China: Reform and Development in 1992–93

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China: Reform and Development in 1992–93
East Asia and Pacific Region Series


China: Reform and Development in 1992–93

Peter Harrold
Rajiv Lall

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Abstract

China's economy began a very strong expansion at the start of 1992, based on a revitalization of reform and a renewed emphasis on development. In the last eighteen months, growth has been running at a rate of 14 percent per annum. This paper reviews these recent economic developments, and provides a backdrop against which to assess the recent measures taken by the government to cool down the overheated economy. At the same time, these developments have added greater urgency to the need for deeper reforms, especially those reforms that will equip the government with the tools and institutions of macroeconomic management, and will create enterprises responsive to indirect economic levers. This paper therefore also reviews recent reforms in China, and addresses the main issues still to be faced to create an efficient market economy in China.
CURRENCY EQUIVALENTS

Up to December 15, 1989
$1.00 = Y 3.72
Y 1.00 = $0.27

Up to November 29, 1990
$1.00 = Y 4.72
Y 1.00 = $0.21

At June 30, 1993:
$1.00 = Y 5.70
Y 1.00 = $0.18

FISCAL YEAR
January 1 - December 31

ABBREVIATIONS AND ACRONYMS

8th FYP - Eighth Five-Year Plan, 1991-95
DRC - Development Research Center of the State Council
ETC - Economic and Trade Commission
FDI - Foreign Direct Investment
FEACs - Foreign Exchange Adjustment Centers
FTCs - Foreign Trade Companies
GATT - General Agreement on Trade and Tariffs
GDP - Gross Domestic Product
GNFS - Goods and Nonfactor Services
GVIO - Gross value of Industrial Output
IMF - International Monetary Fund
MFN - Most-Favored-Nation (status)
MIT - Ministry of Internal Trade
MME - Ministry of Materials and Equipment
MOF - Ministry of Finance
MOFERT - Ministry of Foreign Economic Relations and Trade
NBFIs - Nonbank Financial Institutions
NTBs - Nontariff Barriers
PBC - People's Bank of China
SAEC - State Administration of Exchange Control
SAMB - State Asset Management Bureau
SEZ - Special Economic Zones
SOE - State-Owned Enterprise
SPC - State Planning Commission
SRC - State Commission for Restructuring the Economic System
TVE - Township and Village Enterprise
FOREWORD

The World Bank's economic and sector work program in China is a very active one ranging over a wide spectrum of topics from macroeconomics to health and education. Each year we publish a handful of our formal studies, but thus far most of the background papers and informal reports, many of them containing valuable analysis and information, have remained outside the public domain. Through the China and Mongolia Department’s contributions to the East Asia Discussion Papers, we hope to make available to a broad readership among the China watchers and development communities papers which can contribute to a better understanding of China’s modernization.

The present paper by Messrs. Harrold and Lall continues this process. This paper is extracted from our most recent economic report on China, entitled, "China: Updating Economic Memorandum: Managing Rapid Growth and Transition". The pace of economic change and policy reform has been extremely rapid in China since the beginning of 1992, and we therefore decided to produce our economic reports for the government and our Executive Directors on a more frequent basis. While we will continue to publish entire reports as appropriate, we considered that it would be helpful to make available rapidly our review of recent economic development and reform in China. This documents records policy change up to mid-June 1993, and therefore forms a useful backdrop against which to assess the measures being undertaken by the government to overcome the short-term difficulties facing the Chinese economy, and to introduce more fundamental reforms to the system of economic management.

We hope that this brief review of the recent Chinese development and reform is of interest both to those who specialize in Chinese affairs, and also to those who are struggling with the issues of economic reform and management in other economies undergoing transition.

Shahid Javed Burki
Director
China and Mongolia Department
SUMMARY

1. This paper is designed to provide an update of major developments in the Chinese economy and in economic policy in China since mid-1992. It provides a backdrop against which to understand and assess the austerity measures being undertaken in China in the second half of 1992. Veteran leader Deng Xiaoping's spring 1992 tour of the southern provinces set the stage for accelerated reform and renewed investment early in the year. The momentum for investment-led growth picked up further with the ratification by the 14th Party Congress, held in October 1992, of a strategy for the accelerated transformation of China into a "socialist market economy." This paper therefore chronicles a period of both accelerating development and of deep policy change with a major potential long-term impact.

2. The most serious issues facing the government at the present time are two: the overheating of the economy, and the measures needed both to address this in the short term, and to create the degree of macroeconomic management capability needed to avoid these severe stop-go cycles in the future. These are the two main issues addressed in this paper.

3. China ended 1992 with an overall performance even more impressive than that of 1991, recording a real GDP growth rate of almost 13 percent, with low inflation and a smaller albeit nonnegligible current account surplus of 1.9 percent of GDP. In addition, the level of foreign investment attracted was remarkable, at over $11 billion. Coming at a time when the performance of the world economy was lackluster, this has indeed been a major achievement. However, this inflow was matched by an even larger outflow of foreign exchange, and therefore reserves did not increase.

4. While the 1992 high growth can be seen as a recovery, and was well within the economy's potential, this pace of development continued unabated into 1993. It was the continuation of expansion at a very high rate in 1993 that led to the overheating of the economy. GDP grew at 14 percent in 1992/3, and the rapid pace of growth of domestic demand affected the external sector. Imports grew at about 25 percent, but export growth fell to under 5 percent, reflecting diversion of export supply to the domestic market. This was also reflected in a rapid depreciation of the exchange rate in the foreign exchange adjustment centers (FEACs) and a sharp widening of the gap between the swap and the official exchange rates. The continued growth was facilitated by accommodating monetary policy, and money supply rose by over 30 percent in 1992, and at a similar rate in 1993. There was particularly strong growth in deposits and lending by nonbank financial institutions of various kinds, especially new ones.

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1/ This paper is extracted from the most recent World Bank country economic report on China. In addition to the two credited authors of the paper, the study also involved Mr. Erh-Cheng Hwa (reform developments), Mr. Bert Hofman (fiscal issues), Mr. Albert Keidel (economic prospects) and Mr. Tejaswi Saparia (analytical support). The team's work was facilitated by Ms Sonia Zhao of the World Bank's Resident Mission in China, and by Mr. Yang Yingming of the Ministry of Finance. The team would also like to acknowledge the invaluable help of the State Statistics Bureau of China, and notably Messrs Qiu Xiaohua, Zheng Jingping and Liu Qisheng.
5. The strongest force for growth has been fixed investment demand, currently rising by over 30 percent in real terms. This led to price increases of close to 40 percent per annum for raw materials in the last year, made possible by the accelerated pace of price reform in this area, as well as declining stocks. A further indication is to be found in rapid price increases in the "bubble" sectors of real estate and securities. Together with other signs, such as excess demand in the bottleneck sectors of transport and electricity, it became clear by Spring 1993 that the economy was overheating, and that growth at such high rates was not sustainable. However, it was our judgement that the situation was not out of control, and that the application of a range of tightening measures could permit the economy to have a "soft landing," and eliminate the overheating. The concern was rather to avoid the need for a "hard landing" of the type that had to be instituted at the end of 1988.

6. In terms of the balance between direct and indirect measures, the criterion should be the extent of the development of market forces. Administrative measures, such as investment controls, should be limited to those parts of the economy least sensitive to market signals, notably the SOEs and local governments. For the rest, including the "bubble" sectors of real estate and securities, market-friendly measures can be utilized. The paper describes a set of measures that the Bank regarded as the most critical in the short term:

a. Monetary policy was critical, in order to slow down the growth of money supply and credit, as well as reducing investment demand. Interest rates were negative in China—as they were in 1988 at the start of the inflation—and the single most important measure is to restore savings incentives by making these positive again. The Bank also recommended consideration of a restoration of index-linked interest rates for savings deposits of one year or more. While it was encouraging that the People's Bank is proposing to use open market operations to control lending growth, these operations should be used to sterilize excess deposits. Finally, it was critical for PBC to increase and improve its oversight of the financial sector, especially with regard to enforcing the credit plan for nonbank financial institutions and the disintermediation that is occurring via the interbank market.

b. Fiscal policy would have to be prudent. Further changes to Treasury bond rates would be necessary if PBC undertook additional interest rate adjustments. Second, MOF should monitor budget implementation closely, to guard against overspending, especially on administration. However, the limited contribution that fiscal policy can make to addressing the short-term situation reflects the technical and political inflexibility of the present fiscal system, further reinforcing the need for urgent attention to the deepening of reforms in this area.

c. Trade policies had a critical role to play. Imports can meet certain critical supply bottlenecks, and, as already seen, domestic demand can be met by products that were previously only exported. This is therefore an ideal time to liberalize the import regime. The high level of foreign exchange reserves makes import expansion very affordable, and some decline in reserves would help to slow down growth in money supply.
d. Reform of the foreign exchange system should be accelerated, as the external accounts have become much more affected by monetary policy, and more generally, by the level of confidence in the economy, than in the past, as seen in the widening gap between the official and swap market rates. These reforms would help to move China rapidly towards a unification of the exchange rate as soon as possible.

e. Some more direct means of controlling investment, particularly by state-owned units at the local level, would have to be considered. Departments at the central and local levels should determine investment priorities within the state-owned sector, the main source of expansion. In contrast, the solution to problems such as the very high gains being made in the "bubble" sectors of real estate and the stock market, would be better addressed by removing artificial supply side constraints and thus reducing the rents to be earned from such transactions. The suggestion currently being discussed in China of moving to an auction system for land and property transactions seems to have considerable merit.

Structural Reform Issues

7. The reemergence of inflationary pressures so soon after the last austerity program, and the inability of the central government to manage the economy are, in our opinion, the result of the "half-reformed" status of the Chinese economy. Therefore, although short-term action is important, it is critical that this situation should impel the government to move rapidly to deepen a wide range of reforms. This applies especially to those reforms that will equip the government with the tools and institutions of macroeconomic management, and will create enterprises responsive to indirect economic levers. In particular, this concerns the fiscal system and financial sector reform. While increased attention began to be paid by the Chinese authorities to these issues in 1992, concrete measures have yet to be taken.

8. The 14th National Communist Party Congress in October 1992 officially confirmed that China will continue and deepen the same reform and development programs which have dominated the policy agenda since 1978. More specifically, it reiterated China's commitment to reforms and opening to the outside world; it encouraged the current rapid-growth phase of economic reforms, which began in 1991; and—most importantly—it amended official ideology to sanction much greater emphasis on market institutions in China's overall economic system. It did this by abandoning its old formula for a "commodity economy," which had meant that plans would ultimately allocate resources. Instead, official policy now declares that China's development goal is a "socialist market economy" in which markets play the primary resource allocation role. This paper reviews recent developments in and priorities for a range of reform areas, and assesses them by the yardstick of the extent to which they contribute to the creation of the market economy.

