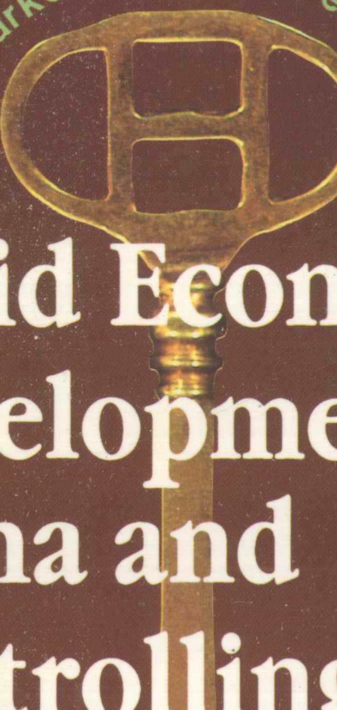
Studies on the Chinese Market Economy Series



Rapid Economic Development in China and Controlling Inflation

Chief Editors:
Gao Shangquan
and Chi Fulin

FOREIGN LANGUAGES PRESS BEIJING

Studies on the Chinese Market Economy Series

Rapid Economic Development in China and Controlling Inflation

Chief editors:
Gao Shangquan *and* Chi Fulin
Written by:
Zhu Huayou

FOREIGN LANGUAGES PRESS BEIJING

First Edition 1997

The project is aided by
(Hainan) China Foundation for Reform and Development Research.

ISBN 7-119-00025-x

Published by Foreign Languages Press
24 Baiwanzhuang Road, Beijing 100037, China

Distributed by China International Book Trading Corporation
35 Chegongzhuang Xilu, Beijing 100044, China
P.O. Box 399, Beijing, China

Printed in the People's Republic of China

图书在版编目(CIP)数据

中国经济快速发展与抑制通货膨胀:英文/高尚全,迟福林主编.—北京:外文出版社,1997
(中国市场经济研讨丛书)
ISBN 7-119-00025-X

Ⅰ.中… Ⅱ.①高… ②迟… Ⅲ.①经济发展-高速度(经济)-关系-通货膨胀-中国-研究 ②通货膨胀-对策-中国-研究 Ⅳ.F822.5

中国版本图书馆 CIP 数据核字 (96) 第 12870 号

责任编辑 程钦华　胡开敏
封面设计 唐　宇

中国经济快速发展与抑制通货膨胀

高尚全　迟福林主编

*

外文出版社出版
(中国北京百万庄大街 24 号)
邮政编码 100037
北京外文印刷厂印刷
中国国际图书贸易总公司发行
(中国北京车公庄西路 35 号)
北京邮政信箱第 399 号　邮政编码 100044
1997 年(大 32 开)第 1 版
(英)
ISBN 7-119-00025-X /F·2(外)
02800
4-E-3093P

Foreword

What do we make of and how do we deal with the relationship between inflation and economic growth? This is probably a major practical question which every nation in the world must face. In the past decade and more, a relatively high level of inflation has repeatedly sprung up in the course of China's rapid economic growth. And in the past two years, the inflation problem has become a prominent contradiction closely linked with the quick development of China's marketization. How to effectively control inflation and to properly handle the relationship between reform, development and stability without impeding rapid economic growth is the problem which we must conscientiously study during the period of economic transformation.

In November 1994 in Haikou, the China (Hainan) Reform and Development Research Institute, China Restructuring Economy Research Society, UN Development Program and the German Technology Cooperation Company jointly held the International Seminar on the Asia-Pacific Regional Rapid Economic Growth and Stable Development. Specialists from the UN Development and Planning Office, Asia Development Bank, Ford Foundation, the United States, Germany, Canada, Japan, the Republic of Korea, Singapore, Vietnam, the Philippines and high ranking leaders and well-known economists of China held extensive discussions on international comparisons of experiences in controlling inflation, of problems involving economic reform, of the relationship between opening up and inflation, of controlling inflation while maintaining rapid economic growth and other problems, and many important theoretical viewpoints and thoughts on policy options were put forward during discussions. Based on the research into inflation problems made by the China (Hainan) Reform and Development Research Institute and relevant materials discussed at the seminar and speeches by experts there we wrote and edited this book; we have also referred to the research results of experts on questions of inflation from recent years. We aim to provide a relatively comprehensive and objective analyses of the problem of inflation and measures to be taken to keep inflation under control during rapid economic growth.

Gao Shangquan and Chi Fulin are chief editors of the book, Chi Fulin edited the draft and Zhu Huayou did the actual writing.

Financial assistance for its publishing was provided by the (China) Hainan Foundation for Reform and Development Research for which we express our sincere gratitude!

