBC's lending to banks and PBC's financing of the government budget deficits (and perhaps the balance of international payments surplus) are the major sources of the money supply. Therefore, by effectively controlling these very "roots", the total amount of the money supply and the supply of funds to the private sector can be properly restrained. In China, are quantitative controls for bank lending as presented in (1) and (2) currently implemented, and if so, how? To the extent that the actual records of the money supply and bank lending indicate, it does not appear that such controls are operating effectively (Figures 11 & 12).

In the case of Japan, the Bank of Japan (BOJ) sets (i) a quota for each of major banks on the maximum amount it can borrow from BOJ. Further, especially in periods of tight-money policy, (ii) BOJ sets a quota for each of major banks

as well as other smaller financial organizations on the amounts by which it can increase lending to its customers within each month or each quarter. The management of the quota system (ii) is called as "window guidance" or "position guidance." The latter terminology readily suggests these regulations extend not only to each bank's lendings to its non-bank customers but also to its securities investments, lending to and borrowing from other financial institutions, and the call-money position.

In short, based on (i) and (ii) BOJ has consulted with, and given directions to, the officers of individuals banks in charge of the management of funds on the supply of funds from the banking sector to the non-bank sectors. In this way BOJ used to watch closely the money supply and the supply of funds, so as to keep them within limits compatible with price stability and, in earlier years, with a balance of payments equilibrium.

Even so, frequently BOJ's "window guidance" has not been closely abided by banks, particularly at the time of monetary tightening. It has been difficult for BOJ to control smaller financial institutions (such as credit association banks and credit co-operatives) with which BOJ has only a small amount of transactions or no transaction at all at normal times. Further, foreign banks (branches of foreign-based banks in Japan) are outside the range of "window guidance" since they do not receive credit from BOJ. Considered in light of Japan's experience, through what sorts of measures and under what institutional setup it is possible to ensure that the quota system (2) set by PBC on the lending of banks to their customers are orderly abided by remains a difficult question.

My own view on the Japanese situation is that (i) and (ii), particularly (ii), are not necessary for rational operation of monetary policies. In Japan the financial markets are sufficiently well developed, so that I have long since thought that monetary policy objectives can be achieved basically through the three orthodox measures of (a) changes in the BOJ discount rate, (b) buying and selling of bills and bonds, and (c) alterations of the

reserve requirement ratio. Nowadays this is probably a majority view among Japan's academic economists. As for (ii), in these days of financial deregulation and internationalization of financial organizations and markets, a majority view is that it is not necessary, nor would it be effective.

While considering that (i) and (ii) are not necessary in Japan, why then do I consider that both (1) and (2) necessary for China? This is because, as stated earlier, neither enterprises nor banks in China generally have not yet grown up to be a full-fledged decision-making entity, free from political and nepotistic outside influences, nor have the financial markets developed enough to ensure that price mechanism in the financial sector function fully and smoothly.

Use of Functions of the Interest Rate For the purpose of regulating bank lending and the money supply in China I believe that it is necessary to establish and strictly enforce the quota system (1) at the central bank level as well as the quota system (2) at the level of individual banks. I also believe that at the same time for the purpose of macroeconomic management the demand-supply adjustment functions of the interest rates must be fully utilized.

I stated earlier that the interest rate for common people's term deposits with banks must be maintained at a level 2-3% higher than the rate of increase in consumer prices. I believe that the interest rate on bank to enterprises should generally be at a higher level than the deposit rate. Further, in period of financial tightening, the interest rate on discounts with and loans from PBC to banks must be kept slightly higher than the interest rate on the interbank money market. Also as previously mentioned, if a bank needs to borrow from PBC in excess of the quota on borrowing, a high penalty interest rate must be applied.

In periods of favorable business conditions the interest rate level (real

interest rate rather than nominal interest rate) should go up sufficiently, and in times of stagnating overall demand it should go down. In this way the interest rate should perform an important function in adjusting demand and supply of funds.

On the other hand, for the purpose of promoting the development of new industries or backward regions, separate organizations or institutional arrangements should be established to supply special low interest funds to them, in addition to funds through ordinary banks.

Controls of Wage Levels and Total Wage Bills Another important matter in the aggregate demand management, second to the control of bank lending, is the control of the wage levels and the total wage bills. The increase in overall wages including bonuses was one of the two most important causes of the "economic overheating" since the end of 1984, as stated earlier. In an attempt to deal with this, a progressive "wage adjustment tax" and an "excess bonus tax" were introduced in 1985. Undoubtedly measures of this sort making use of "economic leverage" are commendable, but at the present stage of the Chinese economy, more direct regulations on the wage levels and the total wage bills are clearly necessary.

Of course it was desirable to have got away from the low-wage policies of the past and reformed the conventional, uniform wage system based upon a straightforward equality principle. Indeed, a new wage system still needs to be created, which would work as inducements to draw out employees' willingness to make a positive contribution to the enterprise or organization in which they are employed. But the raising of nominal wage levels by much more than the increase in labor productivity throughout the overall economy is clearly inadmissible.

In the case of postwar Japan through to the present, the determination of the wage level in the private sector has been left to the self-determination of private enterprises and the labor unions, and/or to the working of demand and

supply forces in the labor market. Through this process, wage levels have been settled down generally to economically rational levels. Incomes policies like those pursued at times in Western Europe or the United States have not been necessary in Japan. Yet for the central government employees in Japan, assessments and recommendations are made by National Personnel Authority each year on the rate of increases in wages and salaries (including bonuses and fringe benefits) and working conditions on the basis of comparison with the level of wages and salaries in private sector. There are similar procedures to determine the compensation levels of employees of the local governments and other public bodies. Before recent privatization or dissolution for eight major government enterprises called "three major public corporations and five central-government-run enterprises" the total amount to be paid as wages and salaries (inclusive of bonuses) by each of them was assessed and approved each year by the Diet and the employers (eight enterprises) had to observe their respective approved totals strictly.

Because the degree of financial dependence by most enterprises in China on the government is still high, relatively rigid regulations for wage levels or the total amounts of wages, similar to the regulations for the public sector compensation levels in Japan just explained, would be necessary.

What is the appropriate form for an incomes (wage) policy in China? Some guidelines for the wage levels in each year and/or the control of the total amount of wages, salaries and bonuses for each enterprise or organization should be given and each enterprise or organization should observe these guidelines and/or the total. These kinds of regulations may be "loose" ones for enterprises owned by individuals or by groups of farmers and cooperatives. On the other hand, until a legal system of bankruptcy, reorganization of enterprises under financial difficulties, and rules on employee dismissals at the time of business difficulties are well established the wage controls for government-owned enterprises must be fairly strict ones. For administrative organizations which depend totally on the government funds, the system of wage control must

be even stricter.

Further, the above-mentioned "wage adjustment tax" and "excess bonus tax", and the expected future introduction of an individual income tax for workers, are important as "built-in-stabilizers" especially for times of boom and inflation. But they cannot be a means for suppressing the very "root" of increases in the aggregate demand.

Control of Government Expenditures: The Problem of "Soft" Budget Constraints From a macroeconomic point of view it is important to keep the annual rate of increase in the expenditures spent by the central and local governments from becoming too high. But at the same time, or even prior to it, controlling the government budget balance (deficit or surplus) and how to finance the deficit are most important matters for macroeconomic management. In particular, of critical importance for macroeconomic management are the size of financing of the government budget deficits by the central bank (PBC). Further, borrowing or bond issues by various local governments needs to be closely monitored and controlled. But these matters have already been discussed in Section III and earlier in this section, it is not necessary to repeat them here.

The problem which I wish to discuss here is related to what is called the "soft" budget constraints in "socialist" economies. Janos Kornai has pointed out the tendency toward softening of the budget constraint in "socialist" economies in Eastern Europe,⁴¹⁾ but I have some difficulties with some of the points he makes.

Consider a state (central government) organization of Japan, such as the University of Tokyo to which I belong. It is comprised of faculties (schools), research institutes, and hospitals. The university and its constituent components are totally dependent on the government, and have no financial independence. Even if incomes do not match expenditures, they do not go bankrupt. Also regular employees including professors and officers are all

central government employees, so that they enjoy a life-time tenure as a government employee until they reach their respective legal retirement ages. The administrative system with regard to the number of each type of employees which the university and its constituent organizations may employ and the compensation system for these employees greatly resemble those of the government-owned enterprises and administrative organizations in China. In this respect, Japanese government organizations and public enterprises resemble the enterprises of "socialist" countries including China.

The "budget constraint" of government organizations in Japan, however, is by no means soft but extremely hard, and the budgetary controls are generally far stricter than that of private enterprises in Japan. "Not a penny" is spent on expenses which have not already appropriated and approved in the budget, and deviations from budget apportionments and regulations, and from laws concerning numbers of employees and their compensations are impossible.

In the explanations of the national budgetary system of China, it is said that there are strict regulations regarding transfer of appropriations from one item of the budget to another, use of the reserve funds, and supplementary appropriations.⁴²⁾ However, in the Finance Minister's report of budget execution which is presented every year to the National Congress, it is simply stated that there were a number of expenditure items of which actual spending during the year exceeded the budget appropriation. Moreover, among the expenditure items of which actual spending exceeded the budget appropriation, it is said, there were "rational and necessary spending" as well as "irrational ones".⁴³⁾ This is really surprising to those who know the strict enforcement of the government budget in Japan.

If there is a difference between China and Japan concerning central government budget constraints it is perhaps soft (lenient) in China (and other "socialist" countries) and hard (strict) in Japan. It appears to me that this difference arises not from the difference between a "socialist" economic system and a private-enterprise, market-economy system, but from a difference in the

degree of strictness of financial discipline.

An Example of "Soft" Budget Constraints: Loans to Employees from the Enterprise To give a specific example, according to a Japanese engineer who had worked for a long period in a factory run by a "xiang" (prefecture) government in China and then returned to Japan, it was not unusual for employees of a factory (enterprise) to receive loans in varying amounts from the factory. The following is a portion of the extremely interesting of the interview with this engineer.

Q: Do workers borrow money from the factory?

A: Yes...There are people who borrow more than 1,000 yuan. Some of them borrow a large amount which they cannot repay even with a year's salary. There are many who borrows some hundreds of yuan...Especially those people who were sent to business trips borrow 100 yuan before they go and when they return they do not repay it, so whenever they take business trips, their borrowing is compounded and could easily reach a couple of hundreds yuan.

Q: The loans are not collected?

A: There are directions, say once in a year, from the central and provincial governments that the loans must be repayed promptly. But even if repayed on such an occasion, large debt is once again accumulated.

Q: So about once a year loans are paid up?

A: No, they aren't paid up. The people return a little bit from their salaries but they hardly ever repay it fully... But this is not only at the factory where I worked, and it has become a matter most people take it for granted. If calculations were made for the whole country it would be an enormous sum.

Q: How does the employee borrow? If the accountant says O.K, can he borrow?

A: There is a lot of borrowing at times of business trips and even though they are told to repay when they return, they do not repay. Then the

borrowing accumulates.

Q: They cannot borrow unless they go on a business trip?

A: Yes, even at normal times there are people who borrow. Almost everyone
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borrows.