9. Fiscal reform should now be taking center stage in the reform effort. This is not only because of the continued worrisome decline in the share of revenue in GDP, but also because as monetary and exchange reforms continue, fiscal policy will be the main instrument of macroeconomic management. As noted above, reflecting the limited role of fiscal policy in the
short term, the present system is manifestly ill-equipped to take on this task, and reforms are becoming urgent in three key aspects. First, efforts to broaden the tax base should be redoubled, especially with respect to the extension of the VAT, and the reform and extension of the personal income tax. Second, the separation of taxes and profits seems to be lagging, and this is critical for the success of the enterprise reform program. Third, the present experiments in tax-sharing have deep flaws, and are unlikely to lead to systemic solutions. Rather, there is merit in an alternative approach of gradually expanding both the local taxes, such as land, vehicle and property taxes, and of simultaneously expanding the central taxes, such as the income tax, which should be separated from the enterprise ownership relationship. In addition, the budget itself needs to undergo a deeper overhaul than the present "dual budget" exercise, so that it reflects more accurately the actions of the public sector in China.

10. Financial sector reform is the second key strand in strengthening macroeconomic management, in which three points seems paramount. First, central bank reform is becoming critical, calling for the early approval of an appropriate Banking Law to strengthen the autonomy of PBC, and for an early resolution of the role and structure of PBC which is in need of extensive restructuring. In particular, noncentral bank functions should be eliminated, the number of branches sharply reduced, and the present profit retention system abandoned. This would leave PBC free to focus on its primary role as a central bank. The present experiments, which give greater control to local branches of PBC, seem to run counter to the main goal of the reform. Second, the government is now focusing on reforming "policy lending"—or more generally directed credit—primarily through the creation of a new "policy bank or banks." It is important that these should only be responsible for long gestation public projects, and that all other policy lending should be the responsibility of the budget. Third, inadequate attention has yet been given to increasing competition in the banking system, and consideration may have to be given to breaking up the present, very large specialized banks into smaller units.

11. The government reorganization does not appear to have yet gone deep enough to resolve two key issues. First, and most important, it has not created an agency with overall responsibility for macroeconomic coordination and policy formulation, and we consider that this function should be carried out by an agency below the level of the State Council. We hope this can be resolved as the details of the plan are spelled out. Second, the reorganization has made only limited headway in creating new institutions more suited to the market economy, especially with respect to the management of state assets.

12. Enterprise reform made enormous progress in 1992, with the formulation of a framework for the effective corporatization of the state-owned enterprises. The main challenge is now to make progress with the implementation of the new regulations for this policy, to approve a unified set of relevant laws, notably a Company Law, and to create an appropriate institutional framework for these polices. Of particular importance in this regard is the creation of institutions to represent the interests of the state as owner, but without resort to the exercise of bureaucratic power. In this regard, there is room for a wide range of experiments to find suitable models for China. There is also a need for development of a regulatory framework governing monopolies, especially state-owned monopolies, and there is scope for a more aggressive policy in diversifying ownership of state assets. Related social reforms, such as
In the overall reform effort, in the three key areas of fiscal, financial, and labor reforms, the economy now needs difficult structural reforms. Improved economic performance in the economy and the banking sector, and increased labor market flexibility, are key to enable the economy and labor markets to function well. The challenges of structural reform are formidable, and the reforms need coordination among the various sectors of the economy. A key challenge will be overcoming local resistance to structural reforms. Key issues to be addressed. First, a comprehensive price reform, especially for energy products, would help to price reforms. Second, continued economic growth, especially in sectors that have seen declines, would help to address economic recovery. However, continued economic growth and the economic recovery remain a challenge. In economic terms—a growth in other terms—can now take a much longer period in the reform process. The policy framework of the reforms needs to be improved, and the policy framework needs to be improved. Finally, price reform became a priority in 1992, and the most difficult areas of economic recovery have been addressed very recently.
RECENT ECONOMIC DEVELOPMENTS

A. INTRODUCTION

1.1 China ended 1992 with an overall performance even more impressive than that of 1991, recording a real GDP growth rate of almost 13 percent, with low inflation and a reduced but still substantial current account surplus of 1.9 percent of GDP. In addition, the economy attracted a remarkable level of foreign direct investment, making China the most popular destination for FDI in the developing world. Coming at a time when the performance of the world economy was lackluster, this has indeed been a remarkable achievement.

1.2 The year began with the formal declaration of the end of the rectification program that had lasted three years (1988-91). Inflation, that had reached into the double digits in 1989 having been subdued, 1992 marked the beginning of a more relaxed credit and monetary stance. Veteran leader Deng Xiaoping's spring tour of the southern provinces set the stage for accelerated reform and renewed investment early in the year. The momentum for investment led growth picked up further with the ratification by the 14th Party Congress, held in October 1992, of a strategy for the accelerated transformation of China into a "socialist market" economy.

1.3 As impressive as China's overall performance has been in 1992, the evolving economic situation has not been devoid of risk and there are a number of developments that bear scrutiny. Three issues deserve particular attention. First, as 1992 drew to a close, signs that the economy was being stretched to its limits began to emerge. Transportation bottlenecks, and shortages in certain key industrial raw materials and in energy suggest the onset of overheating. These signs have intensified in the first quarter of 1993, with the real GDP growth rate running at an estimated 14 percent over the same period last year. It is the assessment of this report that the Chinese economy became overheated in 1993, and is growing at an unsustainable rate, and that this requires urgent actions beyond those taken in mid-May.

1.4 Second, a related issue is the threat of more broad based inflation in light of the government's relaxed monetary policy stance. Although monetary aggregates showed strong growth over the year, the retail price index recorded only a moderate rise of under 5.4 percent over the 12-month period, and about half of this can be attributed to price reform rather than price pressure. However, price rises have accelerated over the first quarter of this year and it bears examination whether China is running a serious risk of rising inflation, which might then precipitate another costly austerity program.
1.5 Third, there have been important developments in the external sector that bear closer scrutiny. The widening gap between the swap and official exchange rates (now equivalent to almost 50 percent of the official rate) is a reflection of the rapid pace of development and indicates the need for continued exchange system reform. Short-term capital outflows have become very large, and the implications thereof remain unclear. Finally, flows of foreign direct investment (FDI) have reached record levels in 1992. It is important to reach a judgment about the extent to which the sudden jump in these flows is the result of catching up from the lean 1989/90 years and to what extent it represents a higher sustainable rate of capital inflow from overseas.

1.6 This overview describes the most important developments in 1992 and in the first several months of 1993, and then explores the three sets of issues identified above.

B. RECENT DEVELOPMENTS: AN OVERVIEW

The Real Sector

1.7 Output and Income. Rapidly rising investment demand has induced rapid growth in industrial output—the gross value of industrial output (GVIO) grew 26.7 percent in 1992 (20.8 percent on a value-added basis), almost 50 percent faster than in the previous year, and the highest recorded since the start of the reforms (see Figure 1.1). Output of collectives, especially township and village enterprises (TVEs), and joint ventures grew fastest, at about 50 percent (see Figures 1.2a and 1.2b). Expansion was not evenly balanced throughout the country, and the coastal provinces of Jiangsu, Fujian, Shandong, Guangdong, Guangxi and Hainan contributed over 60 percent of the growth in GVIO. These trends continued and even intensified in the first months of 1993. As a result, the nonstate sector now accounts for over 52 percent of gross industrial output, and more than 57 percent of nonagricultural employment in the country.

1.8 Agricultural production registered modest growth of 3.7 percent in 1992. Grain output reached a record high of 443 million tons, and record production levels were also achieved for sugarcane, tobacco, and fruits and vegetables. On the other hand, production of oil bearing crops stayed level, while that of cotton and beet root experienced a significant decline owing to drought. However, agricultural incomes have not kept pace with the rise in agricultural output, and farmers’ real incomes have consistently lagged behind those of urban dwellers. In 1992, the annual real per capita net income of farmers was less that 43 percent of that of urban dwellers, and the real income of the latter continued to grow almost 1.5 times faster than that of the former. Moreover, 1992 saw the accumulation of payments arrears to farmers. Not only were farmers handed out "white slips" or IOUs for grain procurement, but there has also been a growing problem

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1/ In the first four months of 1993, urban household incomes rose by 27.6 percent, 10 percent more than the rise in living costs.
of "green slips." The terms of trade continued to turn against agriculture in the last 18 months, with procurement prices for grain accompanied by sharp rises in prices of agricultural inputs. If these trends continue, farmers will inevitably seek to move out of agricultural activity, and sustaining current levels of agricultural production will become increasingly difficult.

1.9 It is reported that the tertiary sector turned in a real growth of 9.2 percent, again lower than industrial growth with the result that the share of services in GDP appears to have declined for the third year in a row. According to national accounts data, services now account for 26.8 percent of GDP in constant prices, compared to 29.8 percent in 1989. Considering that the tertiary sector has been subject to special attention under the 8th Five Year Plan and was the beneficiary, last year, of preferential tax policies, and taking into account visual evidence of booming growth in this sector, this result looks questionable. It is likely, therefore, that deficiencies in the statistical reporting system for the services sector account for this phenomenon.

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2/ "Green slips" are postal orders sent by migrant workers to their families in rural areas. In several inland areas, notably Sichuan, cash-short banks have been unable to redeem the postalorder. The name comes from the fact that these P.O.s are white paper with green lettering.
Figure 1.2a: **Industrial Production—Annual Growth Rates by Ownership Type**

- % Annual growth of total GVIO
- % Annual growth by ownership type

![Graph showing annual growth of total GVIO and by ownership type from 1986 to 1992.]

- Total GVIO
- State owned
- Collectively owned
- Individually owned

*Note: Data are for real gross value of production*

Figure 1.2b: **Composition of GVIO by Ownership Type**

![Graph showing composition of GVIO by ownership type from 1985 to 1992.]

- State-Owned
- Collective-Owned
- Individual-Owned
- Other-Owned
1.10 **Investment.** GNP growth was driven by a sharp rise in fixed investment. Fixed investment grew 38 percent (24 percent in real terms) during 1992. The share of gross fixed investment in GDP reached close to the 1987 peak of 32 percent (Figure 1.1). Although investment by collectives recording the fastest growth rate (77 percent), state-owned enterprises (SOEs) still accounted for more than two thirds of total investment (see Figures 1.4a and 1.4b). This trend continued unabated over the first five months of 1993, with investment by SOEs growing an estimated 69.3 percent (about 40 percent real), with investment by local level SOEs growing the most rapidly.

