Gradual versus Rapid Liberalization in Socialist Economies

Financial Policies in China and Russia Compared

Ronald I. McKinnon

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社会主义经济渐进自由化与迅速自由化

——中国的财政政策与俄国的财政政策相比较

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About the Author

Ronald I. McKinnon is William Eberle Professor of Economics at Stanford University, where he has taught since 1961. He is an internationally known expert on international and development finance, and on the transition from socialist to market economies. In addition to numerous articles and essays, he has published four books which have been translated into several European and Asian languages.

Preface

Gradual versus Rapid Liberalization in Socialist Economies: Financial Policies in China and Russia Compared is the tenth in ICEG's series of Sector Studies. A Sector Study analyzes one country's response to a specific policy problem or compares the policies of several countries. In this study, Ronald I. McKinnon examines the experiences of Russia and China to help explain the different outcomes associated with liberalization of their economies.

China liberalized gradually from 1978 to 1992, while Russia's ''big bang'' decontrolled prices within the state sector in January 1992. China maintained a mostly stable price level with very rapid output growth; high inflation and declining output characterized Russia's liberalization.

Dr. McKinnon argues that while there may be differences between regions and countries, China's longer-term experience with making the transition from a planned to a market economy can hold valuable lessons for those socialist economies now embarked on this path. By examining China's financial policies in depth, he looks at the problems that reform governments face and how these can be resolved. He notes, however, that the Chinese model is not perfect—inflation will require further restructuring, putting the sustainability of its macroeconomic policies in doubt.

In his concluding remarks, Dr. McKinnon suggests that Russia's short-term outlook presents a policy dilemma. He argues that to attain macroeconomic stability and to control inflation, the Russian government should recentralize its control over money and credit, and reestablish a state-controlled banking system—moves which run counter to the desired direction for the long-run liberalization of the Russian economy.

We are pleased to publish this study of gradual versus rapid liberalization in socialist economies, which has important messages for economists and policy makers who face the challenges of developing sustainable market-oriented and institutional reforms in Eastern Europe and elsewhere.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
March 1994

Gradual versus Rapid Liberalization in Socialist Economies: Financial Policies in China and Russia Compared

From 1978 to 1992, China's liberalization was gradual with a fairly stable price level and extraordinarily rapid output growth. Since 1989 in Eastern Europe and the former Soviet Union, rapid liberalizations attempted in the face of falling real output generated much higher inflation. Yet, both regions' fiscal policies were surprisingly similar. Like its socialist counterparts in Europe, the Chinese government's revenue share in GNP has fallen sharply; in 1991–1993, its fiscal deficit may be approaching 10 percent of GNP. How did China manage to avoid inflation when its government was such a heavy borrower from the state banking system?

China avoided resorting to the inflation tax in four ways. It first liberalized in areas such as agriculture where subsequent productivity growth was rapid. It imposed very hard budget constraints on, and gave little bank credit to, the newly liberalized nonstate sectors in industry or agriculture. It did retain, however, intramarginal price controls on, and (constrained) financial support for, traditional soft-budget state enterprises. Finally, it set positive real interest rates on savings deposits. The resulting enormous growth in savings and stocks of financial assets allowed the liberalized sector to finance itself, the Chinese government, and the deficits of the slowly reforming state enterprises.

How the Chinese accomplished this remarkable financial feat is analyzed in some statistical detail in this paper. The reader will quickly note similarities with the high financial growth policies followed by Japan in the 1950s and 1960s and Taiwan in the 1960s and 1970s (McKinnon 1991b, Chapter 3). Yet, there is an important difference in the Chinese government's failure to get control over the public finances at the outset of liberalization. Nevertheless, I shall argue that many important aspects of China's dualistic banking and pricing policies could well be adopted by other transitional socialist economies in Europe and Asia. Indeed, China's dualistic system of financial controls is consistent with, and nicely illustrates, the gradualist approach to the transition from centralized controls over prices and output to a more decentralized market economy.

