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# Macroeconomic Reform in China

*Laying the Foundation for a Socialist  
Market Economy*

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*Edited by  
Jiwei Lou*

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Market Economy*

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Washington, D.C.*

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## **FOREWORD**

### **World Bank**

After a three-year struggle, the Chinese economy successfully achieved a “soft landing” in 1996. Few had predicted this successful outcome. The adjustment was wrenching from a political perspective. The high and rising inflation of 1993, 1994 and 1995 threatened to derail part of the reform process. The battle was won in 1996 and victory was consolidated in 1997. For the first time since the start of the reforms in 1978, China has succeeded in subduing an inflationary boom without killing the growth momentum. The critical difference, in our view, is made by the government’s timely launching of a package of macroeconomic reforms that have resulted in tightening the “soft budget” constraint on state-owned enterprises and state commercial banks.

China’s program of macroeconomic reform is far-ranging. It comprises monetary, financial, fiscal, exchange rate policy as well as institution building. It was embodied in “Decisions for Establishing a Socialist Market Economy for China,” promulgated at the end of 1993. One of the most important institutions in China that has contributed to the formulation of this policy package is the State Economic Commission For Restructuring Economic System (SECRES).

This volume contains articles written by the staff of the Macroeconomic Department of SECRES in 1992-93. These articles deal with all aspects of macroeconomic reform and policies, most of which have been submitted to the State Council for consideration. Not all the views expressed in this volume have been adopted by the State Council. Some are still somewhat controversial. Nonetheless, the importance of these articles for the debate on reform policy formulation and institutional development in China justifies their wider circulation. Through publication of this volume we hope to contribute to a better understanding of macroeconomic policy formulation in China at a crucial time of China’s overall reform.

Pieter Bottelier  
Chief of Mission  
Resident Mission in China  
Beijing, China—1997

## **Government of China**

Economic reform in our country began in the rural areas after the Third Plenary Session of the Eleventh Party Congress and achieved great breakthroughs. In 1984, the Third Plenary Session of the Twelfth Party Congress approved "The Decisions of the Central Committee of the Communist Party of China on Restructuring the Economic System." With this, priority shifted from the rural areas to the urban areas due to the successful experience with the former. The main features were decentralizing responsibilities and profit-sharing from the old centralized planning system. Also, reforms combined a gradual approach and regional experiments to eliminate the traditional constraints and motivate local government and enterprise initiatives.

In just a few years, various reforms progressed greatly, promoting economic development. By the 1980s, the economy reached a new high level. However, we recognized that, as the reforms were entirely new, we needed continuous exploration and practice.

At present, the deep-rooted problems in the economic system have not yet been addressed, reforms have not been fully coordinated and the piecemeal approach has not yet achieved what was anticipated. These problems were particularly evident given the lag in efforts toward macroeconomic reform: The system was still in transition, mainly due to the lack of experience and insufficient coordination. Thus, we organized large-scale research and preparatory work.

In early 1992, Deng Xiaoping's speeches during a southern tour pointed the way to deeper reform and a policy of opening. These talks brought an enthusiastic response from people all over the country. As a result, a new round of thought emerged: In the System Restructuring Commission (SRC), we intensified our study and organized research on concrete proposals and measures of macroeconomic reform—drawing lessons from the past. We believed macroeconomic reform was inevitable and could not be carried out piecemeal in some regions and sectors; rather, it would have to involve the national economy, and reforms in any one sector would have to be integrated with others.

Thus, SRC's Department of Macroeconomic Regulation Studies (DMRS), cooperating with other government departments, began work on a new design for the macroeconomy. From mid-1992 onward, drafts were made for an integrated proposal of pricing, taxation, fiscal and financial reforms, and the plan was thoroughly discussed in SRC. In October 1992, at the Communist Party's Fourteenth Party Congress, General Secretary Jiang Zemin noted that "the goal of our economic reform is to establish a socialist market economy to further liberate and develop productive forces. Establishing such an economy will involve many areas of the economic foundation and superstructure. A series of systematic restructuring and policy adjustments are required. We must make the overall plan and implement it in a scheduled and step-by-step way as soon as possible."