1.11 We noted earlier that while growth in 1992 was essentially recovery, it was its continuation into 1993 that led to overheating. Sources of growth analysis from the expenditure side indicates that demand pressures in 1992 were evenly spread among major components. However, it is clear that in 1993, the major source of growth is coming from investment, especially at the provincial level. One of the biggest contributory factors to this explosion of over 40 percent real growth of investment appears to have been the new policy of Development Zones in Chinese towns and cities. In these Zones, the local government provides infrastructure and offers tax exemptions, thus significantly reducing the cost of investment. Their number has risen from only 117 at the end of 1991 to...
Figure 1.4a: GROSS FIXED INVESTMENT—ANNUAL GROWTH BY OWNERSHIP TYPE

![Graph showing annual growth of gross fixed investment by ownership type from 1985 to 1992.]

- Total GDFI
- State owned
- Collectively owned
- Individually owned

Note: GDFI is gross domestic fixed investment
Data are in nominal values

Figure 1.4b: GROSS DOMESTIC FIXED INVESTMENT COMPOSITION BY OWNERSHIP TYPE

![Pie charts showing investment composition in 1985 and 1992.]

State owned: 66% (1985), 67% (1992)
Collectively owned: 13% (1985), 16% (1992)
Individually owned: 21% (1985), 16% (1992)

Note: Data are in current prices
10,000 at the end of 1992. The government recently restricted the rights of local governments to create such Zones.

Credit, Money, Interest Rates, and Price Developments

1.12 Domestic Credit. The 1992 credit plan was based on a 6 percent real GDP growth rate and 6 percent inflation. The target for credit expansion was set accordingly at 15.7.3/ By mid-year credit growth was already running at 23.2 percent,4/ so the government tightened control over credit, and the specialized banks were required to post special deposits at the central bank amounting to Y 10 billion.5/ As a result, credit growth slowed to 21.2 percent by year-end, only slightly above the revised target (see Figure 1.5).

Figure 1.5: CREDIT GROWTH—RECENT TRENDS

![Graph showing credit growth over recent years.](image)

Source: People's Bank of China, IMF

1.13 But the credit plan is becoming increasingly less decisive for the overall monetary situation. Net domestic assets grew with an annual 32.7 percent by the end of 1992, over 10 percent more than credit covered by the plan, and the gap is growing. The

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3/ Calculation allows for 4.7 percent "productivity growth."

4/ Note that the expansion of credit according to credit plan definition was slightly lower at 22.6 percent.

5/ These were released in the 4th quarter in order to make funds available for grain procurement.
dominant factor in this credit creation outside the credit plan was the trend in "Other Items, Net" of the monetary survey, the composition of which is not completely known. About Y 122 billion was added to net domestic assets under this category during 1992. The most expansionary component seems to be a diversion of funds by banks away from low-yielding bank loans or reserves towards high returns elsewhere. For this, banks often make use of the interbank market to channel funds to wholly owned Nonbank Financial institutions, such as Trust and Investment Corporations (TICs).

1.14 The interbank market should in principle only be used by banks and nonbanking institutions to fund themselves in the light of reserve requirements. However, an estimated 60 billion is unaccounted for—recorded by banks as lent to the interbank market, but not borrowed—and most likely ended up with enterprises through NBFIs. This illegal practice suggests misreporting by banks and lack of supervision. Moreover, although the Trust and Investment Corporations (TICs), like other NBFIs are not supposed to have a net position vis-à-vis this market, they obtained net funding of Y 25 billion in 1992. As a result, total NPSFI credit reached Y 140 billion, 40 percent higher than in 1991.

1.15 Net credit to government soared at an annual rate of 73.5 percent by the end of 1992, and was a second cause of strong credit expansion outside the credit plan. This change in net credit occurred almost all in the last quarter of 1992 to pay for grain procurement, and consisted of a Y 23.7 billion budget deficit, and a Y 19.7 billion deposit drawdown. Change in net foreign assets, a major cause of monetary expansion in 1990/91, slowed to an annual 12.8 percent by the last quarter of 1992, and thus broad money growth was slightly below the growth in domestic assets of the banking system.

1.16 Money Supply. Broad money growth was 31.3 percent (5 percent higher than the previous year), and currency in circulation soared 36 percent by end-1992, compared with end-1991. Preliminary data suggest that this trend has become even more accentuated over recent months. By the end of the first quarter of 1993, narrow money was growing at 41 percent (although broad money grew only at 30 percent) and currency in circulation

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6/ Note that this item is not registered as lending, and thus seemingly contradictory situation occurs that, while credit is expanding fast, the Loan over Deposit Ratio is actually falling. The expansionary effect of bank operations is better reflected in the ratio of excess reserves to deposits. Increased lending by the specialized banks outside of the credit plan contributed to the decline in their ratio of excess reserves to deposits from 13.5 percent in December, 1991 to 7.6 percent a year later. The other major factor accounting for the sharp decline in these ratios was the decline in bank, relative to nonbank, intermediation—in 1992, total assets of banks grew 16.8 percent, while those of TICs and urban credit cooperatives (UCCs) expanded 38 and 96 percent, respectively.

7/ Apparently, government had to supplement bank lending earmarked for this purpose, because the banks had diverted funds for other, more profitable uses.
Figure 1.6: MONETARY AGGREGATES—RECENT TRENDS

![Chart showing growth rates over previous 12 months.](image)

Source: People's Bank of China, IMF

by over 46 percent, although domestic credit was reportedly contained to within the ceilings of the credit plan, indicating growing liquidity in the economy as a whole.

1.17 Prices. All price indices show that inflation was on the rise in 1992. Although none of the indices show prices rising at the rates of 1988, there has been a marked acceleration in the inflation rate over the last few months. Compared to 1988, when the retail price index (RPI) shot up over 18 percent, the index registered only a modest increase of 5.4 over the 12 month period of 1992. By the end of the first quarter of 1993, however, it was rising at an annualized rate of 8.6 percent. Similarly, the general cost of living index, and the index of living costs in the 35 largest cities registered increases of 6.4 and 10.9 percent by the end of the year, respectively, but at the end of the first quarter of 1993, these indices rose by 10.2 percent and 17 percent, respectively, over the same period of last year.

1.18 A significant feature of the evolution of prices in 1992, was the sharp change in relative prices, with prices of grain, construction materials, and services having registered far greater increases than the average retail price index. This reflects the considerable progress of price reform during the course of the year (see para. 2.65). By December 1992, prices of grain were up by 24.3 percent over the same period last year, services by over 13 percent, and the prices of construction materials (cement and timber)
Prices of steel, for example, more than doubled over year, and the "means of production" price index rose 15 percent by year end. This reflected real growth of 24 percent in sales of raw materials.

Indications are that the first quarter of 1993 saw further tightening in the markets for production materials. As a result, price inflation of production materials has picked up sharply with the price index of the "means of production" rising at close to 38 percent by end-March. In addition, prices of grain and services continued to rise at an annual rate of 33 percent and 29.4 percent, respectively.

On the other hand, prices of food, clothing and other daily necessities have remained relatively stable (less than a 5 percent rise over 1992), while the price of consumer durables such as televisions, refrigerators etc., in fact declined by more than 4 percent over the period.

Part of the reason for low pressure on final goods prices was that growth in industrial and agricultural production was more than adequate to meet rising demand for consumer goods and foodstuffs, with growth in sales of consumer goods was lower than
GDP growth. By end-1992, total stocks of industrial consumer goods, and especially consumer durables such as cassette tape recorders, electric fans, and TVs remained high at Y 480 billion. However, brisk sales growth in 1993 so far has caused a small decline in such stocks to Y 450 billion at end-February. The upward trend in retail sales shows no signs of abating, with an increase of 20 percent in the first five months of 1993, and 27 percent in May alone. In particular, inflation fears seem now to be creating an upsurge in purchases of high value consumer goods as a hedge for the future, with, for example, sales of television sets up 60 percent in May. This may be an indication of rising pressures on final goods markets.

1.22 Interest Rates. Interest rates on short- and medium-term deposits with the specialized banks remained unchanged from April 1991 until May 15, 1993. Developments in 1992 made these rates increasingly unattractive. With the cost of living index in 35 major cities rising at 10.9 percent, deposit rates (7.56 percent for one-year deposits) turned negative in real terms for urban residents. Besides, the deepening of financial markets and creation of alternative instruments generated a host of alternative opportunities for the investment of household savings at potentially significantly higher rates return. NBFIs and enterprises were thus able to raise some Y 100-120 billion directly from the public, by placing stocks and bonds, partly through the stock markets, but more importantly, with their own employees. The spread of this practice in 1992/93 caused the State Council to issue a circular in April 1993 calling for local authorities to tighten up on approval procedures for the issuance of such instruments.

1.23 During the first quarter of 1993 real deposit rates turned sharply negative, and this, not surprisingly, had significant consequences for household deposits with the banking system which declined in parts of China for the first time since 1988. On May 15, 1993, the authorities raised interest rates in response to these growing pressures. However, the initial adjustment was only, on average, 1.5 percent on short-term deposits, and 2-2.5 percent on medium-term deposits. Rates are therefore still negative in comparison with the urban cost of living. It does appear, however, that the rise in rates helped to stem the decline in deposits somewhat.

1.24 Lending rates were adjusted even less, by just under 1 percent for regular loans, and not at all for "policy" lending, and all lending rates remain negative, or are close to turning negative. The authorities seem concerned about the implications for enterprises of raising lending rates further. This concern is misplaced considering that interest payments account, on average, for less than 2 percent of enterprise operating costs. Even more worrying is the continued squeeze on banks of these adjustments, with negative yields on policy loans.

2/ Some enterprises have been offering rates of return in excess of 25 percent on bonds placed with employees.
The External Sector

1.25 **Foreign Trade.** Exports turned in another remarkable year’s performance, growing 18.2 percent (14 percent in real terms) to reach over $85 billion by year end. Imports grew even faster, surging 26.2 percent (22.9 percent in real terms) to total $80.6 billion, and thereby led to a decline in the trade balance from $8.1 billion in 1991 to $4.4 billion at the end of 1992. This narrowing of the trade balance was reflected in a definite and corresponding narrowing of the current account surplus (see Figure 1.8).

**Figure 1.8: TRADE AND CURRENT ACCOUNT**

![Graph showing exports, imports, trade balance, and current account balance from 1985 to 1992]

Note: In current prices and on customs basis (exports are f.o.b and imports are c.i.f)

1.26 Several factors contributed to the strong export performance, including the continuing real depreciation of the swap market exchange rate (see below), deepening of foreign trade reform (in particular the increase in the number of enterprises with direct trading rights), the fast growth in border trade, and the resurgence of outward oriented foreign direct investment (FDI). Exports of foreign funded enterprises reached $17.4 billion, up 44 percent over the previous year and accounting for over 20 percent of total exports, compared to 16.8 percent in 1991. The impact of all these developments was also evident from the changing composition of exports which, in 1992, was characterized by the continued decline in the share of primary goods exports and the expansion of the share of the exports of manufactures (especially of clothing, light industrial products, and machinery and equipment).
1.27 Import growth, as in the past, was fuelled by the strong rise in investment demand and industrial production recorded in 1992 compared to the three previous years. In this context, it should be noted that a very large proportion (an estimated 84 percent) of FDI inflows were in the form of imported equipment and materials, equivalent to about $7.8 billion or about 10 percent of total imports. In addition, the government took several measures to liberalize imports as well as to open the Chinese economy, particularly the inland provinces, further to foreign investors (see below). As a result of these measures imports saw a more than customary surge in the 4th quarter, with imports of inland provinces growing especially fast. Also the composition of imports reveals a significantly larger share of machinery imports in 1992 than in the previous year (39 as opposed to 31 percent). Both these facts suggest that the impact of rising investment demand and FDI on imports were probably more important explanatory factors than measures to liberalize imports.