The Editors
March 1995

Contents

Chapter 1
Inflation in the Changing of Economic Structure

I. The Reasons for Inflation in China

(I) In the last decade, China's inflation has always been connected with its cyclical economic fluctuations

In the last decade or so, large scale inflations appeared repeatedly in China. Each time the economy moved into a period of growth, a relatively high level of inflation occurred. In the past decade, China's economy fluctuated on three occasions and inflation has also exhibited three peaks.

1. The Inflation of 1985

By 1985 the traditional planned economic system had already been weakened gradually; urban and rural production of non-state-owned economy already constituted approximately half of the GNP; the autonomy of state-owned enterprises extended step by step. By freeing up prices on small commody products and part of farm produce and sideline products, and the implementation of the double-track price system for the products produced by the state-owned industrial enterprises (for products covered by the state plan controlled pricing was maintained; for products outside the state plan market prices were adopted), thus the prices of two thirds of the products were adjusted by the market.

In the first quarter of 1985, economic growth reached a peak, and the economic growth rate compared with the average of the previous four years was faster by 12 to 14 percentage points, showing an overheated state. Beginning from the second quarter, prices rapidly went up. For the period from September to December the price increasing rate was more than 10 percent higher than that of the same period in 1984. In 1985 the GDP increased by 12.8 percent; at the same time the resident cost-of-living index went up 9.3 percent from the previous year and the retail price index of commodities rose by 8.8 percent over the year before.

To counter this, in July 1985, the government began to carry out mainly administrative means, measures including re-examining the investment projects of state-owned enterprises; strictly controlling the scale of fixed assets investment; reducing the scale of credit. Besides, the savings-deposit interest rate and that for fixed assets loan were raised twice first in April and then in September of the same year.

By early 1986, prices had dropped noticeably; however, the speed of economic growth dropped rather quickly, in February 1986, industrial production experienced no increase. Due to political considerations and pressure from local governments and state-owned enterprises, the Central Government began to relax control over credit in the second quarter of 1986, causing currency issuing for the following three quarters to experience a consistently high speed of increase. By the end of 1986 the amount of broad currency (M2) was 32.3 percent higher than that at the end of 1985.

2. The Inflation of 1988

In 1988 several new reform measures were introduced: overall implementation of the enterprise contract responsibility system, further expanded autonomy for enterprises; the Central Government implemented different types of all-round contract systems for local financial budgeting; in the area of price system reform the policy of combining readjusting with freeing up while stressing the latter was adopted so as to gradually increase the proportion of market-set prices and, at the same time, raised the purchase price of grain and edible oil as well as coal and shipping prices.

In March 1986 after relaxing control over banks, the increasing rate of broad currency (M2) went up step by step, so that during the first three quarters of 1987 it maintaining an increase above 30 percent. As a result, there was a recovery of rapid economic growth. Despite the adoption in October and November

1987 of the "tightening policy" in finance and banking to control the overheating economy, however, after December 1987, a policy of pouring in large amounts of capital to spur on the industrial growth was again put into effect. In the second and third quarters of 1988 economic growth reached a new peak. Because of this there was a concurrent swift, violent increase in prices. By the third quarter of 1988, people began to pull out their savings and a purchasing rush occurred.

From the third quarter of 1988, in order to bring a halt to the emerging vicious inflation, the government adopted strict controlling measures to stablise the economy. The major ones included: strengthening administration of prices by taking over operation of major agricultural means of production such as chemical fertiliser and setting ceiling prices for major means of production; strictly controlling the amount of loans and the scale of currency issuing, once even halting loans to rural and township enterprises; firmly reducing the scale of fixed assets investment, halting loans to projects outside the state plan; checking companies and straightening their affairs, especially trust investment companies; controlling the purchasing power of social groups; and increasing twice the interest rate for savings deposit.

In 1989 the rising trend of prices went down swiftly. At the end of the third quarter, the inflationary rate (compared to the retail price index of commodities of the previous month) fell to zero, and the price index of urban residents' average costs for daily necessities in 1990 went up by only 3.1 percent. At the same time, the selling on market was sluggish, the speed of industrial production growth fell steeply; enterprises operated under capacity or halted production; pressure on the job market increased; and the general financial situation was worsening. Beginning in the fourth quarter of 1989 the government adopted a policy of credit expansion in order to restart an economy that had fallen into dire straits.

3. The Inflation of 1993

From 1992 to 1993 price reform took a relatively big steps forward; commodity prices for the vast majority of items, including grain and edible oil, were relaxed, and only a minority of commodity prices, constituting between 10 to 20 percent of gross sales, remained under administrative control. Concurrent with this, non-state-owned enterprises developed rapidly, the proportion of these enterprises among the gross industrial output value went from 22 percent in 1978 up to 52 percent in 1992.