In the spirit of the Fourteenth Party Congress, SRC, together with other government departments, began planning the overall reforms, focusing on the macroeconomy. The "Proposal for Establishing a New Macroeconomic Regulation Mechanism in a Socialist Market Economy," drafted by DMRS, was submitted to the National Conference on Economic System Reform in early 1993. The plan was to be discussed by local governments and others to complete and improve it, and make it more operationally feasible.

In the first half of 1993, some serious problems occurred due to rapid economic growth. By late June, a document with 16 measures to strengthen and improve macroregulations was approved by the Central Committee of the Party and the State Council. Thus, macroeconomic reforms were introduced.

Following the State Council's instructions, our Commission (specifically DMRS) took an active part in designing the fiscal, financial and foreign exchange reforms. DMRS staff have cooperated closely with various government departments and academic institutions, completed a number of research projects with practical feasibility in the field of macroeconomic reform, and proposed many valuable policy recommendations. It also suggested some measures that were imposed this year, based on previous research. Due to limited theory and practice, there may be some inappropriate and incomplete views, or even mistakes—which can be improved or corrected.

Various macroeconomic reforms introduced this year are moving the process forward, with notable effects. We hope DMRS staff will work harder and never be unworthy of the great mission asked of them by history and the people.

He Guanghui  
Deputy Chairman, SRC  
September 1994

## **ABSTRACT**

This book contains papers produced from 1992 to 1994 by the Department of Macroeconomic Regulation Studies (DMRS), under the direction of the System Restructuring Commission (SRC) of the People's Republic of China. These include reports and essays on Chinese macroeconomic policy and reforms carried out or led by DMRS. More than merely a record of the Department's work, the book reflects the issues and debates during this period. Also, it provide information about the history, corrects some misunderstandings and constitutes a record of the experiences that may be useful for future studies on economic reform and policy initiatives.



## **PREFACE**

This book contains papers produced from 1992 to 1994 by the Department of Macroeconomic Regulation Studies (DMRS), under the direction of the System Restructuring Commission (SRC) of the People's Republic of China. These include reports and essays on Chinese macroeconomic policy and reforms carried out or led by DMRS. More than merely a record of the Department's work, the book reflects the issues and debates during this period. Also, it provides information about the history, corrects some misunderstandings and constitutes a record of the experiences that may be useful for future studies on economic reform and policy initiatives.

As the book focuses on the practical design of economic reforms, proposals and policies, it is not merely a collection of theoretical papers. While theory is a useful guide, it must translate into practice. Thus, although many experts and scholars have contributed to theories of economic reform, and theoretical progress has been the foundation on which the ongoing economic reform has advanced, we believe (through our work experience) that we are not sufficiently prepared to cope with the challenges related to operational techniques such as system design, policy-making and implementation. These elements are still critical to the reform, even after the objectives and models are devised.

This book is organized in line with the working areas of DMRS, which cover almost every aspect of the macroeconomy. The reform proposals and policies reflect the teamwork of experts and scholars. The papers were completed by DMRS staff; however, they also reflect the input of many others in government departments and academic institutions to whom we are heavily indebted. We believe that much more work is needed, and for quite a long period, in this time of economic transformation.

The papers were completed in the process of preparing for the new round of major economic reforms introduced in 1994. It was the favorable climate for reform created by Deng Xiaoping's southern China tour in the spring of 1992 that motivated our research on new proposals for macroeconomic reform; the work was guided by the leadership of SRC.

Our studies began with an integrated proposal of reforms for pricing, taxation, fiscal and financial systems. In October 1992, the Communist Party of China held its Fourteenth Party Congress, on which Jiang Zemin, the General Secretary, pointed out that, "the goal of our economic system reform is to establish a socialist market economy to further liberate and develop productive forces." Also, that "It is a long process and a complicated social systematic project to establish and complete the socialist market

economy.” This requires both a long-lasting endeavor, sense of urgency, and consideration of the real situation. “Establishing the socialist market economy will involve many areas of the economic foundation and superstructure, as well as systematic restructuring and policy adjustments. We must make the overall plan and implement it in a scheduled and step-by-step way as early as possible.”

The report of the Fourteenth Party Congress motivated us and pointed the direction. Also, it assured us that our effort was consistent with the direction of the country’s economic reform.