1.28 The first five months of 1993 has seen a significant turnaround in trade performance. Exports have slowed down sharply, growing at a relatively modest 8.2 percent, while import growth still at 26.9 percent does not show any appreciable signs of slowing down. As a result, the trade balance registered a deficit of $3.1 billion by the end of May 1993, compared to a surplus of $1.7 billion at the same time last year. Given the historically dominant influence of the trade balance in determining the sign of the current account, the latter is almost certain to have also gone into the red by the end of the first quarter.

1.29 The slowdown in export growth is almost certainly due to the diversion of goods onto the domestic market. This seems to have occurred for two reasons. First, with domestic demand rising, a lot of products that would otherwise have been exported are finding profitable outlets on the local market. Second, it appears that a number of implicit subsidies that were previously reserved for exports (such as on transportation, energy and credit) are no longer being applied, making export activity less attractive than before.

1.30 Foreign Direct Investment. In June 1992, China announced the extension of its open door policies to 28 cities along the Yangtze river and to 13 border cities in the North East, South West and North West regions. New sectors such as transport, retail,
and real estate were thrown open to foreign investors. In addition, 11 tourist locations were approved for development by foreign investors. Partly as a result, FDI flows reached a record high of $9 billion, an increase of more than 200 percent over 1991, and equivalent to almost a third of cumulative FDI flows into China since 1979. A total of 48,858 FDI projects were reported to have been approved, with a commitment value of $58.1 billion, up 380 percent over 1991, and more than the total of all FDI commitments between 1979 and 1991. By the end of 1992, there were over 84,000 approved foreign funded enterprises in China (including foreign joint ventures, cooperative and solely owned foreign enterprises) of which 34,200, employing 4.8 million people, were in operation.

1.31 Although the coastal provinces still continued to attract a larger proportion of FDI, in 1992 the number and value of foreign funded projects grew significantly faster in inland regions than in the coastal ones. One fifth of the total number of approved projects, representing about 12 percent of the total FDI commitments went to inland provinces. Also, 1992 saw a marked increase in foreign funded projects in the areas of infrastructure, energy, transportation, raw materials and real estate. Of these, real estate alone accounted for roughly 20 percent of FDI commitments during the year.

1.32 Hong Kong remained the single largest source of FDI into China, accounting for 71 percent of the commitment value. This, however, is misleading. It seems that a substantial proportion of FDI although declared as originating from Hong Kong, in fact comes from elsewhere. In addition, there is growing evidence of the incidence of "Chinese" investment, i.e., FDI financed by the mainland (para. 1.64).

1.33 Other Capital Movements and Reserves. Although China has enjoyed high levels of FDI, the net inflow of long-term capital has been smaller than what one might expect. This is because of the country's rising investments overseas. Long-term capital outflows during 1992 totalled an estimated $16.9 billion and China has now replaced the United States as Hong Kong's largest investor. What the official balance of payments figures do not capture is the rapidly changing reality of short-term capital flows. With the large number of foreign funded enterprises within China, the growing number of subsidiaries of mainland firms abroad, and the increasing complexity of the linkages between the mainland and Hong Kong financial markets, there now exist numerous legal and illegal channels for funds to move in and out of China. Short-term capital outflows almost certainly accounted for a good part of the more than doubling, between the first and second half of 1992, of the category of "errors and omissions" (from -$5.8 to -$12.2 billion) in the balance payments accounts. If so, China in fact recorded net capital outflows by end-1992, instead of the net inflows indicated by the official statistics.

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14/ By one estimate, China's cumulative investment (mainly in stocks and real estate) amounted to $10 billion by 1992.
1.34 However, the current account surplus, which though smaller compared to 1991, was still large enough to offset net outflows on the capital account, and reserves grew by $2.3 billion to $45 billion at the end of 1992. This continued growth of state reserves has contributed to pressures in the swap markets. 15/

1.35 Exchange Rate Developments. The RMB has depreciated sharply in the swap centers since April 1992 and the spread against the official rate has widened to almost 30 percent, even while the official rate itself has been adjusted down in small increments. For the year as a whole (December 1991 to December 1992), the swap rate depreciated 23.8 percent while the official rate devalued 7.2 percent. Over the same period, the real effective exchange rate faced by Chinese exporters depreciated 17.7 percent, while the real effective official exchange rate appreciated by a marginal 1.6 percent (see Figure 1.9).

**Figure 1.9: Exchange Rates—Swap Market and Official Rates**

[Graph showing exchange rate developments with annotations]

Source: IMF

1.36 The devaluation in the swap market basically reflected market conditions. Import liberalization combined with an expansionary monetary policy supported strong import demand. As a result, imports outgrew exports leading to strong net demand for

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15/ Gross official international reserves are defined by the Chinese authorities as the sum of state reserves, gold, reserve position in the International Monetary Fund (IMF) and holdings of Special Drawing Rights (SDRs). State reserves are the foreign exchange assets of PBC. Since August 1992, the authorities have ceased to disclose the foreign exchange holdings of the Bank of China. Only state reserves are now disclosed.
dollars and the consequent depreciation of the swap market rate. In addition, it should be borne in mind that as China's efforts to reenter GATT have mounted, so have expectations that China will further slash import controls, thereby placing greater pressure on the current account. Such expectations may have led to the speculative hoarding of foreign exchange and contributed to the fall of the value of RMB relative to the dollar on the swap market.

1.37 The slide of the RMB on the market continued into the first quarter of 1993. By the end of February, the swap rate had depreciated about 43 percent in nominal terms compared to end-1991 and the gap between the average swap market and the official rate widened to over 45.8 percent. This is not surprising given the sharp slowdown in export growth noted in para. 1.28 above. In addition, the central government's efforts to build up state reserves at this time is likely to have forced some SOEs thereby deprived of centrally allocated foreign exchange to turn to the swap centers, creating additional demand pressure on the swap markets.

1.38 Towards the end of February, the authorities began tightening up administrative measures to regulate swap market activity. State enterprises have been encouraged to place their excess foreign exchange holdings on the swap markets, trading limits have been imposed, and attempts have been made to enforce price ceilings by restraining access to swap markets. The impact of these measures remains unclear. While the swap market rate has stabilized, trade volumes in the swap markets have fallen off and there is evidence of a more active black market in foreign exchange. A related development has been the widening intermarket spread in the swap market rate, which ranged from Y 8.0 to Y 8.5 to the dollar at the end of the first quarter. Local government's have clearly become more parochial regarding access to the foreign exchange resources generated within their respective jurisdictions and this has proven to be a setback for the central government's efforts to create a nationwide unified market for foreign exchange.

1.39 There has been no depreciation in the official exchange rate since the beginning of the year. On the contrary, the official rate vis-à-vis the dollar has appreciated marginally since January, reflecting the latter's depreciation relative to other currencies.

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16/ In some areas, the gap surpassed 50 percent.

17/ This is a setback for the swap markets, which saw a healthy growth in the volume of foreign exchange traded through them in 1992. Volumes traded through swap markets had reached $25.1 billion by year end, up more than 20 percent over 1991.

18/ The black market exchange rate was in the order of Y 8.9-9.0 to the dollar at end-March, 1993. There is also reportedly a widespread practice of officially sanctioned "fees" to complete sales of foreign exchange in the swap markets, of up to Y 1 per US dollar, bringing the swap rate up to this black market rate.
Public Finance

1.40 Revenues and Expenditures. The 1993 budget speech revealed a continuing decline of government's share in GNP. In 1992, government expenditures (GFS definition) amounted to Y 457 billion, about 5.5 percent higher than budgeted.19 Even so, in real terms, government expenditures remained at about 1991 levels.20 The revenue share of GNP declined as fast as the expenditure share, resulting in a deficit of 2.5 percent of GNP, unchanged from 1991, but 0.4 percentage point higher than budgeted (see Figure 1.10). For 1993, a further decline in government's share in GNP is budgeted for, but the deficit is projected to decline.

Figure 1.10: TRENDS IN PUBLIC FINANCE REVENUE, EXPENDITURES AND DEFICITS

1.41 The shifts in the composition of budgetary expenditures essentially reflect the acceleration of reforms during 1992. Specifically, expenditures on price subsidies and SOE subsidies fell from Y 88 billion in 1991 to Y 76 billion, mirroring the accelerated pace of price and enterprise reforms undertaken during the year. Administrative expenses were a major cause of expenditure overruns, and reflect, to some extent, the upward

19/ In recent years, government spending in excess of the budget has been increasing again, after having fallen from a peak in the mid-1980s. In 1992, the budgeted reserves of Y 2.7 billion were not nearly enough to cover the increase in extrabudgetary expenditures.

20/ Deflated with the services deflator, government expenditures dropped 1.6 percent, but deflated with the GDP deflator, expenditures grew a real 2.6 percent.
pressure on government wages resulting from the fast-growing wages in the rest of the economy. Expenditures on capital construction, driven by the economy wide "investment fever" were also an important cause of expenditure overruns, and expenditures on productive capital construction and technical transformation account for over 40 percent of the expenditure overruns for the year.

As noted above, budgetary revenues did not keep pace with expenditures in 1992, nor with the overall growth in the economy, although nonbudgetary sources of finances, especially for local governments, have shown much more buoyancy. Low revenue elasticity can partially be explained by the enterprise tax contract system that leaves tax obligations unchanged in the light of rapid economic growth, or rapid inflation for that matter. China's existing tax system is geared to collect taxes primarily on production and that too mainly from the state owned sector. The rapid growth of the nonstate sector and the expansion of distribution related commercial activity over recent years has consequently left an increasing proportion of economic activity outside the purview of the tax system. Apart from legal tax exemptions, it appears that localities also turned increasingly to illegal exemptions to stimulate development of their respective regions, which eroded the tax base. The VAT was nevertheless the most buoyant tax in 1992, with revenues increasing by 75 percent to Y 70 billion as its product coverage was extended.