China's incredibly high real financial growth, however, is not feasible in Russia and formerly socialist Europe where output growth is low or negative and inflationary expectations are more highly developed. Indeed, such high real financial growth may not be sustainable for much longer in China itself. To prevent inflation and stem financial decline in the liberalizing European economies, fiscal reforms should come much earlier in their transitions than they did in China's.

On the fiscal side, China is an important, if temporary, exception to our preferred order of economic liberalization (as outlined in McKinnon 1991a, 1991b). Nevertheless, China's other financial policies were more or less right. Her interest rate, credit, and pricing policies, and step-by-step foreign trade reforms, were fully consonant with the crucial need to sustain macroeconomic equilibrium as liberalization proceeds—as we shall see.

This paper concludes with a brief analysis of the inflationary explosion and sharp output decline in Russia in 1992 arising out of the Yeltsin-Gaidar government's "big-bang" approach to economic liberalization. Did the Russians get the order of economic liberalization wrong, or was this unfortunate event the result of adverse exogenous shocks beyond any government's control? Given the great receptiveness of the Russian government to Western advice in 1991 and much of 1992, was this advice lacking in important respects? The answers to these questions are not obvious, but they will remain very important in any new stabilization program the Russian government might undertake.

Gradual versus Rapid Liberalization in Socialist Economies

China is often cited as the leading example of a successful gradualist approach to economic liberalization.[1] In 1978, the Chinese began to break up traditional agricultural communes into small farm leases (now of ten to fifteen years duration)—the so-called household responsibility system. From 1979 to 1983, with over three-quarters of the population still working in agriculture, farm output surged by 8 to 10 percent per year (Johnson 1990). By 1984, the focus of rapid economic growth had shifted to rural light industry, which began to absorb much of the labor force released by productivity improvements in agriculture. Although small-scale private traders flourished, hundreds of thousands of the new manufacturing enterprises were owned largely by townships and villages (called township and village enterprises or simply TVEs). In this so-called nonstate sector, the TVEs were market-driven and outside the web of official price and output controls that still circumscribed activity in the old heavy-industry state sector.

In this traditional sector, the much-larger-scale state-owned enterprises (SOEs) remained under the ownership and control of the central or provincial government, with no attempt at some form of rapid privatization or price decontrol. Step-by-step, the pricing and financial arrangements facing the old SOEs were also rationalized, but at a more deliberate pace lasting over a decade. Overall price stability in both the state and nonstate sectors was surprisingly well maintained, with retail price inflation averaging 6 to 7 percent per year since 1978 (see Table 1).

The Chinese approach to freeing foreign trade was also gradualist. Instead of a big bang that suddenly opened up the whole economy to international competition and world prices, special economic zones somewhat outside the control of the traditional state trading monopolies were started in Guangdong in connection with the Hong Kong trade. These then became progressively more numerous and broader in scope. Inside such a zone, exporters could retain all of their foreign exchange earnings while having freer access to imported materials and foreign capital or trading services.

By the end of the 1980s, an export and import boom had become China's new engine of economic growth. Exports had risen from less than 8 percent of GNP in the early 1980s to about 20 percent in 1992. Real GNP growth itself averaged almost 9 percent per year from 1979 to 1992 (see Table 1). By the early 1990s, however, the distinction between a special economic zone and the rest of the economy has eroded. Now, a wide range of SOEs, TVEs, and private enterprises participate with more equal access to foreign trade, and the domestic economy's insulation from world markets has diminished.

Although this great economic transformation has been very rapid, it seems fair to characterize the Chinese government's economic policies as being gradualist—with the possible exception of the "minimum bang"[2] necessary to get the ball rolling in agriculture in 1978–1979. In 1985, these early Chinese successes encouraged Mikhail Gorbachev to embark on perestroika, and in 1986 smaller Asian economies such as Laos and

TABLE 1 China's Main Economic Indicators, 1975–1992 (percentage rate of growth)