The above was a condition in the 1970s, but in 1987 I saw on a bulletin board (blackboard) near the entrance of a research institute in Beijing a written notice urging its employees to repay loans borrowed from that institute. In this notice, names and amounts were written, and some owe as much as over 800 yuan. At the time, employees of that research institute were probably receiving an average monthly salary of 70 yuan or so.

In Japan, whether in cases of business trips or on other circumstances, and whether it be in a private company or a government agency, borrowing from one's place of employment and not repaying cannot occur. Employees can borrow for the purchases of housing or for some other reasons from private employers or from cooperative societies of public employees, but in such a case regulations on lending procedures, mortgage and repayment schedules are rigidly stipulated and no deviations are permitted.

The Impossibility of Macroeconomic Management with "Soft" Budget Constraints The above sort of differences between Japan and China do not seem to me to be rooted in any "systemic" differences between the soft budget constraints of the "socialist" economic system and the hard budget constraints of the private-enterprise, market-economy system. In short, in China (and perhaps in other "socialist" countries as well) discipline on financial affairs are lax, and there is a certain degree of sloppiness.

Of course, in Japan too, various violations of financial regulations occur, including wasteful and improper uses of government funds, misappropriations of public or company funds, tax evasion and others, but there are various institutional arrangements of financial regulations to prevent such violations. There are arrangements for internal inspections at various stages, and a system

of formal account auditing by outside officials, company auditors, and tax bureau officials. Corrective measures for deviations and violations are taken; flagrant violators are charged with administrative, civil, or criminal sanctions. It is difficult for me to comprehend why in "socialist" countries such inspections and corrective measures are not possible, and why limitations on government expenditures, loans from the central bank and wage disbursements by enterprises and organizations, and so forth are not observed under the "socialist" system.

Whether constraints on government expenditures, quotas on bank lending, guidelines on wages or limits on the total wage bills, or import quotas to be mentioned later unless each economic unit observes the limits set by the government or the central bank, macroeconomic management is an impossibility.

Further, not only for the purpose of macroeconomic management but also for economic planning, government expenditures and the total size of investment must be firmly controlled within the planned targets. If constraints are generally or frequently "soft", and if government expenditures, bank lending, the money supply, the wage bills, and the total import cannot be controlled as planned, then national economic plan whether for five-year or for each year would amount to little.

Since 1984, to the extent that movements of various macroeconomic indicators show, the important macroeconomic aggregates do not seem to have been properly controlled. Moreover, this situation of weak controls appears to have been continuing at least through the first half of 1987. If in China budget constraints, various controls and quota systems are generally of "soft" nature, what is the meaning of China's five-year plan or annual "National Economic and Social Development Plan"?⁴⁵⁾

Balance of Payments Policy In order to achieve and maintain an equilibrium in the balance of international payments, what sort of economic policies and measures must be implemented? This broad theme per se will not be addressed at

length here, as the subject of this paper is limited to macroeconomic management. I will discuss certain aspects of balance of payments problems which I believe are important from a macroeconomic management point of view. Earlier I stated that it is advisable for China to keep capital import and accumulation of foreign debt within a relatively low ratio to GNP or exports, and that in order to maintain an equilibrium in the balance of trade, it is of critical importance to maintain a balance between the domestic aggregate demand and supply. Considered below are matters concerning management of exports, imports and foreign exchange reserves in China.

(1) Imports At present stage in order to control import the Chinese government cannot but depend much on direct, quantitative controls, that is, primarily import quotas. A foreign exchange budget, which lists provisions for imports and other necessary payments of foreign exchange, should be prepared for every year or preferably for each quarter. Import items should be classified into a number of categories such as (i) import items (and other uses of foreign exchange) which are generally approved unconditionally, (ii) those which are fairly tightly restricted and approved case by case, and (iii) those imports generally prohibited, and so forth. The import approval and quota system should be administered on a centralized basis.

In Japan after World War II, there was a long period of balance of payments difficulties, and during the latter part of this time import items were classified into three groups: 1) automatic approval (AA); 2) automatic import quotas (AIQ); and 3) import quotas (IQ), and the semi-annual foreign exchange budget was compiled.⁴⁶⁾ If this type of foreign exchange budget or plan is prepared and import regulations are administered efficiently and equitably, then it is unlikely that imports unexpectedly increase more than 50% over the previous year, that certain goods cannot be imported in a certain region, while they can be imported in other regions, and that some enterprises, government organizations, or individuals can make large profits by importing such items in

one region and reselling them in another, as it happened in China in 1984 through 1987.

In order to control imports, it is possible to use price mechanism measures (economic leverage) such as exchange depreciation, increases in customs tariffs, and control of import financing. From the end of 1983 to 1986, however, the yuan exchange rate had already been much depreciated (Figure 10), and at present, probably further depreciation would not be advisable. Tariff policy is mainly a device for long-term industrial development, and is not appropriate as a device for macroeconomic management.⁴⁷⁾ Further the effectiveness of restrictive measures on import financing in controlling import would be probably limited. In China under the present conditions, therefore, direct quantitative restrictions are probably most appropriate for the purpose of controlling imports.

Aside from merchandise trade, imports of technologies, which fall under "invisibles" account of the balance of payments should be administered in a more or less centralized way, similarly to controls on import of technologies implemented in Japan until the 1960s.⁴⁸⁾

(2) Exports The export policy of present day China seems fairly complex. I am not familiar with the details of "directive planning" and "guiding planning" in the area of export, regulations on authorized trading organizations (only a limited number of enterprises, organizations, and government agencies are authorized to engage in foreign trade at present), and the foreign exchange retention system under which a portion of foreign exchanges earned through exporting may be retained by the exporters. What follows is only a rough idea of a direction of future improvements.

First, all "directive planning" concerning exports should be discontinued in my view. Enterprises thrive on profits, so that it is best to let them engage themselves in production of exports and export trade as far as such activities are profitable to them. If export trade is profitable, enterprises

will come to participate in export trade. That is to say, where exports are concerned, the competitive market mechanism should be fully utilized. Generally export industries have no special merit, except that they earn foreign exchanges through export. It is enough if industries and enterprises which earn foreign exchange with the lowest possible cost mutually compete and become active in exporting.

Recently large depreciations of the RMB yuan have greatly strengthened the incentives to export through the price mechanism, and enterprises looking for export now appear to be increasing. For the time being further price-mechanism incentives for export would not be necessary.

Second, formal or informal (hidden) export subsidies, foreign exchange retention systems, and other systems of complicated price incentives for exports should all be discontinued.

In any country, various complicated systems concerning imports and exports have large visible and invisible administrative costs. Frequently, their effectiveness is questionable. Moreover, they can easily become a hotbed of wrongdoings and corruptions. Today in China there is a sharp shortage of competent administrative and business officers in both the government and business, so that it is advisable that the simplest system of "economic leverage" with high transparency and low administrative costs be employed. As far as export is concerned, an exchange rate which is sufficiently low will suffice.
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Third, the policy for export promotion by the Chinese government should concentrate on those activities which individual enterprises or a group of them at present cannot perform by themselves. These would include offering information for purposes of opening up new export markets, guidance in the area of new products, technologies and designs, holding fairs abroad or in China, overseas activities for publicity and advertizing, sending abroad delegations and study teams composed of managers in charge of export and establishment of an export insurance systems. They should aim at improving the technological and

managerial capabilities of export-related industries and enterprises and renovating industrial organization of the areas concerned.

Low interest loans to export industries and preferential treatment of export trade financing are nothing but a sort of price incentives and the expected effects of such promotive measures are much weaker than those of exchange depreciation, so that in this respect they are not too meaningful. But such export promotion measures could be useful means of promoting dissemination and exchanges of information related to export as well as means to change the attitude and mentality of enterprise managers.

In Japan in the 1950s and the first half of the 1960s, one of the most important considerations, or about the most important one for macroeconomic policy was maintaining an equilibrium in the balance of payments which tended to turn into deficits and hence expanding export was the government's economic policy target of utmost importance. For this purpose, in 1954 the Export Councils (the Supreme Export Council and a number of industry-wide Export Councils) was established to coordinate the efforts of the government and the private enterprises in expanding export. Until the middle of the 1970's these Councils served as forums for the exchange of information on enterprise activities and government policy lines, and for developing common knowledge 50) in the area of export trade. This type of organization for exchanging information and opinions and coordinating activities and the system of price incentives might be more useful for the promotion of exports than "directive planning" which has been in force to date in China.

(3) Foreign Exchange Management It appears that in China at present foreign exchange funds are not quite centrally managed. Some provincial governments and enterprises (and even universities) seem to be allowed to retain a portion of foreign exchange funds acquired through export of goods and services, and then use it later. The provisions for the foreign exchange retention appear to be exceedingly complicated. Also various ministries of the central government,

provincial governments, and some government corporations can borrow foreign exchange funds fairly freely through trade organizations they established in Hong Kong, and they can use foreign exchanges acquired from international trade or borrowing through such organizations. Thus the powerful government ministries and organizations in China can purchase imports through these Hong Kong based companies, which are said to number more than 200. This is an exceedingly disorderly situation from the point of view of management of foreign exchange reserves and control of import.

Both foreign exchange funds and import should come under a unified management on a national basis. A centralized control in these areas is more efficient and equitable than decentralized controls in which strong ministries, provinces and cities exercise their respective discretionary power and import whatever items they like. Such a disorderly condition might have been one of the major factors in the sharp increase of imports in 1984 through 1986, especially imports of luxurious passenger cars and consumers' durables. It would be no wonder if import controls end up "leaking" and a sudden increase of import occurs.

In Japan during the period of the severe balance of payments constraint, a system of centralized foreign exchange controls was operated. As a rule, any enterprise in Japan had to hand over to the foreign exchange authorities all the foreign exchange funds they acquired through export or by other means. On the other hand, when the use of foreign exchange fund by an enterprise or some other body was authorized, it was allocated from the centralized pool of the foreign exchanges reserves. In the immediate postwar period, the retention of foreign exchange funds by Japanese enterprises or any other bodies outside the foreign exchange authorities, such as trading companies, banks and shipping companies was authorized only within a very limited scope.

At the present stage in China, it would be advisable that all the approvals for import and all foreign exchange funds be centrally managed. If this is not possible, the whole country might be divided into six to eight regions at most.

and there should be a centralized organization responsible for the administration of foreign exchange funds and import licenses in each region. A certain foreign exchange quota should be distributed to each of such organizations, and all foreign exchange funds and imports in each region should be centrally managed. But the import regulations should be fairly unified nationally, and each regional organization should abide by these import regulations. As already stated the system of retention of a portion of export earnings should be promptly abolished.⁵²⁾ Further the regional foreign exchange authorities should report to the Beijing authorities in charge promptly the amounts of authorized import, export earnings, actual use of foreign exchange funds, and so on, so that the nation-wide statistics on these can be known quickly by the government.

Control of Investment and Improving Efficiency In order to control the level of investment relative to GNP at a level somewhat lower than at present, and to avoid sudden increases in investment, first, a careful and strict control of government budgetary expenditures for "basic capital construction" investment is necessary, and the "softening" of budget constraints on such expenditures must by all means be avoided.