Financing the Deficit. Net domestic bond issue was sharply in excess of the budgeted amount in order to accommodate unbudgeted expenditures. Gross issue was Y 45.5 billion, of which Y 6.5 billion was in "fiscal bonds" placed directly with the banks. Net issue was much lower due to a bunching of repayments in 1992. Foreign financing of the deficit was restricted to borrowing for projects in 1992. PBC financing of the deficit was within 0.9 percent of GNP, slightly lower than 1991, and the fiscal deficit in itself does not seem to have been the cause of monetary expansion. The planned 1993 domestic bonds issue of Y 30 billion is not particularly large compared to the 1992 issue and given China's deepening financial markets. However, the initial interest rates—11 percent on the five-year maturity and 10 percent on the three-year maturity—offered a yield substantially below the market yield of about 12.4 percent. The government was compelled to postpone the April 30 deadline for completing bond issuance in 1993. When PBC raised interest rates in May 1993, MOF followed, raising these rates to 14.06 and 12.52 percent, respectively. As of the first quarter, no government bonds had been placed and the "hard deficit" financed by PBC totalled Y 2.4 billion over the first quarter, compared to a surplus of Y 6.4 billion over the first quarter of 1992. Thus the initial reluctance to increase rates discount on government bonds increased inflationary pressure, and it remains to be seen whether the steps taken are adequate to ensure voluntary placement of the bonds.

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21/ Calculated using the current discount rate of 0.94 to the yuan on the secondary market for five-year fiscal bonds with four years remaining to maturity.
C. OVERHEATING: NO LONGER A THREAT, NOW A REALITY

1.44 The sharp change in relative prices that took place in 1992 cannot of itself be interpreted as a sign of overheating. A good part of this change was, as noted, due to price reforms. It should be emphasized that the number of controlled prices was reduced from 737 to 89 in August 1992 and only 10 percent of retail prices are now controlled by government. Price adjustments induced by these reforms can explain most of the relative price changes for grain, fuels, and certain services such as housing, water and transportation. This also explains, at least in part, why the cost of living index (particularly that for the 35 largest cities) went up much faster than the average retail price index.

1.45 However, other signs clearly indicate the degree of overheating. One key indicator is the marked rise in the index of prices for the "means of production," especially for key industrial raw materials such as steel. Clearly, the domestic supply of such materials has not been able to keep pace with the accelerating investment demand. For 23 of the 27 products categorized as "means of production," stocks declined an average of 10 percent over 1992. The stocks of steel fell 5 million tons, or 20 percent. To some extent, this emerging shortage of raw materials could be met through larger imports—import liberalization could be used as a safety valve to dissipate upward pressure on prices and allow the economy to grow closer to potential. However, there is evidence of growing congestion in the ports (see below), and there are limits to how much can be imported at any given time. Thus, for example, steel prices have jumped 14 percent just since the beginning of the year, despite rising imports.

1.46 The above emphasizes the fact that there are physical limits to the pace at which the economy can grow. Domestic infrastructure bottlenecks are clearly beginning to constrain the rate of growth. Anecdotal evidence suggests that China's transport infrastructure is stretched to its limit and is falling behind the pace of demand growth, with the existing irrational fare structure making the situation worse. In 1992, recorded freight transportation overall grew only 3.8 percent (in terms of tons/km) over the year, with highway freight transport growing a mere 2 percent and railway freight transport being able to accommodate only a 5.9 percent increase over the year. According to one estimate, the railway network is able to cope with only 60 percent of current demand for rail transport services. Likewise there is growing evidence of energy shortages in the coastal provinces, where it is estimated that energy supply is currently meeting only 75 percent of demand. As concerns the situation of the country's ports, it seems that average ship turnaround times have increased significantly. More than 50 percent of ships arriving in port at any given time this year have to wait before they can be handled.

22/ For a review of recent price reforms, see Chapter 2, paras. 2.64-2.67.

23/ Computed by SSB on basis of the ratio of rail transport quotas allocated to the total number of applications submitted.

24/ Calculated by SSB on basis of number of lost production days owing to restricted access to electricity.
In 1991, only one in three ships arriving was subject to a wait. It appears, therefore, that these bottlenecks will stop China from continuing real growth rates of the type recorded in the first quarter of 1993. If there is no cooling off, growth of output will inevitably be choked off, and rising demand would then inevitably be reflected in higher prices.

1.47 Given the slow gestation of investment in energy and physical infrastructure, shortages in these sectors can only be alleviated over a period of years. The current shortages are less a failure to expand capacity, but more reflect the unexpected pace of expansion. In the case of SOE investment, the share of energy fell from 28.3 percent in 1991 to 24.9 percent in 1992, and that of raw materials fell from 15.7 to 14.9 percent. Preliminary indications are that the share of these sectors in fixed investment has dropped even further in the first quarter of 1993. This is not a good sign and suggests two things. First, greater attention should be given to investing in energy capacity and in key bottleneck sectors, and to planning for these sectors based on more realistic growth rates. Second, short-term measures which focus on cooling off investment in downstream processing seem particularly urgent, particularly through more appropriate pricing of energy and capital, and via fiscal reforms.

D. INFLATION: THE NEED FOR CAUTION

1.48 While it seems evident that, constraints to physical infrastructure being what they are, the Chinese economy cannot sustain real growth rates as high as experienced in 1992, the question of whether or not China is now in imminent danger of slipping into an inflationary spiral is more complex. In analyzing the threat of broad based inflation, it must be borne in mind that the current situation is in several important respects different from the last boom cycle, which resulted in serious inflationary pressure in 1988.

1.49 First, compared with 1988, China started 1992 with a very comfortable foreign exchange reserves position, and it had built up significant stocks of both consumer goods and raw materials. Following a succession of good harvests, China also entered the year with adequate grain reserves of about 45 million tons, equivalent to almost one year's urban consumption. There was also slack both in production and infrastructure capacity as a result of the 1989/90 slowdown. On the whole, therefore, the economy was much better equipped to deal with an increase in aggregate demand in 1992 than in 1988. This is evident from the fact that the RPI remained well within reasonable limits over the year, and unlike 1998, food prices remained more or less stable, and prices of a range of consumer goods actually declined (see para. 1.20).

1.50 Second, a substantial proportion of such price increases as did take place over 1992 were not due to structural reasons, but to price reform and the abolition of subsidies to urban consumers on grain, housing, fuel and transport and other services. The State Statistical Bureau (SSB) estimates that price reform contributed about 70 percent of the 5.4 percent rise recorded in the RPI and about 80 percent of the 10.9 percent rise recorded in

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the cost of living index for 35 major cities. Moreover, price reform has continued into the first quarter of 1993, and although all the price indices have registered an accelerated rise, they still in part reflect the impact of additional price reform measures taken since January 1993.

1.51 Third, the structural decline in the velocity of money over the reform period has been exceptional: the velocity of M2 declined from 1.39 in 1988 to 0.94 in 1992. The decline in velocity—the inverse of the money to GNP ratio—has been a major facilitator for the absorption of strong domestic credit creation with only limited inflation and moderate interest rates. During the early stages of reform forced savings and precautionary demand for money may have played a role in this phenomenon, but financial deepening and income growth have been the main forces behind the decline. Monetization of agriculture, marketization of SOE transactions and the growth of the nonstate sector all increased the number of market transactions per unit of GNP, and thus fuelled demand for money. Moreover, until very recently, monetary assets such as cash and bank accounts were the only instruments available for the majority of Chinese. The increased demand for assets that accompanied rapidly rising levels of wealth over the 1980s was thus also manifested in the form of declining money velocity.

1.52 Notwithstanding all these factors, however, there are sufficient danger signs to warrant the exercise of extreme caution in determining the monetary stance of the authorities over the course of this year. These are each discussed briefly below.

1.53 Insufficient Control Over Monetary Aggregates. A major contributing factor to the acceleration in the growth of broad money was credit creation by NBFIs fuelled in good part by funds leaked from the interbank market. In addition, deposits are increasingly being diverted from the specialized banks and are finding their way directly into the hands of enterprises and a variety of fast growing NBFIs (para. 1.13). This implies that ceilings on domestic credit creation have become a significantly less effective tool for controlling monetary aggregates. Although ceilings on credit creation by NBFIs have been used in the past, and were reintroduced in 1993, their enforcement is clearly an important problem with regard to the oversight and regulation of the growing interbank market and NBI sector.

1.54 The authorities are taking some steps to try and bolster regulatory control. These are mostly administrative measures designed to tighten the implementation of credit ceilings. Specifically, PBC recently issued a circular intended to restrain credit for fixed investment. The circular calls for more careful scrutiny by PBC the granting of credit to other financial institutions. It prohibits specialized banks from acquiring equity in SOEs and from using credit allocated to working capital for fixed investment loans instead. In parallel, PBC has issued rules for the operation of the interbank market. A second circular prohibits enterprises from participating in the interbank market, and it imposes conditions and ceilings on the circumstances in which banks and NBFIs can access the market, on how much they can borrow, and what they can use these funds for. These are well meaning regulations, but PBC's enforcement record has been very poor in the past.
Without strengthening the institutional position of the central bank itself (for example, by finalizing the central banking law), it is not clear to what extent these, or any other regulations, can be effectively implemented.

1.55 A measure more likely to meet with success is the proposed Y 10 billion placement PBC bills with the banks for mopping up excess liquidity from the banking system. This would work, provided the yields on these bills are sufficiently high and the resources mobilized are not then fed back into the system via PBC lending. More generally, as financial markets continue to deepen rapidly, the authorities will find it increasingly difficult to maintain control over monetary aggregates only through administrative means.

1.56 Likely Trends in Money Demand and Velocity. It is improbable that the secular decline in velocity witnessed so far will continue for any length of time, and China's financial assets to GNP ratio has now reached a "normal" level. In addition, the rapid development of alternative assets besides money and quasi-money holdings will reduce the demand for money holdings, and growing innovation and competition in the financial sector will decrease the need for liquid assets for transactions purposes. This implies that monetary policy can no longer count on a steady expansion in real money holdings, and the same level of credit expansion will be more inflationary than before.

1.57 Relative Agricultural Prices. Food prices remained stable through 1992, having declined during the austerity period. Partly, this reflects intensified planning of planting decisions over this period. As rural reforms are revived and planting is liberalized, there is a distinct possibility of farmers turning away from food production. The problem of stagnating real incomes for farmers has been made worse by the increasing reluctance of the specialized banks to finance grain procurement. Grain purchasing agents had only 17 percent of the Y 60.5 billion to meet the targets for grain procurement following the 1992 autumn harvest. PBC covered 70 percent of the shortfall with emergency bridging loans (which coming as it did over and above the credit ceilings, was in itself inflationary), with the difference of Y 42.4 billion being made up with government IOUs. All this suggests that the agricultural sector is unlikely to continue to be a strong force holding down prices.

1.58 Rising Disposable Incomes. Urban incomes have been running ahead of improvements in productivity. Part of the problem is that as enterprises have gained autonomy without being subject in parallel to greater discipline in the form of hard budget constraints, their wage and payroll bills have been ballooning. In 1992 real SOE wages rose 5.3 percent, while the SOE payroll grew 8 percent in real terms, with bonus and bonuses and cash subsidies accounting for an appreciably larger proportion than in 1991.