Then, in the first half of 1993, given the country’s rapid growth and overheated economy, some problems occurred with the financial order and scale of investment, such as overheated business activities in real estate, development zones, securities and fundraising. In this context, we paid more attention to analyzing the economy and its dynamics, and put forth the report, with policy recommendations.

At the same time, we felt the economic system was the fundamental source of periodic fluctuations and policy change. Reform of the financial system already lagged far behind, defects in the fiscal system had intensified, and neither flexible indirect instruments nor effective institutional backup in macroeconomic regulation were available. And, although it was agreed that some macroeconomic regulations had to be introduced immediately to cope with the overheated economy, it was also clear that major economic reforms were needed.

In June 1993, an international conference on macroeconomic management, organized by SRC, the Ministry of Finance (MOF) and the World Bank, was held in Dalian, and suggestions were made with respect to short-term policies and systemic reform. The State Council considered these recommendations, and, along with the Central Committee of the Party, it imposed various macroeconomic regulations. Meanwhile, it was officially decided that macroeconomic reform would begin. Based on its research, DMRS proposed various measures. Together with other government departments, we discussed and designed fiscal, financial, foreign exchange and investment reforms for each sector.

It has been noted in “The Decisions of the Central Committee of Community Party of China on Issues in the Creation of the Socialist Market Economy” (the “Decisions”), approved by the Third Plenary Session of the Fourteenth Party Congress, that “the socialist market economy is consistent with the basic socialist system. Market forces will play a fundamental role in allocating resources under the State’s macroeconomic regulations.”

The *Decisions* also confirmed that “the Government’s function in managing the economy is principally to design and implement macroeconomic policies, improve infrastructure and provide a good environment for economic development. In addition, it is responsible for developing a market system, overseeing market operations, safeguarding fair competition, adjusting social distribution, organizing social security

systems, controlling population growth, protecting natural resources and the environment, managing state-owned assets and overseeing their operations, and realizing national economic and social objectives. The government should manage the national economy by economic, legal and administrative measures; it should not interfere with enterprises' management of production." Further, "the tasks of macroeconomic regulation are to maintain a basic equilibrium of economic aggregates, upgrade the economic structure, guide the economy to a sustained, rapid and healthy growth, and promote overall social progress."

The *Decisions*' proposals on the function of macroeconomic regulation illustrate the basic objectives of reform. These include:

- The socialist market economy cannot be developed in a laissez-faire environment. Instead, the government must play an active role in the transition to and introduction of the market economy because international competition is intense and there is not enough time to allow market mechanisms to simply evolve. Because of China's enormous size (with a population of 1.2 billion), it is difficult to estimate the cost of this approach.

Worldwide, over 100 market-oriented economies exist, but only a few are well developed. Thus, merely stating the objectives is quite different from establishing such a system. Indeed, successful models vary; however, the common features can be summarized as economic order, fair competition, flexible and effective macroeconomic regulations, and distribution mechanisms that emphasize efficiency while addressing the concerns of equity and social welfare. These factors are the elements of a successful market economy, and must be introduced with the State's participation and guidance.

- The major tasks of macroeconomic reform are to create an institutional framework through which the government can manage the macroeconomy, ensure economic order, safeguard the rule of fair competition, provide indirect instruments of regulation, and build effective mechanisms with which to carry out policies.
- Macroeconomic regulation is one of the important government functions in a market economy. However, interventions into major economic activities are not necessarily appropriate; rather, the government should adjust the aggregates through economic policy. Therefore, the government should determine the regulations' contents and methods so as to maintain stability, increase the efficiency of the national economy, and unify rules, markets and the nation.
- Macroeconomic regulation should be carried out primarily through monetary and fiscal policy. In this respect, the use of direct or indirect instruments is not a question of government preference; rather, it is determined by the economic system and the operational features of the national economy, whether indirect instruments and an institutional foundation exist. To fundamentally change the way the government

regulates economic activities, it must introduce a new economic system that would be a mechanism for flexible and effective macroeconomic regulation, and the matching microeconomic institutional foundation.