Second, there must be a tight control, as is already mentioned, of the level of bank lending which is now the main source of finance for the investment by enterprises. Also serious consideration should be given to investment efficiency and the commercial principle introduced in financing in the management of enterprises. Furthermore the principle of "user charges" should be adopted with respect to certain types of "basic capital construction" investment. These reforms will prevent a relapse of the "malady of investment hunger", in which various ministries of the national government, provinces, cities, and enterprises rush to invest.

Along with the appropriate control of the aggregate national level of investment, it is of utmost importance to improve investment efficiency, in

order to achieve a stable but high rate of growth. There are three tasks in this area. First, a serious cost-benefit analysis must be undertaken on each investment item included in the government (central and local) budget, so that only such an investment project as yields sufficiently high benefits relative to costs be adopted.

Second, bank loans should be made only for investment projects with good prospects of sufficiently high returns and hence of repayment as scheduled. In order to properly carry out this task, the borrowers, that is enterprises (factories), must be changed into a full-fledged enterprises operating on a commercial basis, and the creditors themselves, that is, banks must also become an independent business entity operating on a commercial basis. Banks must have a high degree of autonomy in their relations with the supervisory ministries or bureaus of the central, provincial, municipal or other local government. In particular, they need to be sufficiently independent to hand off pressures from politically influential persons or government officials whose requests are in conflict with economic rationality. On the other hand, in cases where investment projects should not be evaluated solely in terms of business profits, such as social "infrastructure" investment or investment in a newly emerging "infant industry", it is necessary to establish a specialized financial organization distinct from ordinary banks.

Third, even in cases of large-scale "basic capital construction" investment projects financed and administered directly by the government, the principle of "user charges" should be adopted as much as possible. This is to levy some sort of charges (prices, fares, tolls) on those using the products or services supplied from an investment project, and in this way to recover a part or whole of the costs of investment. This applies to electric power and other energy supplies, railroads, subways, harbors, expressways, and telegraph and telephone communications. If the investment is economical and socially useful, it can essentially be expected that through the proceeds of such charges, the funds invested will be totally or in large part recovered.

It is repeatedly reported about electric power supply and freight transportation in China that over the past several years the supply capacity has been extremely insufficient in the face of rapidly increasing demand. For example, in each quarter from 1986 through the first half of 1987, there was an increase in manufacturing production at an annual rate between 9.2% and 15% in real terms over the same quarter in the previous year, but the corresponding increase in energy supply was only 2.9-4.1%. In the middle of 1987, there was an average electric power shortage of about 20% in most provinces across China, and the power supply to almost all factories were stopped one or two days a week. The actual record during the period of the Sixth Five Plan (1981-1985) showed the real rate of growth of industrial production was about 10%, but the rate of growth of freight transportation volume was less than 3%. It has long been urged that two major bottlenecks in China's economic development were electric power supply and railroad transportation, but the situations in these two area have not been improving but probably worsening.

To deal with these bottlenecks, from 1983 a fixed proportion of the "non-budgetary funds" of enterprises and local governments has been levied as a sort of tax called "Special Fund for the Basic Capital Construction of Energy and Transportation". It has been recently reported that in 1986 the levying of this tax was extended to enterprises owned by villages, farmers' groups, cooperatives and individuals.⁵³⁾ From an economic point of view, however, this method of taxing is not an economically rational measure to cope with the scarcity of electricity supply and transportation facilities. According to the principle stated in (C) above, the rational approach would be to raise freight transport fares and electricity charges across the board, or if that is difficult for some reason, to charge individual users a higher rate on the portion in excess of the shipment of freight or use of electricity in excess of the amount actually shipped or used in the previous year. Further, in regions where the demand and supply for energy is especially tight, or where transportation conditions are especially congested, prices (charges and fares)

should be raised considerably higher than in other areas where conditions are less tight. It is economically rational that regional scarcity of electric power and freight transport services be reflected in their prices.⁵⁴⁾

Moreover by charging higher prices for services in shortage or in regions where shortage is acute, investment funds for expansion of capacity could be collected and faster depreciation would be made possible to repay the loans used for financing investment.

By applying the "principle of user charges" as explained just now a more rational allocation investment funds will be achieved. If a rapid increase in the demand for electric power and transportation in the future is predicted accurately, and investment plans in these years are worked out accordingly, tight conditions of demand and supply cannot continue for many years.

VI. CONCLUSIONS

This article analysed macroeconomic developments in recent China, particularly the process of "economic overheating" from 1984 to 1987, with a focus on its causes and the possibilities of improving China's macroeconomic management. Main conclusions of the article are as follows.

(1) From the fall of 1984, an abnormal condition of "economic overheating", which is nothing but a typical case of demand-pull inflation, developed in the Chinese economy.

(2) From the fall of 1984, China's trade balance slid into large deficits, and the period of deficits extended for more than three years. The size of the total deficits accumulated over the deficit period was very large: it amounted to 12.5% of China's GNP in 1986.

(3) Chinese leaders appear to consider, at least until early 1987, that this condition of "economic overheating" more or less came under control in the course of 1986. So long as statistics available to foreigners indicate,

however, the "overheating" phenomenon was only temporarily appeased in the first half of 1986 and rekindled from the second half of 1986 on. The inflation rate in major cities (the rate of increase in the Cost of Living Index) in the middle of 1987 was again reaching into the double digits. It appears that the situation of "economic overheating" was still going on at the end of 1987.

(4) The high inflation in the prices of goods and services and the large trade deficits apparently came from the same roots, or the same macroeconomic causes. The annual increase in the aggregate domestic demand for goods and services was much in excess of that in the total domestic supply capacity. It appears that this point was not well recognized by Chinese leaders.

(5) The principal sources of demand-pull inflation were: (i) too fast an increase in bank lending supported by the central bank credit to banks, and (ii) the sudden rise of wage levels and the total amount of wages paid. Next to these two factors, (iii) the large increase in government expenditures was also responsible for "economic overheating."

(6) Excluding those parts of "non-budgetary funds" and "non-planned investment" which were financed through bank lending and possibly some other types of borrowing such as borrowing from abroad, "non-budgetary funds" and "non-planned investment" do not seem to have been a primary cause of "economic overheating".

(7) In order to maintain public confidence in the national currency, the financial system and the government, price stability is a very important target for China's macroeconomic management. When the rate of inflation goes over a certain level, say 5-6%, it tends to accelerate and/or fluctuate greatly from year to year, making rational economic calculation difficult and often getting out of hand. The rate of inflation must be controlled at a level low enough, to maintain the real (in terms of currency's purchasing power vis-a-vis goods and services) interest rate of financial savings of the general public at least above the 2-3%.

(8) The trade deficit (or the deficit of the balance of payment on current

account) as well as net international indebtedness (the accumulated balance of payments deficits on current account); both relative to GNP, must be kept at a low level. Macroeconomic and balance of payments policies should aim at keeping yearly fluctuations in the trade deficit (and surplus) within a small range. The total amount of trade deficits resulting from unforeseen external conditions should be kept more or less within the size of the foreign exchange reserves at normal times.

(9) In order to prevent a recurrence of "economic overheating", the annual rate of increase in the money supply must be controlled at a proper level through quantitative restrictions on central bank lending to non-central banks and the central government as well as on lending by non-central banks to enterprises and local governments. Furthermore, whether by some sort of guidelines or by "directive planning", the level and the overall amount of wages must be controlled.

(10) Macroeconomic management and financial disciplines must be strictly observed in three areas: (i) each item of government expenditures, (ii) the size of the government budget deficit, and (iii) the central bank financing of the government budget deficit. "Softening of budget constraint", that is expenditures being allowed to exceed the budget appropriation, must be prevented.

(11) China's present control of export and import appears far less loose than the Japanese government control of export and import in the period immediately after World War II. Imports should be regulated through a centralized import quota system, and a "foreign exchange budget" (an overall plan for receipts and payments of foreign exchange funds) for the entire national economy must be compiled and implemented in as centralized a way as possible. On the other hand, as far as exports are concerned, the competitive price mechanism should be fully applied. "Directive planning" for production of exports by enterprises (factories) and for procurement thereof by national and provincial trading corporations should be abolished, and the complicated foreign

exchange retention system currently in force should be discontinued.

(12) In the present Chinese economy it is necessary for the purpose of macroeconomic management to establish a system of strict controls on central and local government expenditures and quota systems (quantitative restrictions) on bank lending, the level and/or amount of wages paid by each of state-owned enterprises and other government organizations, and imports, and to implement and enforce properly such "hard" budget constraints and quota systems. If because of "softening of budget constraints" such constraints and the quota framework are not orderly observed, not only macroeconomic management but also any kind of economic planning will be impossible.

(13) In China the ratio of investment to GNP and the marginal capital coefficient are remarkably high. It means that efficiency of investment in raising productivity is quite low. It is desirable to lower the investment ratio on the one hand, and to raise investment efficiency on the other.

(14) It is advisable to adopt the principle of "the user charge" in certain areas of infrastructure investment. It would raise the efficiency of investment and at the same time contribute to alleviate and dissolve the present bottlenecks and congestion in energy supply, railroad transportation, and harbor facilities.

NOTES

* This is an English version of an article presented at the Third Japan-China Economics Symposium held in Beijing on April 1-3, 1988. The Japanese language version will be published in a forthcoming book, Ryutaro Komiya, The Contemporary Chinese Economy: A Sino-Japanese Comparative Study, Tokyo: The University of Tokyo Press.

In the process of writing this paper, I was taught and assisted by many people. Although their number is too large to list their names here, I wish to express my deep gratitude to all of them. The factual accounts presented in this paper are based on numerous newspapers, magazines, and reports. In order to avoid troublesomeness both for the readers and myself I decided not to give the source for each piece of information. They are mostly based upon following sources and I wish to express special thanks for them: Nitchu Keizai Kyokai Kaiho (Bulletin of the Japan-China Economic Association) (monthly); the annual Nitchu Keizai Koryu (Japan-China Economic Relations), from the same association; JETRO (Japan External Trade Organization) Chugoku Keizai (The Chinese Economy) (monthly); Bank of Japan, Chosa Geppo (Monthly Bulletin), especially the August 1986 issue; Katsuhiko Hama, 1987.

1) In the period of "high economic growth" in an early stage of industrialization of developing countries (the so-called "take-off" period), a remarkably high agricultural growth rate is exceptional. The following special circumstances may be mentioned for the period from 1980-1984 in China: (1) the economic reform began first in the rural areas and more drastic than in the cities; (2) a part of production of rural industrial and other non-agricultural businesses (the production of enterprises run by individuals and village-run enterprises) is included in the total value of agricultural production: however, the industrial production of the village-run enterprises (namely, those enterprises which were formerly under the management of the production brigades, but now are under the village committees) was

formerly included in the total value of agricultural production, but has been transferred from the total value of agricultural production to the total value of industrial production beginning from 1984.

2) After the economic reform had already started from 1978, grain imports peaked at 3.4 billion dollars in 1982, reaching 17.7% of total imports. So longer as such an enormous amount of grain imports persists, despite the fact that approximately 80% of China's population was engaged in agriculture, the condition of the Chinese economy cannot be said to be satisfactory. Incidentally, agricultural production, especially of wheat, which had been favorable until 1984, seems to have slid into depression in 1985 and 1986, and recently the expansion of agricultural production appears to have been taken up as an urgent, top-priority policy target again.