Among developing countries, only Jordan has a velocity below one, whereas Ethiopia and Egypt are the only other low-income countries with a velocity below two (World Development Report, 1992, Table 13).
Total incomes of SOE workers in fact grew even faster than these numbers indicate because of the rapid rise of "in-kind" benefits, estimated to be the equivalent of about 35 percent over and above the payroll in 1992. The surge in employee compensation that this trend represents is adding swiftly to purchasing power. So far, this has been reflected in very high savings, but as the growth of savings slows—partly in response to falling real interest rates, this purchasing power will be reflected in demand for consumer goods.

1.59 Trends in Asset Prices and the Exchange Rate. Finally, apart from price and cost of living indicators, attention must be paid to other emerging signs of excess liquidity in the economy, the most important of which is the slide of the swap market rate.

1.60 While the rapid depreciation of the swap rate can be ascribed in part to recent measures to liberalize imports, the unusually large surge in imports in the last quarter, fuelled as it was mostly by the growth in machinery imports, indicates that rising investment demand accommodated by a relaxed monetary stance were the primary causes of developments in the swap markets. The rapid rise in the swap market rate, that continued into the early months of 1993, is akin to the familiar "overshooting" that occurs when, in the wake of strong monetary growth, prices on asset markets, driven by expectations, react stronger than those on goods markets. Also, the large gap between the swap and official rates which has developed, with the latter rate having remained stable, is not unlike the one that developed in 1988 and 1989.

1.61 It is improbable that the current situation can be sustained for any length of time, even with the authorities intervening in the swap markets as they have done since end-February. Unless the growth in import demand is contained through a tightened monetary stance, the authorities will find it difficult to prevent a further slide of the of the RMB on the swap market and/or keep from allowing the official exchange rate to depreciate.

1.62 In addition to the slide in the swap market exchange rate, other signs of excess liquidity include rising real estate prices, albeit from very low levels. Prices of land and housing rose sharply during 1992. Real estate prices in Fujian reportedly rose 50 percent, and in Hainan by more than 100 percent during the course of the year. Although land prices were no doubt fuelled in part by the construction boom, there is evidence to suggest that much of the price pressure in the real estate sector is caused by speculative activity, financed largely by NBFIs flush with liquidity from deposits and funds diverted away from the banking sector (see paras. 1.15).

E. THE CAPITAL ACCOUNT: MAKING SENSE OF RECENT FLOWS

1.63 Capital Outflows. The dynamics underlying capital flows in and out of China are not fully revealed by the official statistics of the balance of payments. It appears that very significant short-term capital outflows took place in 1992 through a combination of
legal and illegal channels,\textsuperscript{27/} and that the capital account surplus was much smaller than suggested by the official data.

1.64 There were two likely reasons for short-term capital outflows last year: (a) speculation driven by expectations of inflation and further depreciation of the RMB; and (b) "roundtripping," i.e., the outflow of funds for reinvestment in the mainland, but under the guise of foreign funded enterprises, which are eligible for significant fiscal and other benefits. Whatever the cause of these capital movements in 1992, it seems likely that as links between the mainland, especially Guangdong, and the Hong Kong financial market, become even stronger, short-term capital flows in and out of the country will become more volatile, making the balance of payments more vulnerable to deficits. This further emphasizes the importance of action for maintaining macroeconomic stability.

1.65 Capital Inflows. Although the growth of FDI into China has surpassed all expectations, the figures \textsuperscript{28/} should be interpreted with care. Of the $9 billion recorded as FDI in the balance of payments accounts, only about $1.5 billion was in cash, and the rest was mainly in the form of imported equipment, some of which is likely to have been overvalued. Moreover, of the total, one estimate puts the share of "disguised investment" from the mainland at 25 percent, or $2.3 billion. Thus, real FDI flows into China may have been in the order of $6.5 billion (see Figure 1.1).

1.66 Therefore, private capital outflows are certainly much higher, and inflows appreciably lower, than recorded in the official statistics. The capital account surplus recorded in the balance of payments in 1992 was thus to a large extent illusory. Given the volatility of the rapidly growing legal and illegal short-term capital outflows, and the likely elimination of the current account surplus in 1993, China’s balance of payments situation is likely to be much more vulnerable in the next year or two.

F. CONCLUSIONS

1.67 There are now undeniable signs that the economy is overheating and the threat of accelerating inflation in China’s economy has become real: bottlenecks on the supply side have become more and more evident; price indices have been rising faster every quarter; and the divergence between swap market and official exchange rate and increasing yields in the bonds market signal more inflation to come. \textit{These signals necessitate policy action now} for a soft landing of the economy on a structural growth path with low inflation. Postponing action would almost certainly lead to high inflation, and would necessitate administrative rectification, highly disruptive of growth and efficiency, of the type seen at the end of 1988.

\textsuperscript{27/} One channel would seem to be the maintenance of export earnings in legal (i.e., in the name of legitimate overseas subsidiaries) or illegal overseas accounts. This would explain the exceptionally large discrepancy between import values reported on a customs basis and those reported on a cash basis.

\textsuperscript{28/} The MOFTEC figure of $11.2 billion was reduced to $9 billion by SAEC because of valuation concerns.
1.68 In formulating policies for the short term, three things need to be emphasized. First, as economic reforms deepen, administrative controls are becoming less effective, and the authorities will soon have no choice but to turn to indirect instruments for macroeconomic control. In some areas, the economy may already be more responsive to indirect instruments than to traditional administrative intervention. On the other hand, given the persistence of the problem of soft budget constraints for example, full reliance on indirect measures for macroeconomic management is not as yet feasible—it will be some time before the conditions are ripe for this form of management. Meanwhile, in order to address China’s short-term macroeconomic problems, a combination of both direct and indirect measures that can be implemented immediately, needs to be considered. Second, markets for money, foreign exchange and government debt have become more closely connected. This means that a package of measures is required, each component of which is related to the others. Third, measures taken in the short-term should not just be ad hoc, but should consistent with, and facilitate medium-term structural reforms of the economic system.

1.69 In terms of the balance between direct and indirect measures, the criterion should be the extent of the development of market forces. Administrative measures, such
as investment controls, should be limited to those parts of the economy least sensitive to market signals, notably the SOEs and local governments. For the rest, including the "bubble" sectors of real estate and securities, market-friendly measures can be utilized.

1.70 With these criteria in mind, an agenda for immediate action is proposed below. While we only present recommendations for short-term actions in this chapter, the recent difficulties of the government in managing the economy only serve to emphasize the need for much greater efforts in deepening macroeconomic reforms. This refers in particular to reform of the fiscal system, and the strengthening of the central bank. Unless these reforms are addressed, with necessary accompanying reforms in other areas such as enterprise reform, these sharp swings in economic activity can be expected to continue. Priorities for medium-term system reforms in these areas are discussed in Chapters 2.

1.71 Monetary Policy. The credit plan in its present form is no longer an effective tool for monetary policy, as disintermediation and NBFI-activities have loosened the link between credit plan and monetary aggregates. At the same time, reliance on reserve requirements is yet imperfect, not least because of accounting difficulties and interest regulations. The credit plan should be adapted to include credit to government and to the interbank market, and in the light of the financing activities outside the specialized banks, could possibly be more limited than the present Y 380 billion, without unduly restricting investment activities.

1.72 The planned issue of PBC bills in the order of Y 10 billion should go ahead as soon as possible, but with yields in line with the revised interest structure. These bills would probably be a major instrument for mopping up liquidity from the banking system and should, therefore, not be counted as bank reserves. Special deposits at PBC—used successfully in mid-1992—could be used to further limit credit creation by specialized banks, if PBC bills issue proves to be too small.

1.73 The recent interest rate adjustment has two major defects. First, it is modest, and if it has only limited effects, government should move swiftly with further adjustments. A rise of the order of at least 5 percent, in contrast to the average of 2 percent, had been indicated by inflation and by the secondary markets. Second, the failure to raise lending rates by the same margin was an inappropriate decision, both with respect to the solvency of the banks, and with respect to its negligible impact on investment demand. This should be corrected, and any future rise in deposit rates, which seems likely to be necessary, should also be reflected in lending rates. At a time when overexpansion of investment is the primary threat for inflation, negative borrowing rates seems a most inappropriate policy. In addition, consideration should be given to the reintroduction of index-linked deposits for maturities of less than one year, to remove depositors' fears that their savings would lose value.
1.74 NBFI lending should be kept strictly within levels of 1993 (i.e., within Y 140 billion). In addition, reserve requirements and capital adequacy rules should be strictly imposed. In particular, the prohibition of net positions against the interbank market should be strictly imposed. For these rules to be effective, stricter oversight over NBFI activity through the immediate strengthening of the supervisory and regulatory capacity of PBC is imperative.

1.75 Fiscal Policy. The main concern for fiscal policy is prudent financing. The 1993 budget deficit is not large by international standards, but the present difficulties with placing the 1993 bonds issue suggest that the deficit might end up being financed through the creation of additional credit. This is to be avoided. Therefore, if the initial adjustment in rates proves not to be adequate, it would be essential that the yields on these new issues be raised. MOF should monitor budget implementation closely to guard against overspending, especially on administrative expenses and by local governments, as occurred last year.

1.76 Trade and Exchange Rate Policy. Accelerated implementation of import liberalization measures would relieve bottlenecks in some sectors, and would take some inflationary pressure off the economy. This may induce a reduction of international reserves, but in the light of the robust present levels, and the high creditworthiness of China, a decline seems acceptable. The monetary counterpart of such a reduction in reserves would, of course, be a reduction in high powered money.

1.77 Recent trends in the foreign exchange markets indicate the urgent need to deepen these markets. In this regard it is recommended that the retention rate be increased to 100 percent as soon as possible. In parallel, to reduce the incidence of hoarding, limits (a maximum of six months) should be introduced for the length of time retention quotas can be held by the original owner of the quota. In addition, on order to counteract increasing provincial protectionism in these markets, the State Administration for Exchange Control (SAEC) should play a stronger role in creating a truly national market for foreign exchange. Finally, access to these markets should be eased, especially to finance the imports of goods in short supply. Restrictions on access were imposed in February 1993, and lifted on June 1, 1993. Such restrictions should be avoided in future.

1.78 Investment Controls. The rapid growth in investment demand suggests that the relative cost of capital is too low. In addition to the monetary measures outlined above, it is recommended that the creation of new Development Areas, along with all their fiscal and other concessions, be frozen. In parallel, taxation on investment could be increased through making the Investment Orientation Tax simpler, more effective, and ineligible for exemption.