After relaxing the hold on banks from the fourth quarter of 1989, the banking system by means of granting loans poured large amounts of currency into national economy. However, from 1989 to 1991 the influx of large amount of currency did not bring about any obvious increase in inflationary pressure. The reason for this lies perhaps in the fact that during this period finance underwent a rapid and deepgoing development, new financial messures emerged continually, large plots of land which were originally allocated free were being sold in the form of bulk rentals; all of this led to the large-scale emergence of new financial capital and real estate, enabling the rapidly expanding credit and capital to be absorbed and saved up instead of bringing any immediate inflation.

But, after 1991, the continued large-scale influx of currency caused the situation afterwards to undergo a great change. In the middle of 1991, the increase in broad currency reached 30 percent, and this level remained all the way through the middle of 1993. The inflationary pressure following this increased steadily; by the second half of 1992 the price index began to climb step by step. However, the Central Bank did not take any effective regulatory measures for a long time. On top of this, some people took advantage of the chaos in the financial system to speculate for profit, thus intensifying the inflation.

In May and June 1993 the Central Government began to strengthen its macro-regulatory efforts; the major measures issued include: halting loan issuing power of the branches of the Central Bank; requiring specialised banks to take managerial responsibility over the entire bank's risk. It demanded that all banks recovered capital lost to breaching of regulations for loaning; put the amount of bank loans under control; strengthened the examination and approval of new investment projects; tightened financial outlays and strengthened tax collection and management; raised the interest rate of savings deposit and loans twice in a row, and for resident deposit accounts of three years or longer implemented inflation proof savings deposits.

Following the promotion of the stabilising program in early July 1993, during the third quarter of that year, currency growth and production development both slowed down noticeably. By October, the growth rate of the currency supply (M1) went down from 34 percent in June to 15.6 percent: the growth rate of industrial output value also fell from 30.2 percent in June to 16.4 percent; the growth rate of investment by state-owned industrial sectors went down from 74 percent to 58 percent; the increase rate of the price for production means fell from 52.95 percent to 31.35 percent (All of these are figures compared with those of the same month in the previous year).

However, the pulling back in credits influenced the operational activities of state-owned enterprises. As a result, enterprises particularly state-run enterprises were short of funds, which caused industrial growth to slow down, and local governments raised the need to ease controls on credit. Under such circumstances, between September and October 1993, the Central Bank poured huge amounts of money for short-term loans into state-owned banks (totalling 170 billion RMB yuan). Although strict loan quotas of an executive nature limited bank's function of creating currency, in November and December 1993 the growth rate of broad currency (M2) rose again. At the same time, the price increasing trend eased by the retraction in currency growth in the period from August to October 1993 sprang up again and went up sharply from November 1993. In the four months from November 1993 to February 1994 the retail price index rose 3.4 percent on average over each preceding month. In 1994 more important reform measures continued to be introduced with the establishment of a socialist market economic system as their objective, and all in all things progressed relatively smoothly. Viewed from the relationship of gross supply and gross demand, a fundamental balance was maintained; for more than 90 percent of consumer products supply remained higher than or was equal to demand, and nothing like the purchasing rush of 1988 occurred. Therefore, inflation in 1994 was quite different from the previous ones. Many major economic indicators make clear, in comparing the economic situation of 1994 with that of the first half of 1993, there was a marked improvement. The basic economic objective of "soft landing" was reached.

(II) An expanded demand for investment is the direct incentive for inflation

China's economy has all along had an incredibly deep-set internal drive seeking to expand and broaden the scale of investment. This drive originated in the merging of the state political authority with economic authority under the past system of planned economy. It is precisely this merger that put the policy decision on investment and the allocation of capital investment under the government control; and the financial restrictions were ineffective to enterprises, and they did not need to pay anything when they used or held investment capital. Even though the state changed from allocating investment capital to providing loans, a weak effect brought about by the interest rate on loans, could not change the situation fundamentally. Following the Central Government's granting more power to localities, local authorities had greater power to decide on investment strategy and with this, the drive to expand the economy also got stronger. Since the 1980s almost all of the inflations were induced by excessively expanding investment. The major factor inciting the 1993-1994 inflation in China was also the swell in investment that had occurred since 1992.

Due to the factors known to everyone, an expanding investment mechanism has existed in China for a long time; every area, every work unit strives for investment project, causing, first of all, the basic construction plan to grow ever larger. Moreover, many construction projects adopt the method of under-reporting their construction budget to gain approval. As a result, these projects often remain unfinished before the fund allocated for the projects have long been used up. This forces department of higher authority to have no choice but to allocate additional investment. Under such a mechanism the actual level of investment will by necessity exceed the project quota that had been worked out according to the amount of materials that could be provided. The public finance sector has to make an overdraft on the Central Bank to make narrow currency (Mo) increase. This is one of the holes through which currency expands. Corresponding to this is the fact that the government cannot but approve the People's Bank's expansion of credit quota, thus creating the second loophole by which currency expands (broad currency also increases). Inflation, thus follows inevitably.