3) The allocation of clothing by means of rationing tickets which operated for many years was completely abolished in 1984.

4) However, there are problems, to be related subsequently, with the concept of the government budgetary deficit or surplus fiscal balance in China. See Section III.

5) "Decisions concerning the Reform of the Economic System", October 20, 1984. For my comments on this see; Ryutaro Komiya, 1987.

6) On October 21, 1984, when the above mentioned decision of CCP (see footnote 5) was announced, I happened to be in Beijing. As soon as the news was publicized, I saw the Beijing residents rushing to buy such things as flour, rice, sugar, and even eggs. Later, in the middle of 1985, I heard that the prices of food products (especially fresh foods such as pork and fish) in the free markets of Beijing and Shanghai had greatly increased, some 30-40% over previous year's levels or even more. I had not quite understood why Beijing residents had rushed to buy foods in October 1984, but I realized in 1985 that common Chinese had sharp sensitivity to economic developments.

7) The Chinese concept of "foreign exchange reserves" seems to be accompanied by a number of ambiguities. In periods when the amount of foreign exchange

reserves suddenly decreased, as a result of a sudden increase in imports, it was reported in newspapers that officially announced reserves included long- and short-term assets held not only by the central government and the Bank of China, but also those held by local governments and trade-related enterprises, and that the proportion which could be readily used for international settlement was only a small fraction of the officially announced amount of foreign exchange reserves. Furthermore, it was also reported that the accurate value of the holdings of the provinces and enterprises was not known by the government. The common usage of the term "official foreign exchange reserves" in Western countries usually includes liquid assets denominated in convertible currencies (including the SDR and the IMF position) held by the monetary and foreign exchange authorities (in the case of Japan "Foreign Exchange Fund Special Account" of the government and the Bank of Japan), not counting holdings of other government agencies or private enterprises. Thus it designates only the liquid assets which can be used by the monetary authorities immediately for the purpose of international payments. According to the international standards, therefore, China's foreign exchange reserves seem to be substantially overstated.

8) These figures are from the Customs Office statistics. Figures of exports and imports in China's trade statistics differ considerably across different sources. For example, according to Customs Office statistics the trade deficit in 1986 was 12.0 billion dollars, but according to an announcement made by the Ministry of International Economic Relations and Trade, the amount was no more than 5.75 billion dollars. See Nitchu Keizai Kyokai (Japan-China Economic Association), Nitchu Keizai Koryu (Japan-China Economic Relations), March 1987, p.1. Among these, the Customs Office statistics, recorded on an F.O.B. basis for exports and a C.I.F. basis for imports, is probably most reliable. Since its 1986 edition "China's Statistical Yearbook" gives the figures of the Customs Office statistics for years after 1981 and those of the Ministry of International Economic Relations and Trade for earlier years.

9) In China, bills, notes, and checks drawn or written by individuals or enterprises have not been used for payments. Checking accounts which served as a means for payment were almost nonexistent, so that the "money" has consisted mainly of People's Bank of China (PBC) notes. In the U.S. and Britain, the traditional monetary policy means for absorbing excess liquidity is the "open-market (selling) operation" in which the central bank sells short-term government bills in the open market. Corresponding to this, in China "Credit Huilung" and "Merchandise Huilung" policies seem to be standard monetary policy means. "Huilung" means calling the birds (cash currency, Renminbi RMB) back to the cage (the central bank). In the former, loans from PBC earlier and from the China Industrial and Commercial Bank and other banks today are recalled. In the latter, government enterprises sell sizable amounts of consumer goods which the people desire to have and will be eager to buy, thereby calling the cash currency in circulation back to PBC's vault. During the 1984-87 inflation period the foreign exchange reserves were also spent for the purpose of "Merchandise Huilung" policy to import consumers' durables, passenger cars and what not. "Merchandise Huilung" policy seems to have been extensively undertaken before the Chinese New Year periods, but also several times including April 1985.

10) China's real GNP or real national income has been rising at a fairly high rate in recent years (see Figure 1), but since the exchange rate for China's yuan (PBC) against the U.S. dollars greatly depreciated in 1984 through 1986, as stated in the text, nominal GNP in terms of the U.S. dollar evaluated at the year-end exchange rate has not been increasing much. It increased, for example, only about 1.1% in 1986. Hence, the burden of the foreign debt for the Chinese people has not been much reduced by the rise in GNP.

11) "Gendai Chugoku Keizai Jiten" (Handbook of the Contemporary Chinese Economy), 1982, pp.24-25.

12) On Japan's export-import trade policy in early postwar years, see Ministry of International Trade and Industry, 1971, Part 5 "Sengo no Boeki Seisaku"

("Postwar Trade Policy"). See also Section V of this article.

13) However, from the fall of 1984 until April 1987, the rate of increase in the Retail Price Index and the Workers' Cost of Living Index in China totaled 16-20%, whereas the rate of exchange depreciation, as quoted in the text, was clearly higher. The official exchange rate of the RMB yuan at the beginning, as is normal for "socialist countries", was greatly overvalued. The overvaluation was reduced through the depreciation described in the text, but not entirely eliminated, in my view.

14) For example, Prime Minister (at that time: now CCP's General Secretary) Zhao Ziyang stated in the "Report on Government Activities" to People's National Congress (March 25, 1987): "In the economic field, the economic overheating which temporarily appeared between the fall of 1984 and 1985 has been suppressed in principle. Certainly the most important outcome of the last year (1986) is that now the 'whole ship' of the national economy can proceed on the beaten track of continuous, normal development."

15) The above is an elementary explanation of the so-called "absorption approach" of trade deficits and surpluses. See H.G. Johnson, 1958, ch. 6, "Towards a General Theory of the Balance of Payments," for a "classic" exposition of this theory.

16) For example, Prime Minister (then) Zhao Ziyang's "Report on Political Activities" to People's National Congress in March 1985 contains a penetrating analysis, referred to later, of the causes of inflation since the latter half of 1984 and discusses the developments of bank lending, total wage bills, the level of investment, and price increases in detail. However, concerning the large trade deficit which had been already developing, the report offers nothing more than a trite statement that expansion of foreign trade is progressing satisfactory and that the policy of opening-up the country is attaining favorable results.

Similarly in People's National Congress in March 1986, the report of Prime Minister (then) Zhao Ziyang discusses details of the "excessively fast

growth in manufacturing" and the "expansion of investment" in 1984 and 1985, but there is no mention at all about the large trade deficit. Concerning foreign trade and the import of technology, not much is stated other than that the major problems in these areas are: "in certain regions and sectors, contrary to the regulations, too many agencies are engaged in foreign trade and importation of technologies, there is blind competition, redundant technologies are being introduced, and high quality consumer goods are imported in excessive amounts."

Reading such reports, one gets the impression that Chinese leaders tend to understand foreign trade and other foreign economic relations as problems related only to those industries, enterprises, and agencies which are specialized in foreign trade and other foreign economic relations. A viewpoint which considers foreign trade and international balance of payments (the balance of foreign exchange receipts and payments) as a macroeconomic problem is lacking.

Even in Prime Minister (then) Zhao Ziyang's March 1987 report, there is a lengthy discussion of controls for investment and expenditures where a sort of macroeconomic approach is taken, but the discussion of foreign trade deals with the export promotion policy, inappropriate controls for imports, "the principle of satisfying domestic demand as much as possible through domestic supply so long as the products can be produced within the country" (at whatever cost?), and "the active promotion of import substitution". All of these are concerned with a "sectoral", not "macroeconomic", approach to the problem of trade deficit or international trade at large.

17) In China, "equality" and "mutual benefits" are frequently emphasized as principles for international trade and other international economic relations, but it has never been made clear what these words actually mean. At the very least, "equality" and "mutual benefits" in trade should not mean "bilateralism" in the sense of bilateral by balanced trade. At present, China is applying for membership in GATT, of which the basic principles are multilateralism, non-

discrimination (most-favored nation treatment for all member countries) and free trade. These are principles fundamentally in opposition to bilateralism. Discriminatory treatment for another member country by reason of bilateral trade imbalance is illegal under GATT. I have the impression, from their complaints about the China-Japan trade imbalance, that some Chinese leaders do not fully understand the basic principles of GATT.

18) However, the lack of understanding of the relationship between the increase in the aggregate demand and the trade deficit has been previously commented upon. See Note 16).

19) Previously, funds for "basic capital construction" investment which were used to obtain fixed assets of enterprises were allocated free of charge from the central and local governments to enterprises, but as a part of the economic reform since 1979 this procedure has been gradually converted to a system in which such funds were provided through bank lending. In 1985 this conversion was nearly completed.

20) As a result of this reckless expansion of bank lending, there was an increase in bank loans for which repayment was impossible at the time of maturity. See Akira Fujimoto, 1986.

21) When the balance of international payments is in deficit, to the extent that there are no other major sources increasing the supply of "high-powered money", such as increased government borrowing from the central bank or the latter's lending to non-central banks, the money supply will decrease.

22) According to newspaper reports, 17.6% of government enterprises were running losses between January and August 1986, and the amount of the losses increased 68.8% over the same period of the previous year: throughout 1986, nearly 20% of all government enterprises were running losses and that the number doubled over the previous year: in 1987, conditions continued to worsen, and between January and March and the number of enterprises running losses increased 11.7%, and the amount of deficits 41.9%, over the same period of the previous year.

23) Through this conversion, the weight of funds for "basic capital construction" investment in government expenditures decreased from 40.7% in 1978 to 31.3% in 1985, and the weight of funds for working capital of enterprises from 6.0% to 0.8% "China's Statistical Yearbook". Expenditures for "basic capital construction" investment which still remain in the government budget at present are perhaps funds for investment in the public sector, or those for investment of the "infrastructure" nature, rather than investment in the enterprise sector.

24) As is well known, in a simplified Keynesian model the multiplier effect of an expansionary but balanced budget is equal to one.

25) According to the most orthodox monetarism, this crowding-out effect is 100%: that is, the expansionary effect of the increase in government expenditures financed by the issue of government bonds to the public equals zero. Today, such an extreme position is held only by a small minority in macroeconomics. The majority view is that such an increase in government expenditures results in an increase in the aggregate demand at least to some extent: in other words, the crowding-out effect is thought to be less than 100%.

26) It is not possible to obtain from the published statistics the figures for the Chinese government expenditures, revenues and deficit or surplus in the usual Western meaning of these terms. By the way, the increase in government expenditures financed by foreign loans and foreign bond issues, as distinguished from domestic ones, would give rise to less inflationary pressure, but its inflationary effect would never be zero.

27) "Gendai Chugoku Keizai Jiten" pp.606-607: Kokumuin no Yosangaishikin Keiri Kyoka ni Kansuru Tsuchi (State Council's Notification on the Strengthening of the Control of Non-Budgetary Funds), (April 13, 1986), "Chugoku Keizai" (The Chinese Economy), JETRO, September 1986, pp.64-66.