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30/ Trade reforms are discussed in depth in "China: Foreign Trade Reform: Meeting the Challenge of the 1990s".
1.79 Some more direct means of controlling investment, particularly by state-owned units at the local level, would have to be considered. Work should begin now in the Planning Departments at the central and local levels, to determine investment priorities within the state-owned sector, the main source of expansion. In contrast, the solution to other problems emerging in the course of the reform, such as the very high gains being made in the "bubble" sectors of real estate and the stock market, would be better addressed by removing artificial supply side constraints and thus reducing the rents to be earned from such transactions. The suggestion currently being discussed in China of moving to an auction system for land and property transactions seems to have considerable merit.

1.80 These measures could, in our opinion, be sufficient to stabilize the economy in the short term, laying the basis for steady, noninflationary growth. However, as emphasized at several points in this report, avoidance of future episodes of this type require much deeper reforms, as discussed in the next chapter.
ECONOMIC REFORM IN 1992-93

A. INTRODUCTION

2.1 China's 14th National Communist Party Congress in October 1992 officially confirmed that current policy is continuing the same reform and development programs which have dominated China's policy agenda since 1978. More specifically, it reiterated China's commitment to reforms and opening to the outside world; it encouraged the current rapid-growth phase of economic reforms, which began in 1991; and—most importantly—it amended official ideology to sanction much greater emphasis on market institutions in China's overall economic system. It did this by abandoning its old formula for a "commodity economy," which had meant that plans would ultimately allocate resources. Instead, official policy now declares that China's development goal is a "socialist market economy" in which markets play the primary resource allocation role.

2.2 Since its inception, the Chinese economic reform program has been "market-oriented," in that the role of planning has been progressively reduced and that of prices and markets has been increased. The decisions of the 14th Congress thus represented both a consolidation of past reforms and a strong push for market-oriented reform in the future. Official emphasis on a "socialist market economy" and the growth surge in 1992/93 serve as catalysts for the current reform agenda, which includes the following critical areas 30/:

(a) Fiscal and financial sector reforms to strengthen macroeconomic management;

(b) Restructuring the government to meet the demands of the new economic system;

(c) Reforming the state-owned enterprises;

(d) Related reforms to delink social services (especially housing and social security) from enterprises;

(e) Completing price and market reforms;

(f) Enacting economic laws and regulations; and

(g) Accelerating trade and exchange rate reform.31/

2.3 While these reform initiatives are facilitated by the outcome of the 14th Congress, they also build on the economic stability achieved during the 1989-91 slower-growth period, when institutional consolidation and financial tightening succeeded in reducing inflation. The following sections review the new ideology, recent progress in each of these key areas, and the challenges facing Chinese policy-makers in the future.

B. THE SOCIALIST MARKET ECONOMY

2.4 The 14th Congress clearly defined China's economic reform objective as being the establishment of a socialist market economy. Until then, recurrent debates about how to handle the relationship between planning and the market had been a constant feature of China's 14-year old reforms. Those who opposed giving more role to the market would link marketization to capitalism, while stressing planning as the main instrument of a socialist society. The 13th Congress in 1987 characterized the new economic system as one in which "the state regulates the market, and the market guides the enterprises." However, the 13th Congress did not indicate whether planning or market should be the main method of resource allocation in China.

2.5 Now, not only is the market established as the main instrument for resource allocation, it is enshrined in the Constitution, which was amended in March 1993. The phrase "planned economy under public ownership" was replaced with "socialist market economy." However, what constitutes a socialist market economy is a subject much discussed in recent months.32/ It seems to be generally agreed that a socialist market economy, while allowing market forces to play the major role in resource allocation, would additionally incorporate two fundamental socialist principles:

(a) public ownership would be the mainstay in the economy, but supplemented by non state ownership, with "public ownership" defined as either state or collective ownership, which includes most township and village enterprises, thus providing a very broad definition; and

(b) the distribution system would raise income differentials rationally in order to stimulate economic efficiency, but it would simultaneously adopt measures to prevent an "unfair" income distribution, and emphasize the elimination of remaining poverty in China.

2.6 While this new definition has cemented the role of the market, therefore, this should be seen as the logical extension of the past reform approach, and not as a radical

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31/ See World Bank: "China: Foreign Trade Reform: Meeting the Challenge of the 1990s".

new departure. The test of the new approach is now to translate this model of the market economy into action programs in the main reform areas, and the following paragraphs review each of these in turn. The importance of the decision on the socialist market economy is that it provides an underlying philosophy for the design of the reform program, which should now be able to be seen as a coherent whole, rather than simply a collection of efficiency-enhancing measures. It therefore provides us with a yardstick by which to assess the appropriateness of reform proposals in different areas: the extent to which they contribute to the creation of the market economy.

2.7 This is not to say that there is such a thing as the market economy, for there are many different modes for such economies. But market economies do have two key common features: the allocation of resources is fundamentally achieved through the forces of demand and supply meeting in markets; and macroeconomic management is exercised fundamentally through indirect economic levers. It is by the extent that reform proposals contribute to creating these two features for the Chinese economy that we assess the current reform proposals in the following paragraphs.

C. THE ECONOMIC REFORM AGENDA

2.8 Enterprise reform currently occupies the center stage of China’s economic reform program. In implementing the enterprise reform, the authorities have recognized the need to launch complementary reforms external to the microeconomic management of enterprises in order to facilitate the enterprise reform. Key reform areas include transforming government functions, reforming social sector policies, reforming the price system and developing commodities markets. In addition, a crucial element of fiscal reform has been to redefine the government’s relationship with enterprises. Financial sector reform is also an urgent task both for maintaining macroeconomic stability and for performing efficient intermediation of the saving-investment process. Conversely, enterprise reform will benefit the financial sector immensely, as the state banking system has been burdened by "policy lending," at least part of which has been induced by the loss-making SOEs. Thus, enterprise reform has catalyzed the need to pursue a more comprehensive reform agenda.

2.9 The authorities have come to recognize increasingly that for reforms to succeed, they should take place in a relatively stable macroeconomic climate. With the present threat of a repetition of overheating and of past "stop-go" cycles, increasing attention is also being given to macroeconomic reforms. It is the view of this report that it is in these macroeconomic areas that most remains to be done, both in terms of conceptual work and in reform implementation, and so we address these issues first.

Macroeconomic Reforms: Improving the External Environment

2.10 Fiscal System and Policy Reform. Economic developments in 1992 and early 1993 have served to emphasize the critical importance of continued deepening of reform in the area of macroeconomic management, a recurring theme of this report. In particular,
this concerns the fiscal system and financial sector reform. These two sets of issues need to be addressed in tandem, for they are very closely intermingled at present. Notably, it seems unlikely that the problems associated with directed credit can be solved without fiscal reform to strengthen the budget. Similarly, reform of the fiscal contract system would seem a key part of relieving pressure on local branches of the central and specialized banks. While increased attention began to be paid by the Chinese authorities to these two sets of issues in 1992, concrete measures have yet to be taken.

2.11 The increasing openness of China’s economy will make fiscal policy the dominant macroeconomic policy as monetary policy and exchange rate reforms continue. Past experience and analysis has shown that the present, contract-based taxation system in China does not provide the government with the capacity to use fiscal policy in any meaningful way to manage the economy and is itself an obstacle to reform in this and other areas. Reforms to equip government with the appropriate tools for fiscal policy in a market-based economy are therefore a matter of urgency. In partial recognition of this, the Chinese government has initiated a number of reforms and reform experiments in four major areas: (a) the tax system; (b) tax sharing; (c) accounting regulations; and (d) the budget system. Each of these is reviewed below, and in each case the outstanding agenda offers major challenges, indicating that these issues will be with us for a long time to come.

(a) The Tax System

2.12 China’s tax system is in the transition from a revenue system to a true tax system. Revenues from SOEs, the main prereform source of financial revenue, sharply declined in the course of reforms, and as a matter of policy. However, alternative forms of government revenues have been slow to materialize, not least because of problems with the decentralized tax collection system. Moreover, the present system has proved to be highly inelastic, contributing to the further decline of the share of revenue in GDP. The main reforms in the tax system are the experiment on the separation of taxes and profits, and the gradual diversification of the tax base.

2.13 Separation of Taxes and Profits. This reform experiment aims to replace the tax contracting system with a true tax system, thus normalizing the relationship between the government and enterprises. The three main features of this experiment are: (a) each enterprise pays the same income tax rate of 33 percent, irrespective of ownership; (b) the enterprise pays out dividends to the level of government that owns it on the basis of a contract; and (c) repayment of loan principal can no longer be deducted from taxable

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33/ Planning reforms were treated at some length in our last CEM "Reform and the Role of the Plan in the 1990s," September 1992, especially Chapter 3.

34/ It was notable during the last austerity program (1988-90), and in the subsequent recovery, it was monetary policy and administrative instruments such as investment controls that were used first to reduce demand, and then to expand it, with virtually no reliance on fiscal measures.
income. Experiments in this reform were initiated in 1988, but since then only about 2,400 enterprises have switched to the new system, despite attempts to widen the experiment in 1992. The abolition of loan principal repayment seems to be the main barrier for extending the experiment nationwide. Moreover, drawing lessons from the experiment is hampered by the fact that a variety of terms for the new system have been utilized in different localities, making it difficult to estimate the impact of a generalized introduction of the system.

2.14 This reform is critical, both to creating a meaningful taxation system, and to enterprise reform. It would equalize treatment of different forms of enterprise, and it would further reduce the scope for government interference in the operation of enterprises. Therefore, the hesitant implementation of the reforms is worrisome. The primary obstacle of the inability of enterprises to service debt after tax could be overcome by the application of a "grandfathering principle" to existing loans, i.e., existing loans would continue to be deductible until repayment was completed. The unsatisfactory nature of the present experiment suggests two things. First, it provides lessons for the design of future experiments in a wide range of reform areas, and the need for central management of such experiments. Second, it also suggests that it may be necessary to move to a nationwide application of the reform without further experimentation, applying the new system to enterprises as contacts come up for renewal.

2.15 Diversifying the Tax Base. China has recently made some progress in preparations to broaden the tax base. Value added tax (VAT), a highly buoyant tax, is gradually replacing sales taxes, and the business tax is increasingly being extended to cover services. The business tax rate was finally increased from 3 to 5 percent in 1993. It is also proposed that the resource tax will be extended to all petroleum and metallic and nonmetallic mineral mining. Finally, personal income taxation with a standard rate of 35, and a maximum rate of 45 percent is currently under NPC review.