Table: The Increase Rates of Investment and Inflation (%):

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Society-wide fixed assets investment	28	38	18.7	20.6	23.5	-8	7.5	23.8	42.6	50.59	28.50
Fixed assets investment of units owned by the whole people	24	41.8	17.7	16	20	-8	15	24.3	45.4	51	
Imported foreign investment	35	70	59	16	21	-1	3	11	65		35
Rate of inflation	2.8	8.8	6	7.3	18.5	17.8	2.1	2.9	5.4	13.2	21.7

Source: China Statistics Yearbook.

It is apparent from the table that during and before the year inflation occurred, society-wide fixed assets investment, including the fixed assets investment of the units owned by the whole people, unexceptionally experienced large scale increase. For the corresponding periods, the growth rate of imported foreign capital were also at a high level. If we consider the process from the input of investment to the point of the actual rise in prices, one can see clearly from the chart that the increase of investment is the direct inducement of each instance of inflation in China.

In 1993, when China's economy continued to take big steps forward, a new set of contradictions and problems appeared. Especially serious were indiscriminately raising funds, unjustifiably providing short-term loans and arbitrarily establishing financial institutions (known as three disorders), all of which contributed to the breakdown of the normal financial order, and moreover forced currency issuance to shoot-up, wreaking havoc on the macro-economic environment. The "three disorders," brought about by the customers' searching for loans, gave financial support to the "real estate boom" and the "development zones boom." The "three disorders" and the "two booms" fueled to the flames, creating a vigorous demand for investment and leading directly to price increases for steel and other construction materials for domestic construction projects. The large-scale imports of steel caused the exchange rate to climb higher. Though the Central Government promptly adopted stronger macro-regulating measures, curbed further soaring of steel prices, and even stabilised the exchange rate between the US dollars and RMB yuan at about 1:8.7, the sharp rise in steel prices, however, gave way to a general rise in prices of industrial products.

The symptoms of investment starvation and thirst resulted from the traditional investment system serve as the crux of the swelling of fixed assets investment. Let us analyse the increase in commodity prices caused by the swell in the total scale of fixed assets investment: First, in the past the great majority of China's fixed assets investment was formed by allocated funds from the budget, but following the replacement of allocated funds by loans and the emergence of multiplying investment bodies, now a large amount of them come from bank loans. In the past, the expansion of fixed assets investment increased the budget deficit, now it increases the credit deficit. Regardless of whether it is a budget deficit or a credit deficit, in order to remedy them, both require issuing more currency. Second, fixed assets investment is such a type of economic activity that within one year or more than a year, no means of production or means of livelihood, or any useful result will be provided, but it will take labour, means of production and means of livelihood from the whole year's total production. That is to say, to put same amount of money for other economic activities, although it is also necessary to increase society's overall demand (taking away labour, means of production and means of livelihood from the year's gross production), it quickly brings with it an increase in society's overall supply (goods or services). However, for fixed assets investment, before projects have actually been completed and put into production, not only requires an increase in society's total demand but will "take away" the total supply of the society. This doubly widens the margin between society's total supply and its total demand. Third, the bottleneck effect. The swelling of fixed assets investment certainly leads to the shortage of energy and raw material supply and the pressure on transport, thus forming a bottleneck restricting the national economy as a whole, and furthermore, causing the prices of products in short supply and services to skyrocket. Within several months from the winter of 1992, the price of wire rods used in construction was more than doubled, a prominent example of this phenomenon. Fourth, when fixed assets investment is really hot, there are always enterprises and work units which shift circulating capital to basic construction projects, and the result was to force the bank to provide more circulating capital or delayed the repayment of the loans, leading to the occurrence of triangle debts among enterprises. No matter which situation arises, it will increase the amount of currency to be issued.

The root cause of problems resulting from frequent swelling of fixed assets investment is the traditional investment system. Before a capitalist makes an investment, he will repeatedly carry out research on the feasibility of the project. But, according to China's traditional investment system, the decision-makers of the investment do not have to bear any responsibility for the final outcome of the investment; those who make decisions on providing loans do not actually bear any responsibility either as to whether or not the loans can be recovered as scheduled. This type of investment system is the root cause leading to China's inflation.

At present, China's inflation problem results directly from an economic strategy of seeking high-speed development by relying on high investment. In 1992 the GDP growth rate reached a 13.2 percent. However, this type of high growth counts on the support of great capital input. According to estimates, about 60 percent of the annual economic growth was brought about by the in-