28) If one considers how funds corresponding to China's "non-budgetary" funds are controlled in Japan from a macroeconomic viewpoint I believe that

macroeconomic conditions are much taken into account when the annual "Fiscal Lending and Investment Plan" is prepared. Also, the bond issue by the local government, of which an approval by the Ministry of Local Governments is necessary, is controlled from a macroeconomic point of view. However, the use of the current revenues of local governments and government enterprises is not considered as presenting a problem for macroeconomic policy.

29) In China in 1985, the term deposit interest rates of banks increased twice: in March the rate for one year maturity deposits was raised to 5.74% and the rate for five year to 6.84%, and in August they were raised to 7.2% and 9.36% respectively. However, even the interest rate after the latter raises did not reach the rate of increase of the CPI (Consumer Price Index), which was 11.9%. From 1984 to the present, apparently the financial savings of Chinese urban residents have suffered considerable capital losses.

30) Capital imports such as direct investment or purchases of stocks do not involve liabilities in the sense of being accompanied by interest payments and principal repayments. However, if there is no exchange control on the remittance of profits and principals, it will give rise to burdens to the country's future generations similar to those from foreign borrowing depending upon foreign investors' policies.

31) The foreign exchange rate must be used in order to calculate the ratio of the net international investment/indebtedness position to GNP. For the policies of maintaining a nearly constant ratio as explained in the text to be meaningful, the exchange rate (more accurately speaking, the "real" exchange rate) must be kept stable. In the case of China, the official exchange rate was 1.98 yuan to a U.S. dollar at the end of 1983, and 3.72 yuan at the end of 1986. This is a depreciation of approximately 47%. China's national income (nominal) increased approximately 65% in yuan over the three year period between 1983 and 1986, but when converted to U.S. dollar values by the year-end exchange rate, it decreased approximately 12% from 238.8 to 209.4 billion dollars (about 15% from 233 to 198 dollars on a per capita basis).

32) In Japan Credit Rating Institute (JCR), 1984, the value of China's debt service ratio (DSR) is given as 8.9% in 1983 (when services are included in export, 7.4%) and 4.4% in 1985 (or 3.7%) (ibid., Figure 14, p.18). However, this estimate of China's debt service ratio covers only the foreign debt owed by the central government (see "China's Statistical Yearbook", 1986 edition, p.610). On page 16 of JCR, 1984, it is said that China's foreign debt officially reported by the Chinese government is only the foreign debt of the central government (at the end of 1985, 5.1 billion dollars). Different official organizations outside of China give different figures for China's total foreign debt, but they are all 3-4 times the above amount (Beijing Office of the World Bank, 15-20 billion dollars [end of 1986], OECD 19.3 billion dollars [1985], Bank of Japan 14.9 billion dollars [1985]). Therefore, the DSR given in JCR, 1984, is clearly misleading.

33) In the 20 years between 1958 and 1978, the average real rate of growth (per year) of China's national income was approximately 4.5%. Excluding the few years (1961-65) after the Great Famine and the peak years (1967-69) of the Great Cultural Revolution, the ratio of accumulation generally exceeded 30%. Taking 30% as the average accumulation ratio China's marginal capital coefficient was 6.67 for 1958-1978 (on a national income basis).

34) During the 20 year period between 1958 and 1978, the rate of increase of the population was approximately 1.9%. Deducting this from the rate of growth of real national income stated above, the rate of growth of real per capita national income was only 2.6%.

35) The Chinese system of allocating and pricing (or not pricing) capital funds came from the Soviet Union. The original roots are deep, evolving from the labor value theory of Marxian economics.

36) During the seven year period between 1978 and 1985, the growth rate of real national income was approximately 8.5%, and the rate of increase in population was approximately 1.2%. Hence, the rate of growth of China's per capita real national income was 7.3%.

37) On these points, refer to Ryutaro Komiya, 1987.

38) According to a notification issued by the State Council on April 13, 1986 (refer to Note 27) banks "must control the receipts and expenditures of non-budgetary funds ...when they find aberrations, they must rectify them and report properly to their supervisory organizations." It appears that Chinese banks must perform the role of an inspector, which in Japan is assigned to the Board of Audit of the Government, or the Banking Bureau of the Ministry of Finance. Thus Chinese banks seem to have more a character of administrative organization, than an enterprise operating on a commercial basis. The change to make banks a full-fledged, business entity has not yet proceeded sufficiently.

39) As discussed later, the Bank of Japan charges a "penalty rate" of the official rate plus 4% in cases of this kind of excessive lending. However, in possible cases where "penalty" is charged the loss of the trust of the Bank of Japan (and the Ministry of Finance) and the likely effect on the future treatment would be far greater considerations for the banks than the high interest rate itself. In fact, since this "penalty rate" system was instituted, there have been almost no actual instances where the penalty rate was charged.

40) See Ryutaro Komiya, 1984.

41) See Janos Kornai, 1980, and his other works.

42) "Gendai Chugoku Keizai Jiten", pp.610-11.

43) Documents Presented to the Fifth Plenum of the Sixth People's National Congress, 1987, p.93. According to this source, the actual results of the national fiscal expenditures in 1986 were approximately 15 billion yuan over the budget (7% over the total budgeted expenditures). In Japan, it is prohibited to spend more than the original budgeted amount for each detailed items of government expenditures, although a supplementary budget for additional expenditures within a fiscal year may be presented to the Diet, and when it is approved additional expenditures are made. In any case, the total amount of expenditures cannot go over the appropriated amount.

- 44) Toshio Tajima, 1980.
- 45) In my view, Japan's national economic plans, such as the "National Income Doubling Plan" (1961-70), the "Economic and Social Development Plan" (1967-71) and later ones are all a sort of long term forecasts similar to long term weather forecasts. These plans are not binding. They are no more than forecasts with some "seasoning" based on wishful thinking. See Ryutaro Komiya, 1975.
- 46) For details of Japan's import control policy see Suetō Sekiguchi, 1972, pp.130-61, and Ministry of International Trade and Industry (ed.), 1971.
- 47) However, a target of tariff policy should be the strengthening of international competitiveness of a large number of Chinese industries (manufacturing industries); a close-minded approach trying to block imports of any goods which can be produced domestically is inappropriate. See Ryutaro Komiya, 1984. See particularly the section on foreign trade policy, pp.82-88.
- 48) According to an account in the Japan-China Economic Association's Nitchu Keizai Koryu: 1985 (Japan-China Economic Relations: 1985), March 1986, each contract for importing technologies seems to be now subject to new centralized regulation and approval of the Ministry of International Economic Relations and Trade. The author of the above account criticizes this new procedure on the grounds that "these regulations suppress competition and retard improvement in China's international competitiveness, technological advance, and adjustments in industrial structure" (p. 37). But I find this criticism unconvincing, and believe that, at the present stage, a centralized examination and approval system for importing technologies is necessary for China. Based on such a framework, a policy which encourages a certain degree of competition among firms using imported technologies would be advisable.
- 49) In most countries at most of the time, there is a scepticism about the effect of the exchange rate depreciation in the balance of payments adjustment process. This scepticism is especially strong in countries where the role of the price mechanism is not well understood. I believe that the effects of

exchange rate adjustment are different between the short- and long-runs and between small and large countries, and that in the long-run for a "small country" the effect is usually quite large. In the case of the Chinese economy at present, since its share in world trade is still very small, and since it has a large amount of explicit and potential surplus labor within it, the price elasticities of both import demand and export supply are likely to be quite large, and changes in the exchange rate will normally have a large favorable effect on the balance of payments.

50) See Ministry of International Trade and Industry (ed.), 1971, Section V, "Postwar Trade Policy", pp.428-34.

51) See JCR, 1987, p.14.

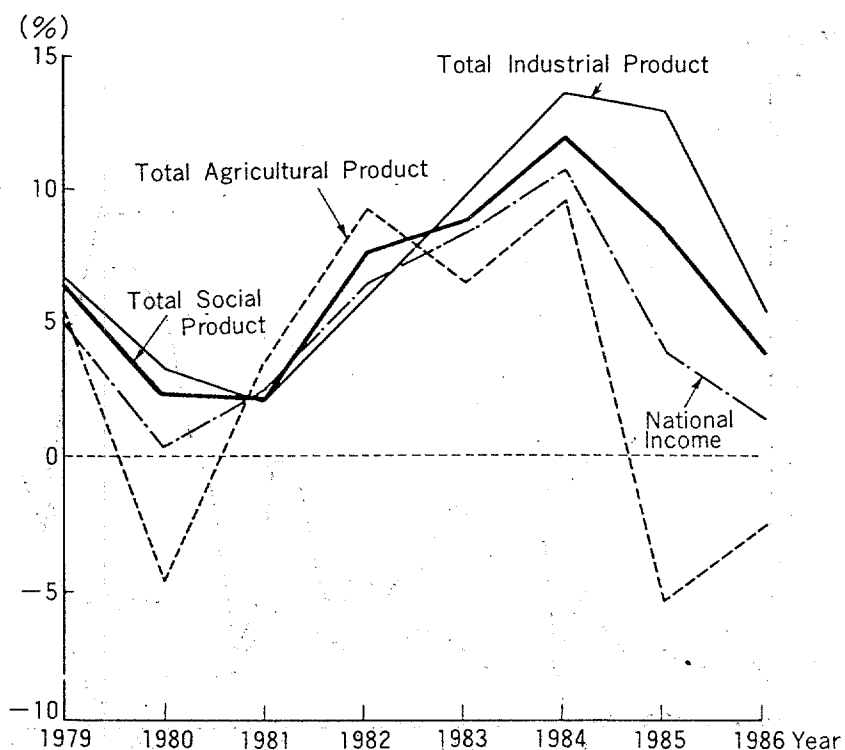
52) The system of allowing the exporters to retain a portion of foreign exchanges earned (the "retention quota" system), while restricting strictly import in general and other uses of foreign exchanges, amounts to a kind of hidden subsidy to export. It is likely to involve infringement against the IMF and GATT agreements. It was also reported that for the purpose of the foreign exchange transfers among foreign-owned enterprises in China a sort of foreign exchange markets were established in Shenzhen, Guangzhou, Shanghai, Dalian and Tianjin. But there is another possibility of infringement against the IMF agreement in such an agreement, since the latter stipulates the use of a single exchange rate for all transactions by a member country. This kind of arrangements not only lack economic rationality, but would constitute a negative factor for international credibility of the Chinese government.

53) It has been reported that since May 1986, a new tax at a rate of 7% on after-tax profits from those enterprises run by cooperative and individual, which earned after-tax profits exceeding 5,000 yuan each, has been levied as a tax earmarked as funds for basic capital construction investment in the areas of energy supply and transportation.