- The main objectives of macroeconomic regulation are to adjust aggregate demand to guarantee stable economic growth and balance of payments; also, to remedy market failures by providing public goods and services, regulate income distributions, ensure social justice, promote balanced regional development, implement appropriate industrial policy to optimize industrial structures, and increase the aggregate supply. Of the major macroeconomic tools, monetary policy should regulate aggregate demand, fiscal policy should promote structural adjustment, industrial policy should be functional and unbiased so as to transform and upgrade economic structures, and the fiscal system should be neutral.
- Efficiency and equity must be considered when systems are designed and policies applied. While the market plays a major role in allocating resources, the government should, by means of income distribution, ensure a reasonably balanced regional development, provide basic public services and necessities, and ensure the gains of economic development are shared by all.

Various ideas and arguments were presented when discussing Chinese economic reform. The following are our views on major issues.

**The relation between anti-inflation policy and reforms.** Macroeconomic stability and economic reform must work hand in hand. First, policies must be introduced to curb inflation and fluctuations, because inflation misallocates resources, exacerbates disparities in income distribution and causes social unrest. Rapid price hikes are usually accompanied by short-term high rates of economic growth and investments in inappropriate sectors. After this, recessions occur, and products and services (that grew beyond the level of real demand) become redundant. As a result, enterprises and society must bear the costs of the recession and adjustment—since resources were applied to the redundant sectors—and reforms must bear the double challenge of systemwide transformation and structural adjustment. Thus, an anti-inflation policy is required in the process of macroeconomic reform. At the same time, reforms should promote economic stability and efficiency.

**The relation between piecemeal and integrated reform.** Gradualism and regional reform are features in the Chinese process that have succeeded in many areas. Although the outcome of the reform is not yet clear, and most public opinion is constrained by the traditional system, the gradual decontrol of industries and agriculture, commerce, trade and banking, and some regions has scored considerable achievements. Moreover, as the reforms liberated the productive forces, the level of public understanding improved. However, the gradual model has its limitations and costs, since it does not meet the needs of some sectors that require a national plan and overall balance: For example, in a unified country, resources should be mobile, nationwide.



Thus, it is inefficient to apply a new tax system or make the currency convertible in just one region. Rather, reforms must be integrated, with priority breakthroughs in some sectors.

The necessity and feasibility of such an approach are fully explained in the documents of the Third Plenary Session of the Fourteenth Party Congress. Mr. Li Tieying, the State Councilor and Chairman of SRC also noted that "Today's reform is deeper than before, progressing from piecemeal actions to a comprehensive approach, from a focus on relatively individual measures to overall economic relations. Thus, strategies must be integrated, with a comprehensive design and measures. Since the reform has entered the final stage, we must achieve a major breakthrough in the key sectors while implementing a comprehensive, integrated reform strategy" (from the speech at the 1993 National Conference of Economic System Reform).

However, an integrated approach should not translate into resistance to the reforms. Rather, the public should understand the need for them and accept the risks. In such a context, fiscal reform begins with the system of tax revenues and then extends to expenditures. In the foreign exchange sector, the proposal that the Yuan should make current accounts convertible first, and capital accounts next, is an aggressive but safe resolution.

**The relation between the Chinese reality and foreign experiences.** The Chinese reality is the starting point of our reform, which must consider both potential and present factors such as population, resources, culture and history. However, this does not mean that current conditions must be preserved. Even with systems that have already experienced reform, further changes are required.

The problem is that during the transition, a new pattern of vested interests has developed and the "Chinese reality" is often used as an excuse to protect them, consolidating transitional systems and measures. These interests insist that establishing a standard system is idealist and out of touch with reality. However, we should learn from the principles, common practices and successful experiences that have been effective in many countries (such as tax-sharing systems, neutral tax systems, central bank independence, basic instruments of monetary policy and international models of foreign exchange regulations). After 14 years of economic reform, deepening it will require standardizing the transitional system in the direction of the socialist market economy.