	Real national income	Real GNP	General retail price index	Urban cost of living index	Free market index	Money (M2)	Exports as percentage of GNP	Foreign[a] reserves (billions of dollars)
1975	8.3		0.2	0.4				
1976	−0.3		0.3	0.3	4.0			
1977	7.8		2.0	2.7	−2.4			
1978	12.3		0.7	0.7	−6.6			
1979	7.0	7.6	2.0	1.9	−4.5	9.7	5.31	0.84
1980	6.4	7.9	6.0	7.5	1.9	24.1	6.07	−1.30
1981	4.9	4.4	2.4	2.5	5.8	19.7	7.70	2.71
1982	8.3	8.7	1.9	2.0	3.3	13.1	7.97	6.99
1983	9.8	10.3	1.5	2.0	4.2	19.2	7.55	8.90
1984	13.4	14.6	2.8	2.7	−0.4	42.4	8.34	8.22
1985	13.1	12.7	8.8	11.9	17.2	17.0	9.45	2.64
1986	7.9	8.3	6.0	7.0	8.1	30.2	11.16	2.07
1987	10.2	11.0	7.3	8.8	16.3	25.3	13.01	2.92
1988	11.1	11.0	18.5	20.7	30.3	20.7	12.60	3.37
1989	3.7	4.4	17.8	16.3	10.8	18.7	12.29	5.55
1990	5.1	5.6	2.1	1.3	−5.7	28.9	16.88	11.09
1991	7.9	7.3	2.9	5.1	−0.9	26.7	19.30	21.71
Average 1979–1991	8.4	8.8	6.2	6.9	6.5	22.7		
Preliminary 1992		12.8	5.4	8.6		31.0	20.00	

NOTES: Blank cells = not available.

a. Foreign exchange reserves are those held by the central bank (The People's Bank of China). Large reserves held by the foreign trade bank (The Bank of China) are excluded.

DATA: International Monetary Fund, *International Finance Statistics 1992 Yearbook,* for M2 data. Other data from *China Statistical Yearbook 1992* (Chinese edition).

SOURCES: Christine Wong, Christopher Heady, and W. T. Woo, *Economic Reform and Fiscal Management in China,* Asian Development Bank, February 1993; Yingyi Qian, "Lessons and Relevance of the Main Bank System for Financial Reform in China," Stanford University, March 1993.

Vietnam adopted their fairly gradualist "new economic mechanisms," which have been fairly successful[3] By 1989, the transition from central planning to more market-based economies had become a political imperative throughout Eastern Europe and the former Soviet Union (FSU).

But this poses a paradox. If gradualism in China and smaller Asian economies was successful early on, why did the Eastern Europeans in general, and Russians in particular, later attempt more of a big-bang approach to economic liberalization? Why were the Eastern Europeans so enamored with more sweeping transfers of property rights (including elaborate voucher schemes for transferring state property) and sudden full-scale price and output decontrol in traditional enterprises? This big-bang approach was often coupled with the intention—not always carried out in practice—to swiftly open the whole economy to unrestricted foreign trade with the hard-currency industrial economies.

At least in the initial stages of these rapid liberalizations, abrupt policy changes in Eastern Europe were associated with economic disorganization, sharp falls in output, and, in some cases, inflationary explosions (Aslund 1992). For the much briefer time span of the transition processes in Bulgaria, Czechoslovakia (before its dissolution), Hungary,[4] Poland, Romania, and the Soviet Union (before its dissolution), Tables 2 and 3 depict the sharp decreases in output experienced by virtually all these economies from 1989 to 1992. This falling output has been accompanied by high, sometimes explosive, inflation—nowhere more evident than in Russia and the Ukraine in 1992–1993. In contrast, Chinese output rose sharply after 1978, and throughout the early 1980s price inflation remained very low (see Table 1).

Were Circumstances in Eastern Europe Essentially Different?

To explain the output decline in Eastern Europe, there were exogenous political and economic circumstances that differed from those prevailing in China (and in similarly agrarian economies such as Vietnam and Laos) and that were largely beyond the economic control of individual reform governments:

1. Eastern Europe was more industrialized and overly specialized in heavy industry. Because agrarian populations were proportionally smaller than in the Asian socialist economies, the possibility of, and the immediate gains from, returning to small-holder agriculture were more limited.