54) Since January 1, 1986, at Chinese coastal and Yangzi-river (Changjiang) ports a new charge earmarked for the construction of port facilities at rates

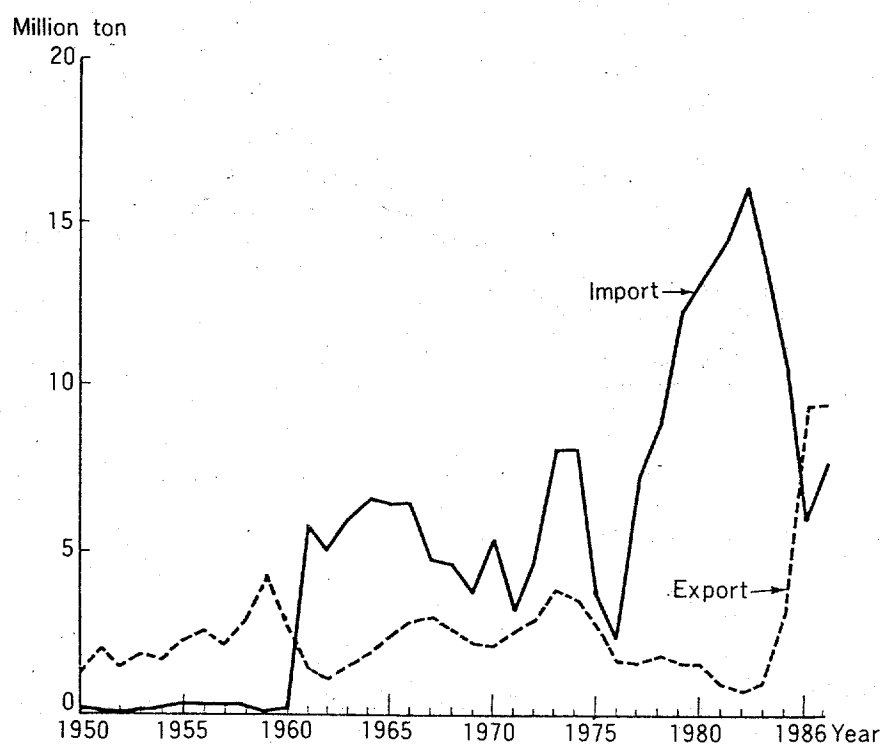
ranging from 0.5 to 4.0 yuan per ton of cargo has been levied for all export and import cargo transported via these ports. See Nitchu Keizai Koryu (Japan-China Economic Relations), March 1986, p.369. Apart from the details which I do not know the basic idea of such a charge (tax) is an economically rational one. Application of this idea for raising funds for other types of basic capital construction investment where users charges are possible is highly commendable.

Figure 1: Real Growth Rate of Total Social Product, Agricultura Product, Industrial Product and National Income: 1979 - 1986



Sources: China's Statistical Yearbook; IMF, International Financial Statistics, various issues. The real rate of growth is derived by subtracting the appropriate rates of price increases from the respective nominal growth rates.

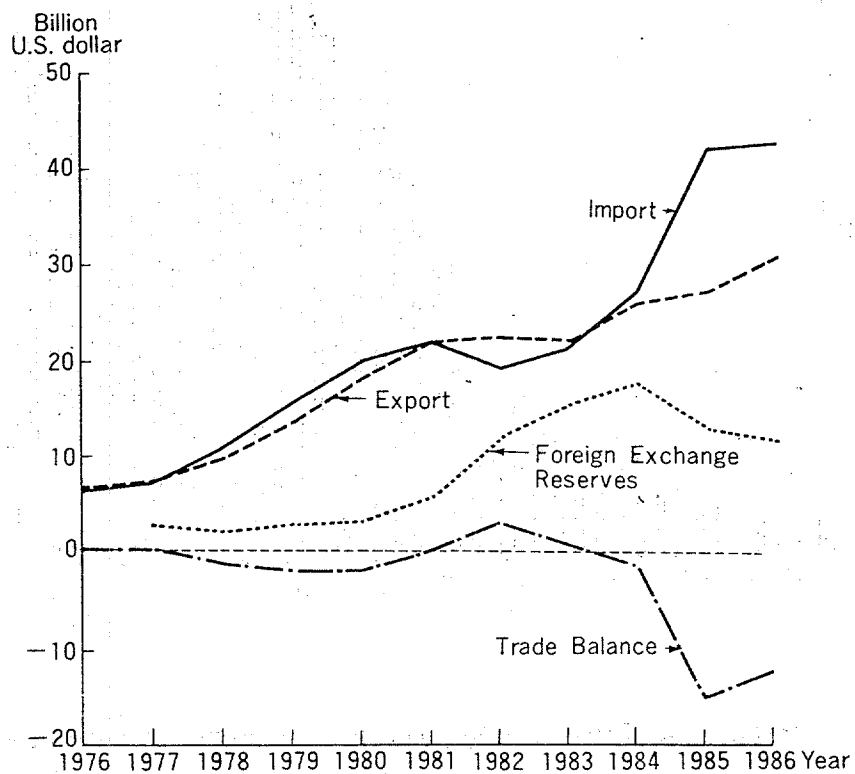
Figure 2: Export and Import of Grains: 1950 - 1986



Sources: China's Statistical Yearbook. "Grain" here is "liangshi" in Chinese and includes not only wheat, barley and rice but also corn, soybean, etc.

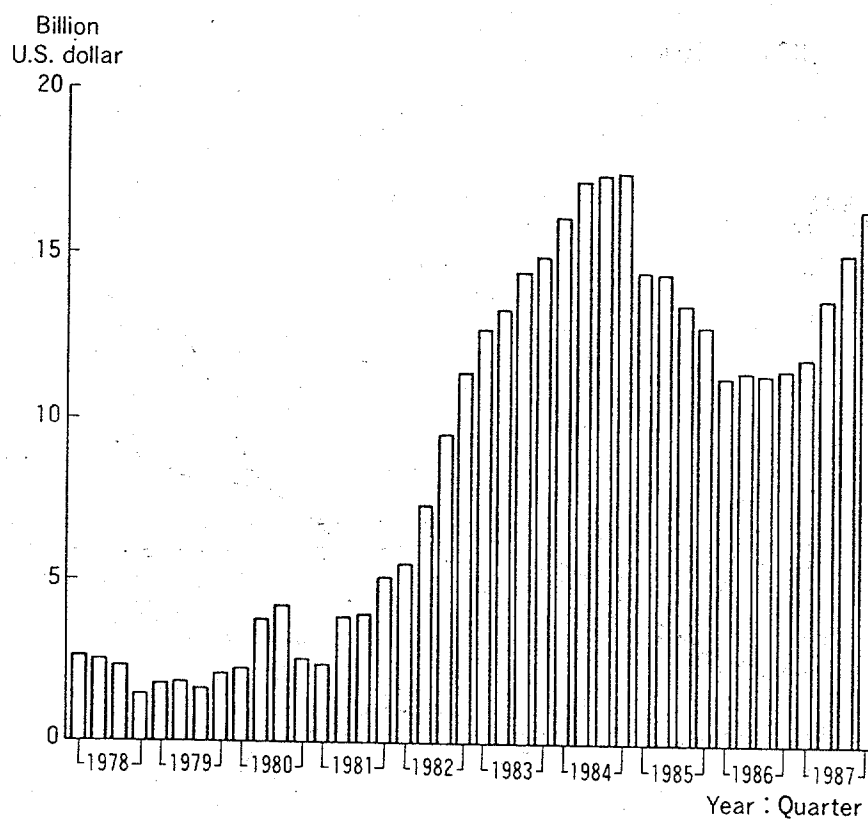
Figure 3: Export and Import, Trade Balance and Foreign Exchange Reserves:

1976 - 1986



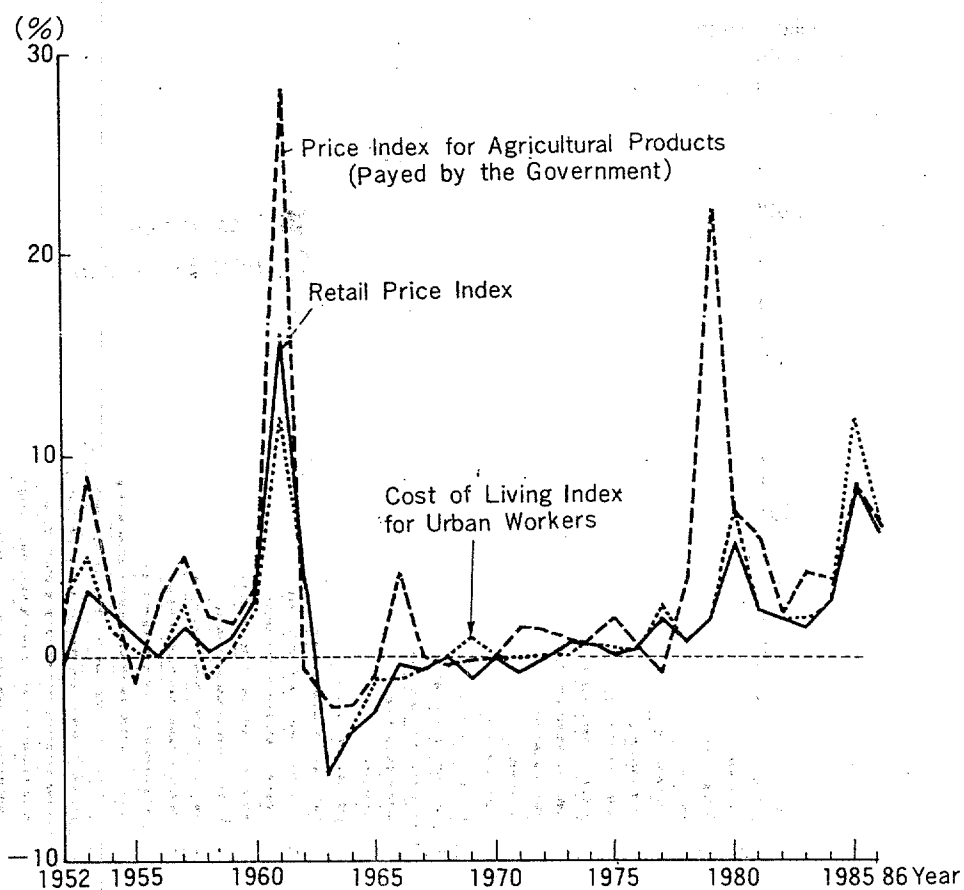
Sources: Same as Figure 2.