**The relation of the new macroeconomic system to centralization.** This issue can be misunderstood. Generally, our economy is still overcentralized. The direction of the reform is to allow the market to play a fundamental role in allocating resources along with further decentralization. Nevertheless, not all decision-making can be decentralized, even in a market economy, and reforms cannot be judged conservative, regressive or progressive simply on the basis of whether systems are centralized or decentralized. Of the macroeconomic reforms adopted in 1994, both processes are involved; and the degree to which each is applied should be adjusted according to the needs of the socialist market

economy. For example, the government must retain control over macroeconomic regulation in order to create conditions for fair competition and further decentralize a wide range of economic activities. However, in the current system, fiscal revenues are far too decentralized, which neither helps local governments nor promotes autonomous enterprises. The central government is not able to guarantee it will carry out its basic functions and its role in the market economy is distorted. Thus, it must centralize an appropriate degree of power. This is not conservatism or the restoration of the old system, but rather the necessary condition for the government to play a reasonable role. At the same time, with respect to constructing infrastructure and providing public services to households, government functions and funds should be further decentralized. With respect to microeconomic activities, enterprises should be autonomous.

**The relation between feasible plans and various groups' interests.** A key factor in the reform is the feasibility of the plans. In the 1994 proposals, many problems surfaced despite the efforts of government departments to work out the implementation details. The problems stemmed from two sources. First, various instruments of the market economy were not fully understood and the techniques with which they could be made operational were not mastered. For example, with tax reform, the unification of tax rates necessarily caused the price of some goods to fluctuate. Those involved needed to understand this and design tax categories and rates of some final, less processed goods in a way that would prevent the price of consumption goods from rising too rapidly. Second, existing work styles and departmental interests were difficult to change: Operational plans were often devised to protect departmental interests and diverged from the reform principles.

Nevertheless, after more than a decade of reform and opening of the economy, as well as the development of various operational techniques, it appears techniques have been learned and operations have improved. Thus, the main hurdle now is vested interests. To solve this, the plans' problems must be addressed and new operational methods proposed. Further, decisionmakers will need to reach agreements that will reflect overall interests.

We have tried to introduce the macroeconomic reforms in a way that reflects the level of awareness and work attitudes. The papers are listed in the order in which they were written, to help readers understand how the process evolved. Undoubtedly, the work has its limitations, and we would be pleased to receive comments to improve our understanding and move the reforms forward.

The book contains a collection of conference summaries. At the closing session of the Dalian conference, Mr. S. J. Burki, then director of the Bank's China and Mongolia Department, summarized the meeting's conclusions. This report was included as Appendix.

I wish to express my sincere thanks to all DMRS staff; it is owing to their wisdom and pragmatic spirit that this book was produced. In particular, I wish to thank the

following for their contributions: Li Keping, who was the leading researcher for studies on integrated reforms; Li Keping, Wang Xiaozhuo and You Xiang, who drafted the reports on fiscal reform; Feng Ailing, Liu Ying, Gao Jianhong who wrote on financial systems, foreign exchange and government bonds; Zong Kaiyuan and Guo Xiangjun, who were in charge of economic analyses and completed the reports on macroeconomic conditions; and Wang Manling, who proofread the material. As I helped organize and select parts of the book, I would like to view myself as their megaphone.

Lou Jiwei  
Director, DMRS, SRC  
April, 8, 1994

## ABBREVIATIONS AND ACRONYMS

ABC	-	Agricultural Bank of China
AD	-	Aggregate Demand
AS	-	Aggregate Supply
BOC	-	Bank of China
BOCOM	-	Bank of Communications
CFETC	-	China's Foreign Exchange Trade Center
CITIC	-	China International Trust and Investment Company
DMRS	-	Department of Macroeconomic Regulation System
FDI	-	Foreign Direct Investment
FEC	-	Foreign Exchange Certificate
GATT	-	General Agreement on Tariffs and Trade
GDP	-	Gross Domestic Product
GNP	-	Gross National Product
ICBC	-	Industrial and Commercial Bank of China
M1	-	Payable Cash and Deposits
M2	-	All Types of Deposits
MOF	-	Ministry of Finance
PBC	-	People's Bank of China
PCBC	-	People's Construction Bank of China
RP	-	Repurchase Agreement
SAMB	-	State Assets Management Bureau
SETC	-	State Economic and Trade Commission
SFEAB	-	State Foreign Exchange Administration Bureau
SOE	-	State-Owned Enterprise
SPC	-	State Planning Commission
SRC	-	System Restructuring Commission [abbreviation for State Commission for Restructuring Economic Systems (SCRES)]
STAQ	-	Securities Trading Automated Quotation System
STB	-	State Taxation Bureau
VAT	-	Value Added Tax



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