TABLE 2 Gross Domestic Product (GDP) Growth Rates, 1989–1992 (percentage change in real GDP)

	1989	1990	1991	1992[a]
Bulgaria	−0.5	−10.6	−23.0	−3.0
Czechoslovakia	0.7	−0.4	−15.9	−5.0
Hungary	−0.2	−4.3	−10.2	−5.0
Poland	0.2	−11.6	−7.2	−1.0
Romania	−5.8	−7.4	−13.7	−10.0
Soviet Union	3.0	−2.3	−17.0	N.A.

NOTES: N.A. = not applicable.
a. Preliminary estimates.
SOURCES: Anders Aslund, *Post Communist Revolutions: How Big a Bang?* Center for Strategic and International Studies, Washington D.C., 1992; International Monetary Fund, "Financial Sector Reforms and Exchange Rate Arrangements in Eastern Europe," *Occasional Paper* 102, February 1993.

TABLE 3 Inflation, Unemployment, and Budget Balance, 1990–1992

	Inflation (% change)			Unemployment (% in December)		General government balance (% of GDP)		
	1990	1991	1992[a]	1990	1991	1990	1991	1992[a]
Bulgaria	26	460	49	1.6	10.5	−8.5	−3.7	−3.5
Czechoslovakia	11	59	10	1.0	6.6	0.1	−2.2	−4.4
Hungary	33	32	22	1.7	8.5	0.4	−3.3	−10.6
Poland	586	70	46	6.5	11.4	3.5	−5.6	−7.2
Romania	50	161	203	N.A.	4.3	−0.5	−2.6	−1.9
Soviet Union	6	152	N.A.	0	0	−8	−26	N.A.

NOTES: N.A. = not applicable.
a. Preliminary.
SOURCES: Anders Aslund, *Post Communist Revolutions: How Big a Bang?* Center for Strategic and International Studies, Washington D.C., 1992; International Monetary Fund, "Financial Sector Reforms and Exchange Rate Arrangements in Eastern Europe," *Occasional Paper* 102, February 1993.

2. The collapse of the Council for Mutual Economic Assistance (CMEA) disrupted trade within the former Soviet bloc, and then trade among the republics of the former Soviet Union was disrupted.

3. The precipitate decline in the power of the Communist party in most of Eastern Europe and the FSU was coupled with the weakening of centralized political control over the economy at large and the weakening of decentralized party monitoring of state-owned enterprises.

In contrast to China, their heavy industrialization denies typical Eastern European economies a substantial margin on which to liberalize to get immediate increases in output. So pervasive has been this pattern of falling output that many observers suggest (Gomulka 1991; Murrell 1990) that the transition from socialism must naturally have to follow a ''J'' curve: output must fall before a long-term growth path more characteristic of a liberal economy can be established. According to this J-curve view, liberalization must first largely destroy the old order before economic resources can be efficiently redeployed.

Countering this view, many argue (Brada and King 1992) that the trade shocks due to the collapse of the CMEA were so enormous that some decline in output was inevitable in any event—given the high degree of specialization in the old CMEA trading regime. In the 1980s, CMEA trade was about half the total foreign trade of Eastern Europe and the FSU. Then in 1991, CMEA trade imploded with 60 to 70 percent of member countries' trade with each other suddenly drying up (Borenstein and Masson 1993). Because this CMEA shock was so enormous, one could argue that a more rapid opening of trade with advanced industrial economies was imperative in Eastern Europe—unlike in the early stages of China's liberalization.

Because of the decline of the Communist party and centralized controls, the ability of the typical European reform government to control resources centrally was so limited that rapid privatization and price decontrol in the industrial sector were more essential in socialist Europe than in socialist Asia. More crudely, ripoffs of the assets of the state-owned enterprises had previously been prevented by the monitoring and oversight of the Communist party. With the decline in the party's power, Jeffrey Sachs (1992) has argued vehemently for more rapid privatization of both industrial and financial enterprises to stem the tide.