Figure 4: Foreign Exchange Reserves: 1978 - 1987



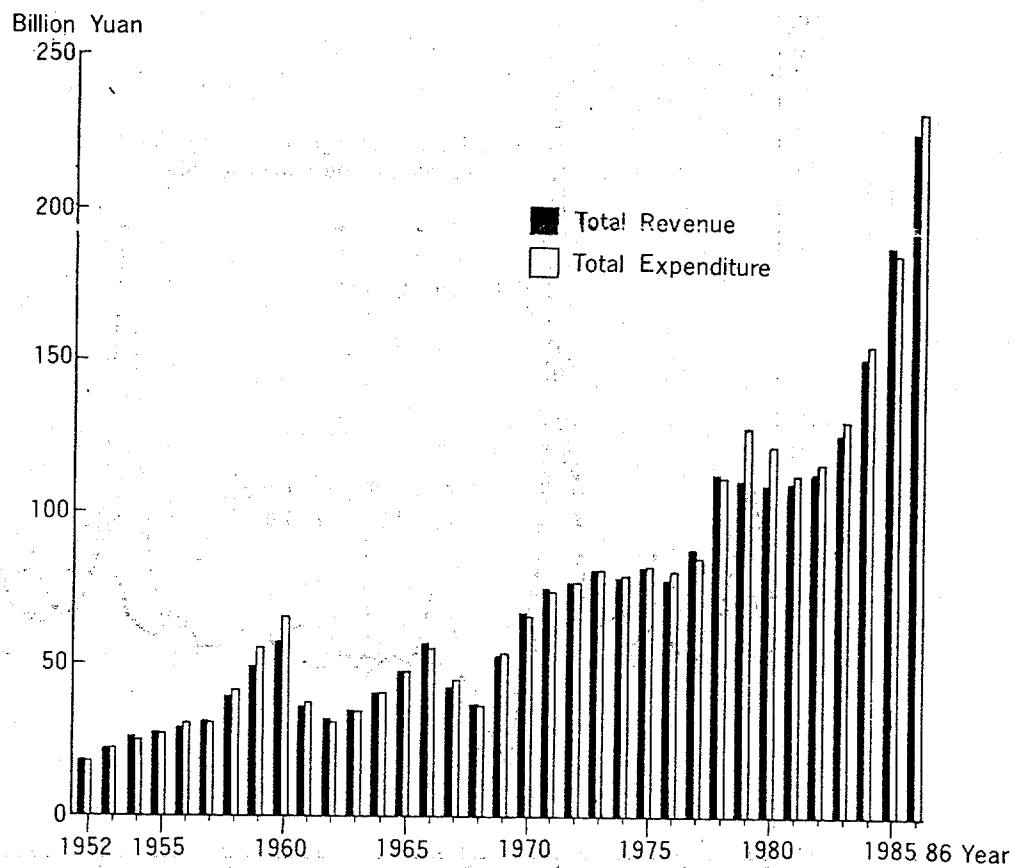
Sources: International Financial Statistics. Foreign Exchange Reserves here is "Total Reserves" excluding the holdings of gold.

Figure 5: Rate of Price Increase: 1952 - 1986



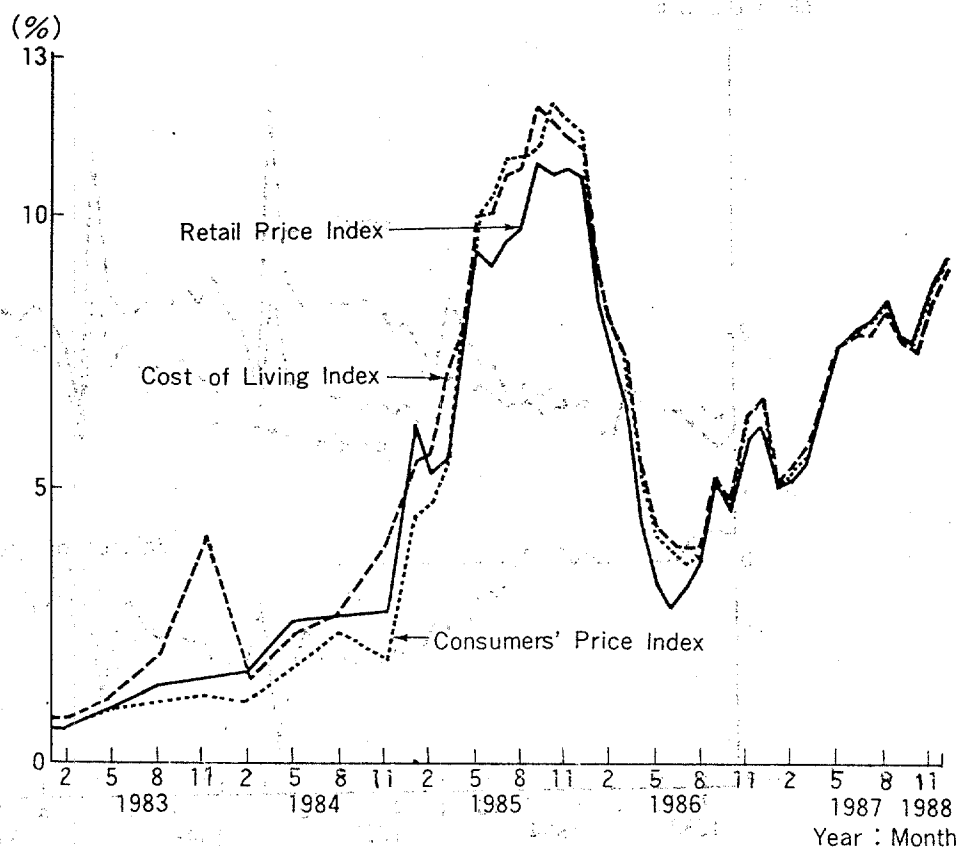
Sources: Same as Figure 2.

Figure 6: National Government Revenue and Expenditures: 1952 - 1986



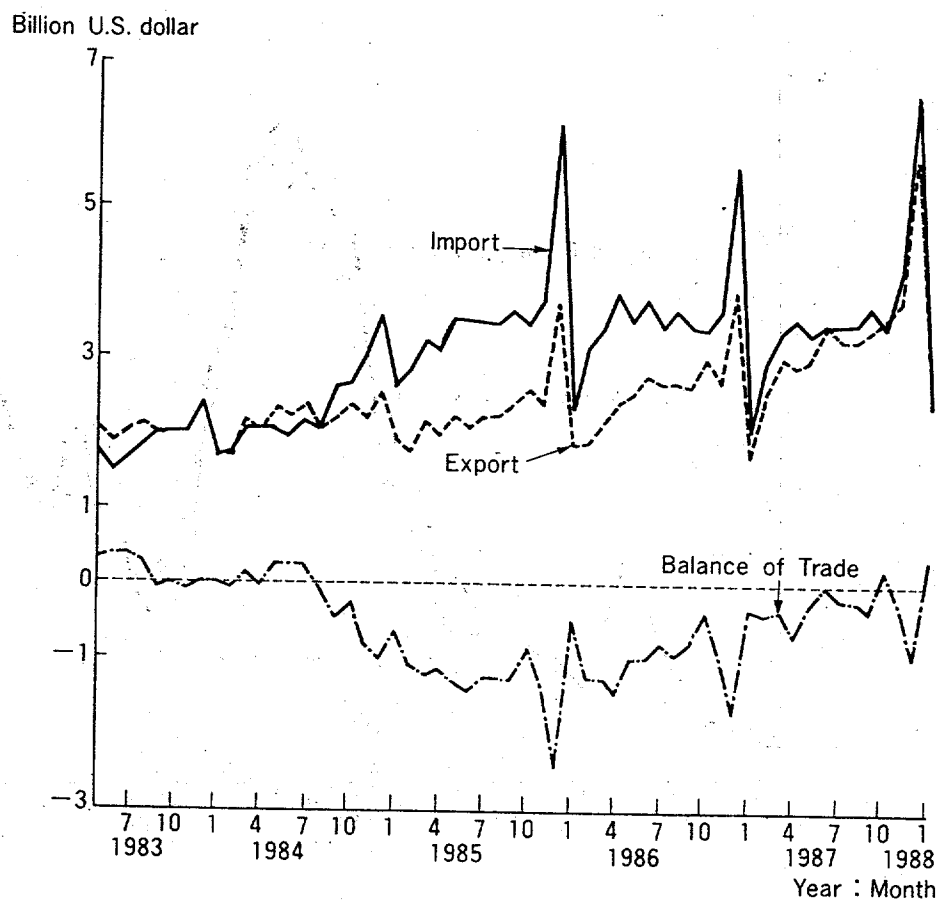
Sources: Same as Figure 2. Refer to Section III of the text for the Chinese concepts of government revenue and expenditures.

Figure 7: Rate of Price Increase: 1983 - 1987



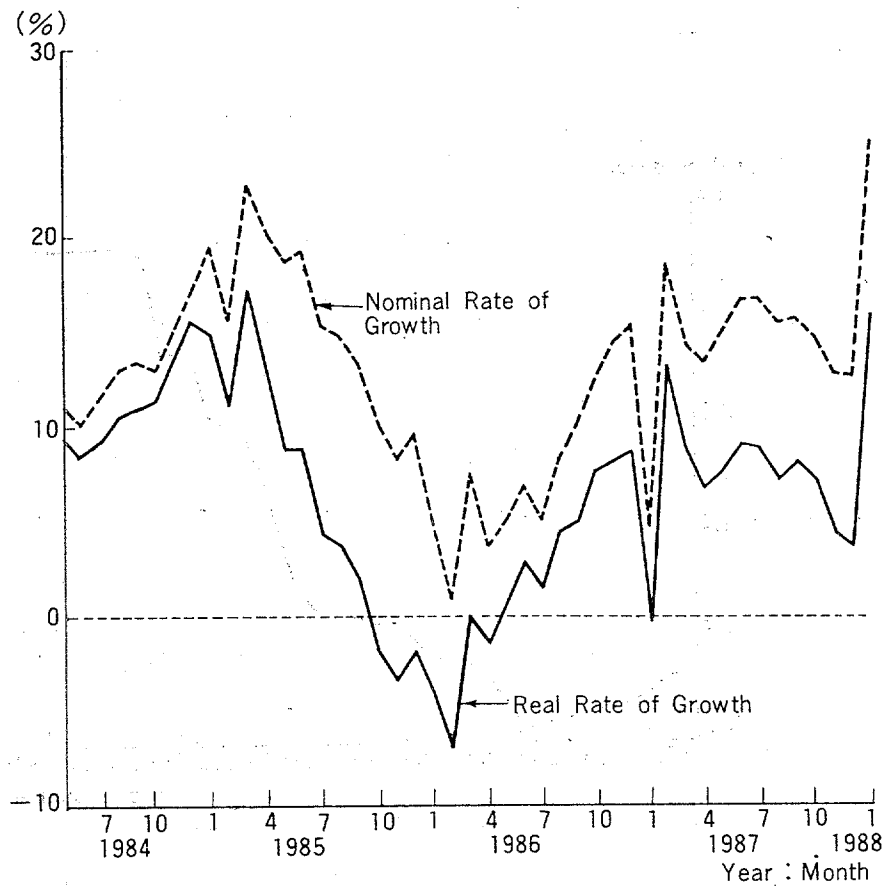
Sources: China's Monthly Bulletin of Statistics. The rate of price increase over the same period of the previous year; until the end of 1984, only quarterly data were published.

Figure 8: Export, Import and Trade Balance: 1983 - 1987



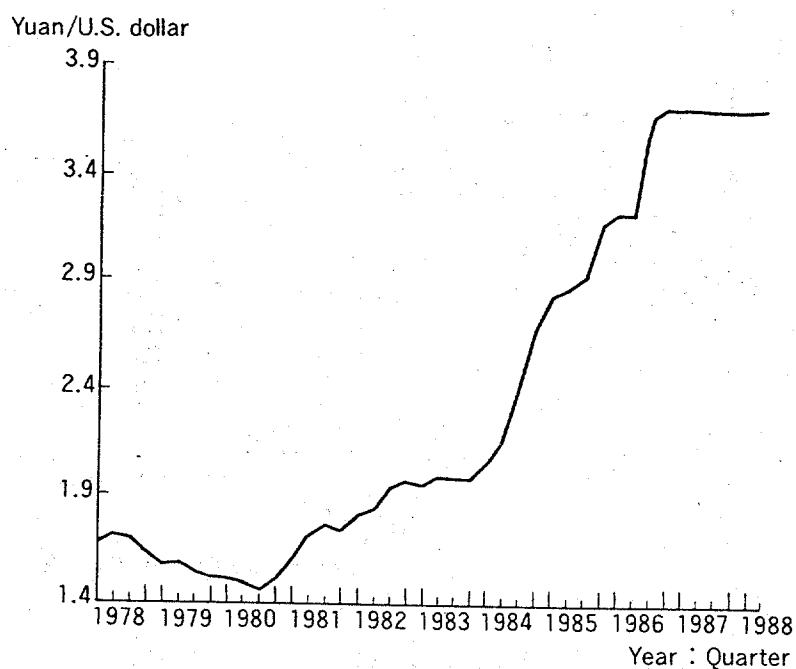
Sources: Same as Figure 7.

Figure 9: Rate of Increase in Manufacturing Production: 1984 - 1987



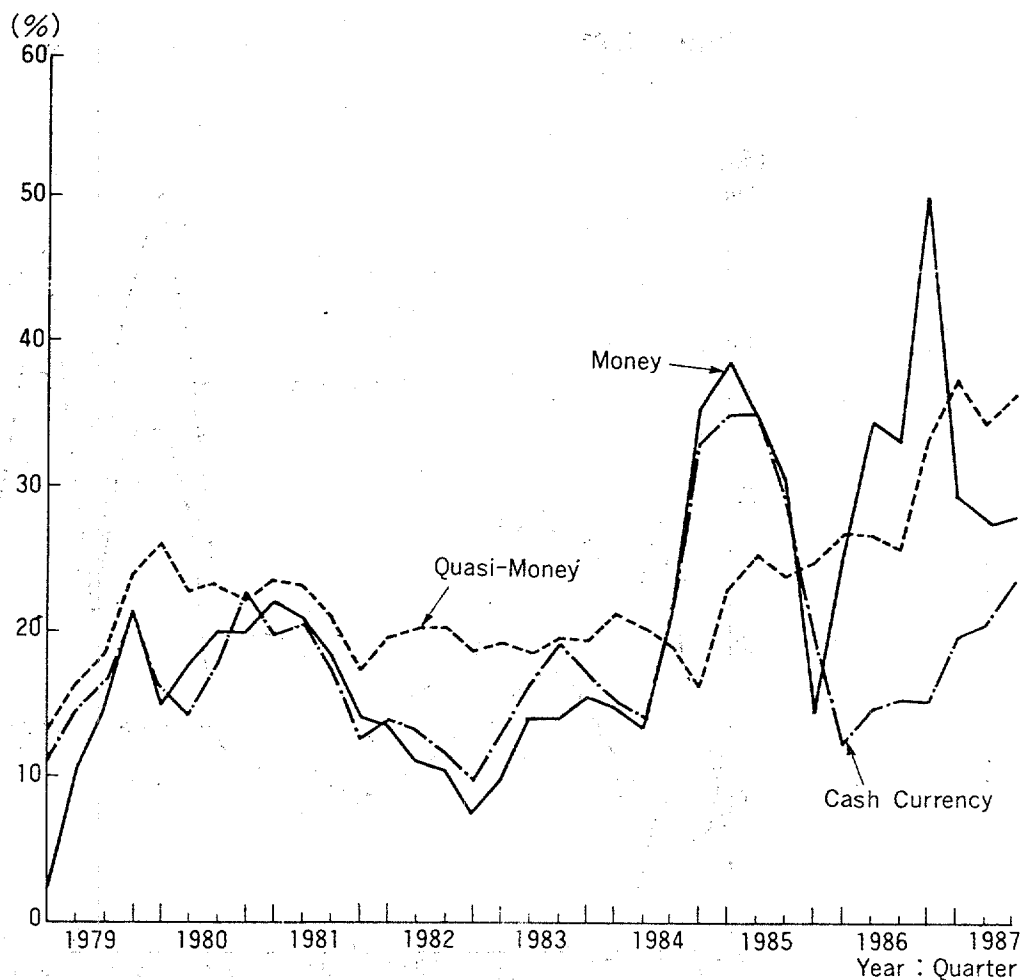
Sources: Same as Figure 7. The rate of increase over the same period of the previous year. The real rate of growth is derived by deducting the rate of increase in retail prices from the nominal rate of growth.

Figure 10: The Yuan-Dollar Exchange Rate: 1978 - 1987



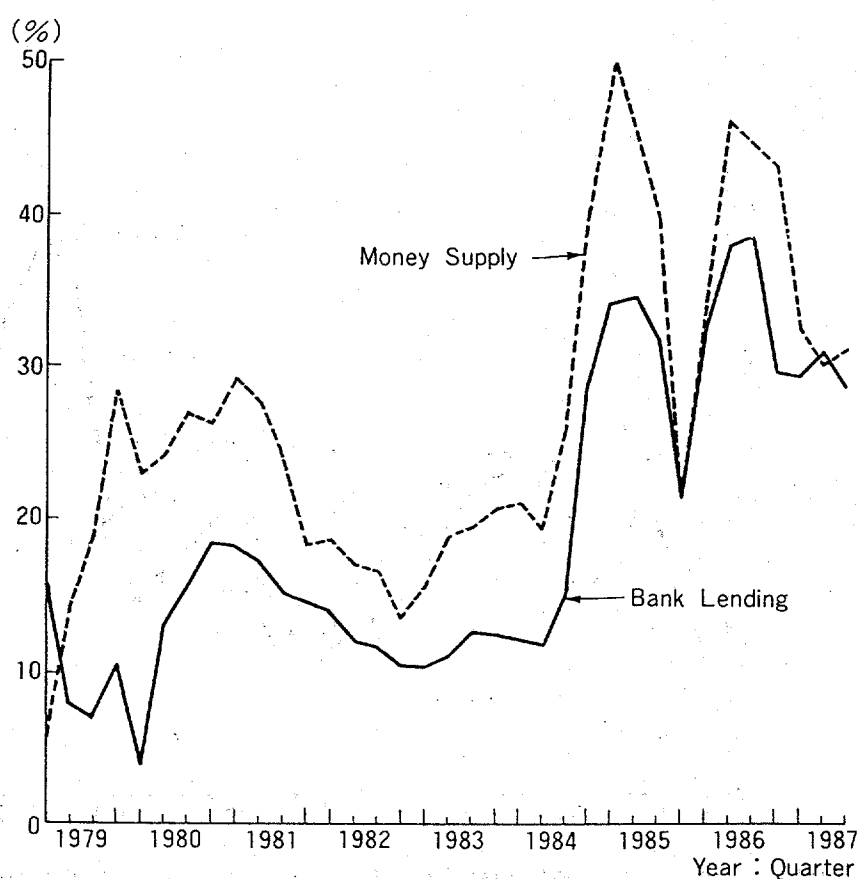
Sources: IMF, International Financial Statistics. The number of the yuan (RMB) per U.S. dollar at the end of each quarter.

Figure 11: Rate of Increase in Money Supply: 1979 - 1987



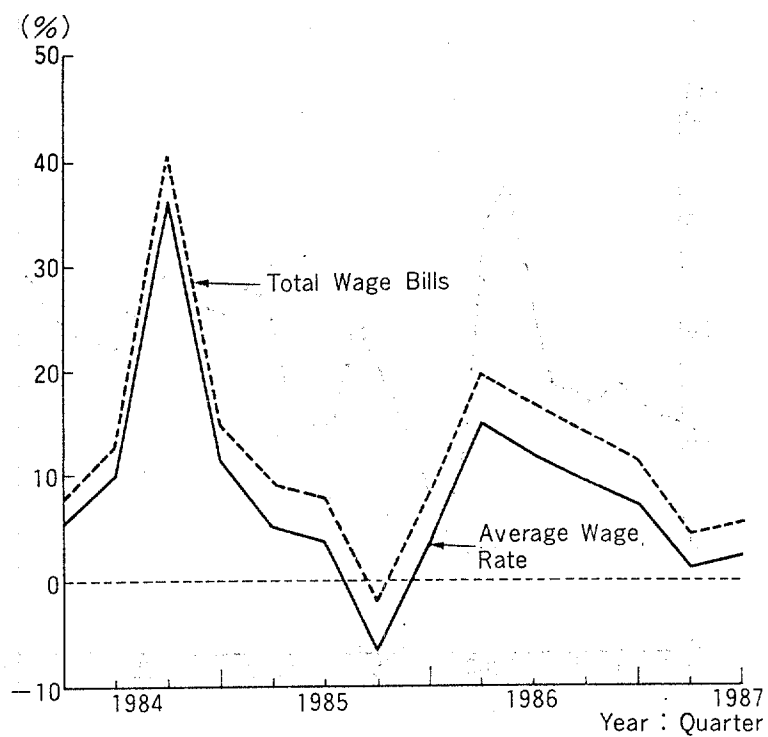
Sources: IMF, International Financial Statistics. As compared to the same quarter of the previous year.

Figure 12: Rate of Increases in Bank Lending and Money Supply:
1979 - 1987



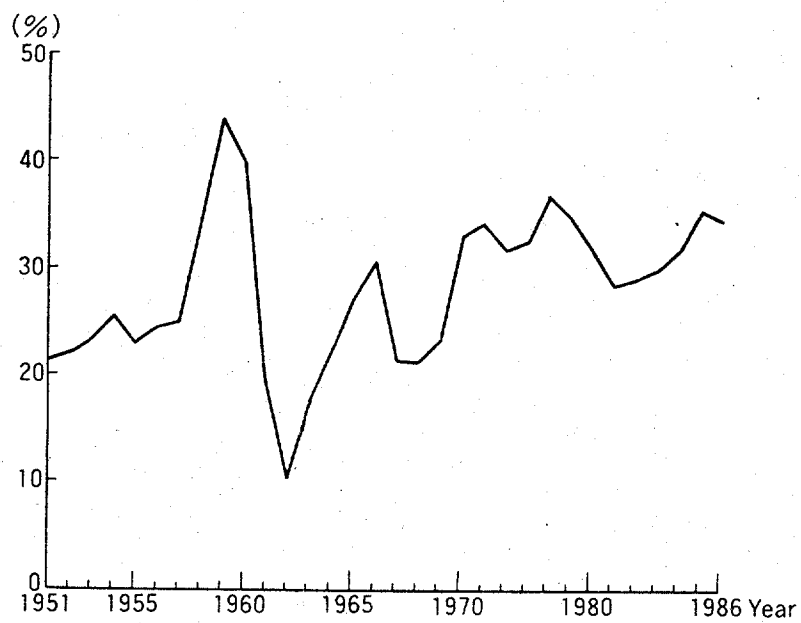
Sources: Same as Figure 11. "Bank Lending" includes lending to the nongovernment sector only, and "Money Supply" is the sum of money and quasi-money. Both series indicate the rate of increase over the same quarter of the previous year.

Figure 13: Rate of Increase in Wages: 1984 - 1987



Sources: Same as Figure 7. As compared to the same period of the previous year.

Figure 14: Ratio of Capital Accumulation: 1951 - 1986



Sources: Same as Figure 2. The ratio of capital accumulation here is the ratio of gross investment to national income.

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