Without denying the great importance of these three reasons for what happened in Eastern Europe in general and Russia in particular, I hypothesize that China's longer-running experience with the transition from a planned to a market economy still contains valuable lessons for Eastern Europeans. But rather than trying to cover the whole liberalization landscape at the microeconomic level, this paper focuses on the problem of macroeconomic control. Using China as a benchmark, what are the fiscal and monetary problems that a reform socialist government will typically face, and how can these be best resolved in ways that encourage ouput growth while maintaining price-level stability in the liberalizing economy?

China is by no means a paragon of virtue, however. The sustainability of its own macroeconomic policies, not all of which are transferable to Eastern Europe, is now in doubt. If inflation is to be avoided in the mid-1990s, China itself must undertake some radical fiscal and monetary restructuring—as we shall see. But first I will review Chinese macroeconomic policies since 1978 in order to point out what is generally feasible in other transitional economies.

A Chinese Puzzle: Price-Level Stability in the Face of Fiscal Decline

In the early 1980s, how stable was the "true" Chinese price level in an environment when most prices were still controlled? Figure 1 (courtesy of Gelb, Jefferson, and Singh 1993) shows that, as late as 1981, only about 10 percent of retail sales were free of price controls. By the early 1990s, more than 70 percent of retail prices and 85 percent of the output prices of the collectively owned enterprises (COEs) were market determined. (Even the output and input prices of SOEs were 70 percent decontrolled by 1991.) Consequently, three different consumer price indexes are presented in Table 1. From 1979 to 1991, an urban employee's cost of living index rose the most, averaging 6.9 percent per year; the more general retail price index averaged 6.2 percent, and the free market index, made up only of commodities whose prices were decontrolled, rose by 6.5 percent.

Because of this relatively modest growth in the free market and other price indexes, it appears that China began its liberalization in 1979–1981 without significantly repressed inflation. At the outset, no major macroeconomic adjustment was needed to work off a monetary overhang by a one-time inflation (as planned in Poland in 1990 or in Russia in 1992) or possibly by a currency reform where outstanding cash balances were cancelled (as in West Germany in June 1948). Thus for many years after 1978, official price controls in trade among the old state enterprises could be effectively enforced with centrally determined deliveries at those prices.

But price liberalization occurred at the margin. In the newly burgeoning nonstate sector, the SOEs could sell their surplus output beyond what the state contracted for at market prices. Figure 1's lower panel shows the 20 to 40 percent premium in prices charged in this free market. Fortunately, the absence of a monetary overhang limited this price gap and thus limited (but did not eliminate) the tendency for supply diversion—illicit transfers of scarce goods from the state sector to higher price nonstate uses.[5] As general liberalization proceeded by rapid industrial growth in the nonstate sector, the number of price-controlled goods in the state sector was continually reduced. But even these pegged prices were rationalized as raw materials prices were increased in stages, and finished goods prices were sometimes scaled down.

China does not calculate a general producer price index (PPI). Because a PPI excludes services, it would show lower rates of price inflation—once the effects of price decontrol are removed—than do Table 1's retail price indexes. Measured productivity growth in services is typically much less than in agricultural and industrial goods, particularly in a rapidly growing economy such as China's. The upshot is that, since 1979, China has had a very stable price level in comparison to the often explosive price inflation in Eastern Europe.

Even without a monetary overhang at the outset, how was macroeconomic control in China subsequently sustained through 1991? One cannot look to Chinese fiscal policy for an answer. On the contrary, like all communist countries, China depended on price controls and ownership of state enterprises for generating and then collecting huge surpluses from the industrial sector. By world standards, the domestic prices of industrial raw materials and agricultural wage goods were kept down compared to the prices of finished industrial goods. The resulting financial surpluses in most SOEs were then deposited in the state bank in blocked accounts as de facto government revenue.

In all socialist countries, however, this implicit revenue system begins to unravel naturally as liberalization begins (McKinnon 1991a, 1991b). First, the government-owned share of industrial assets begins to fall. Second, price decontrol and industrial competition from both domestic and foreign sources tends to shrink the profit margins in all industrial enterprises—whether owned by the government or not. Indeed, many once (artificially) profitable SOEs become loss makers. This tendency toward fiscal deterioration was qualitatively the same in China as in Eastern Europe or the FSU.

Table 4 shows the very sharp decline in the revenue of the Chinese