2.16 However, a number of features of China's diversification effort limit its impact. The VAT, with 12 rates, is still overly complicated, and distorts the allocation of resources over sectors. Some simplification would therefore be desirable before general application. The increase in business taxes is to be welcomed, although it is to be noted that such an increase has been on the books for some time, and it had been postponed a number of years despite announcements. The high exemption in the personal income tax restricts revenue potential to all but a tiny proportion of the population. Thus, substantial expansion of the tax base is unlikely to be realized in the near future unless further and concerted efforts are made. It is to be hoped that there will be early passage of the proposed Enterprise Tax Law, and that it will grant equal treatment to enterprises regardless of ownership or location. However, we would note that the State Taxation Bureau's intent to implement new systems gradually on a sector-by-sector basis—instead of experimenting and then applying nationwide—is an interesting innovation.
(b) Tax Sharing

2.17 Fiscal contracts between central and local governments have been the mainstay of intergovernmental fiscal relations since the beginning of the reforms, but have become increasingly problematic in the light of the growing autonomy of local governments. Moreover, the incentives in the present fiscal contract system have become a main factor behind the low buoyancy of the tax system. In 1992, China’s authorities launched experiments with a tax sharing system in 9 localities. The main features of the experiment are the expansion of local fixed taxes and the restriction of "shared" taxes to all turnover taxes and the resource tax. After sharing, if the revenues of a locality are larger than previously approved expenditures, the surplus has to be remitted to central government; in case of a deficit, a fixed subsidy is provided by the central government.

2.18 Although some shifts in the assignment of taxes have been made, the contracting nature of intergovernmental fiscal relations has been maintained, and the term "tax sharing system" is therefore a misnomer. Moreover, local governments still have no own tax base, as they have no command over the rates or the base of local fixed taxes. Moreover, the experiment fails to address the dwindling equalization among provinces in times of rapidly diverging fiscal capacity. In the medium term, the fiscal program should be designed in such a way as to meet income transfer objectives. An approach to this which merits study by Chinese authorities would be to establish an equalization fund, filled through a proportion of shared taxes. Finally, the assignment of local enterprise income tax and profits to local government increases the incentive for local protectionism and overexpansion, one of the main disadvantages of the present system.

2.19 The Ministry of Finance has stated its intention to introduce the new system nationwide in 1994, although this seems unrealistic. An alternative approach is currently under consideration, which seems to offer more hope of success. This would gradually expand the number of local taxes (to include land and property taxes, vehicle taxes, and the salt tax) and the central taxes (enterprise income tax, customs), while reducing the shared proportion. These should be designed to cover as large a share as possible of respective expenditure responsibilities. It seems likely that such a reform will require the creation of a national tax service to collect the central government’s taxes. A critical step in this regard, however, will be to break the present subordination of taxes by ownership.

36/ For a fuller discussion of this approach, see World Bank "China: Budgetary Policy and Intergovernmental Fiscal Relations” Report #11094-CHA.

37/ At present, enterprises pay their taxes to the level of government that owns them: centrally-owned SOEs pay central government, and TVEs pay township governments. Fiscal sharing is then applied after this subordination.
(c) Accounting and Management Regulations

2.20 In the spring of 1992, the Ministry of Finance published "The General Regulations of Enterprise Financial Management System" to unify the financial management of all enterprises. The regulations clarified the concept of capital, established new depreciation rules and prescribed cost accounting methods. In combination with the "Regulations on Enterprise Accounting System" published at the same time, and the fiscal accounting system to be adopted in July 1993, these regulations promote equal treatment of enterprises under the law, and support enterprise taxation reform. This development is to be welcomed strongly, although its successful implementation over time will require major inputs in training of local taxation officials, and in the encouragement of ancillary financial services, such as private accounting enterprises.

(d) The Dual Budget System

2.21 China's budget has changed to the so-called "Dual Budget System" in 1992. The system classifies expenditures in a regular budget and a construction budget. The authorities hope to achieve greater clarity in the nature of the expenditures, better control over government current expenditures and revenues, and better identification of the sources of the deficit. The new presentation identifies the construction account as the source of the budget deficit, and distinguishes consumption and developmental expenditures. The dual budget also clearly reveals PBC financing of the deficit (the "hard deficit"). The new budget will be supplemented by a new budget law, currently under review by the State Council.

2.22 In several ways, however, the dual budget fails to provide greater clarity:

(a) The budget categories remain highly aggregated, and they mix economic, functional and administrative classification;
(b) Nonproductive capital construction is reported in the regular budget;
(c) Surpluses on the regular budget are double counted by registering them as capital account revenue;
(d) Subsidies for SOE losses are still deducted from revenues. Moreover, this budget reform did not address the systemic problem that a considerable part of government activity falls outside the scope of the budget. Thus the reform has fallen short of making the budget an instrument for signaling government priorities and for determining the fiscal stance in the economy.

2.23 The Need for Further Reforms. As should be evident from the above discussion, the present reforms fail to prepare the fiscal system for the socialist market economy. The fiscal system is in urgent need of being equipped with instruments for effective micro and macroeconomic fiscal policy. The reforms under preparation will need to go much further than currently contemplated if this goal is to be achieved. This suggests that very high priority should be attached to this area of reform, and to related

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37/ For further discussion, see World Bank "China: Budgetary Policy and Intergovernmental Fiscal Relations": Report No. 11094-CHA.
reforms in the financial sector and the government structure, as discussed in the following paragraphs.

**Financial Sector Reform**

2.24 As China continues its transition to a socialist market economy, the design of the financial system is of critical importance for microeconomic efficiency and macroeconomic stability. China has made substantial progress since the monobanking system was split up in the mid-1980s, but it is still far away from a fully grown financial system that would allocate financial resources to the best possible use and contribute to macroeconomic stability. Underregulation, lack of competition and the obligation of banks to supply policy loans inhibit optimal performance of the financial sector. Moreover, the decentralization of the banking system—including the central bank—has promoted regional credit expansion to the detriment of overall stability. Finally, the explosive development of NBFIs in the regulatory vacuum left by the authorities has become a major source of investment finance, and a potential source of instability. Recent reforms aim to address in part these shortcomings in China’s financial system.

2.25 Recent Reforms. In the latter part of 1992, a beginning was made to increase the autonomy of the specialized banks, and to gradually transform them into commercial banks. Essentially, the reforms consist of an application of the Regulations on Transforming the Operation Mechanisms of SOEs to banks. Commercial activities are to be separated from policy lending, at first administratively, but later institutionally. The government has announced its intention to create a "bank or banks" to handle such lending in future. It is understood that the State Council recently approved the creation of an "Export-Import" bank, to take on the present policy lending activities of the Bank of China.

2.26 A new accounting system to become effective in July 1993 should enable PBC to enforce future rules on prudent risk management, and on reserve requirements. The role of the central bank is to be clearly defined in the central banking law, the drafting of which is expected to be completed in 1993. The issue of PBC bills, planned for 1993, will give the authorities the instruments for (modest) open market operations. The development of a modern interbank payments system currently under way, and the planned linkage of the regional interbank markets would further enable the banks to manage their funds more efficiently, and thus enhance the transmission mechanism for indirect monetary policy instruments. During 1992, the PBC also launched experiments in two regulatory areas. It is testing the "equity-debt ratio management" and "asset-risk management" systems in Shanghai, Shenzhen, Guangdong, Hainan, and Fujian, as well as in the Bank

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39/ It is to be noted that in most countries it is not necessary for the central bank to issue its own paper in order to conduct open-market operations, as the Ministry of Finance/Treasury usually issues short-term bills which the central bank can trade in for this purpose. China’s MOF has unfortunately not yet begun to issue any bonds or bills with a maturity of less than three years.
of Communications. In addition, it has launched an experiment in Guangdong with respect to the credit plan, whereby the local credit plans are managed by the local branches of PBC, rather than by the central government.

2.27 Access to the interbank market, which, as noted, was a major issue for macroeconomic management in 1992 (para. 1.53) was regulated by a PBC circular issued in March 1993. The circular forbids access of enterprises, forbids a net position towards the market of NBFIs, and sets prudential standards for participants on the market. NBFIs will furthermore be subject to credit ceilings in 1993. The establishment of the State Council Securities Commission and the China Securities Regulatory Commission strengthen the regulatory environment of the securities exchanges, although a national securities law is yet to be drawn. Foreigners were allowed in the trading of "B" shares, and mutual funds were listed in Shenyang and Shandong.

2.28 Government further plans a number of initiatives which should transform China's financial system, of which the most prominent are: (a) a gradual deregulation of interest rates, and abolition of credit ceilings; (b) reorganization of PBC; and (c) allowing more foreign banks in China.

2.29 Missing Links. Although recent reform initiatives go broadly in the right direction, and the fact that financial reform is back on the agenda is to be strongly welcomed, the speed at which these reforms are proceeding is unsatisfactory, they are to some extent incomplete, and the implementation and enforcement of new regulations seems to be a problem.

2.30 Competition among banks is still limited, due to the specialization and due to limited freedom to set interest rates. The latter is one of the main causes of the mushrooming of NBFIs—many of them owned by banks—which yield more profitable credit opportunities. Limited freedom in setting interest also makes indirect instruments available to PBC—such as reserve requirements—inefficient monetary tools, because banks are not allowed to raise interest rates in order to attract deposits. An increase in the banks' discretion with respect to interest rates therefore seems highly desirable, with the central bank focusing on the base rate only. Competitive behavior of the banks is further inhibited by their quasi-fiscal role, and a speedier separation of this role is highly desirable. Creating new, special institution(s) for policy loans may only slow down the process, and designation of an existing institution as the main policy bank would seem preferable. As a minimum, pressures to create a multiplicity of such banks, especially at the local level, should be resisted strongly, as this would only increase the quasi-fiscal deficit, support local protectionism, and risk crowding out the non-state sector. This type of lending falls into two categories: first, subsidies, mostly on loss-making state-owned enterprises and for agricultural procurement. This lending belongs to the budget. The second category, priority investment, especially in long gestation or very expensive projects, is what belongs to these policy banks, and such investments could be financed by government guaranteed bonds.
2.31 This would obviously be accompanied by re-focusing the attention of existing banks on commercial activities. This will require much-strengthened supervision capacity in the central bank, on which efforts should be undertaken immediately. Finally, competitive behavior is limited by the enormous size of these banks, and, in view of the difficulty of creating new banking institutions, consideration will have to be given to the desirability of breaking up some of these into somewhat smaller units.

2.32 The diversification of financial instruments by means of the NBFIs is beneficial in principle, but the new institutions add to macroeconomic instability if not properly regulated and controlled. Although some regulation on NBFIs is in place, a unified and more extensive legal framework is increasingly necessary, and areas such as insurance, pension funds, and leasing are virtually without legal basis. The monetary authorities should recognize that the rapid development of new institutions implies that the role of the credit plan will be reduced. Given the alternative means now available to finance investments, the role of credit planning should indeed be reduced, and greater reliance placed on indirect instruments of control.

2.33 This said, it should be recognized that many of the current problems of macroeconomic management have their origin in the build-up of deposits in the banking system, which are the only available assets for most households, whose savings have increased significantly during the reform era. Greater financial stability and ease of management would be derived from a diversification of assets for the household sector, notably through housing and pension funds, as well as various types of securities.

2.34 Perhaps the most important bottleneck in financial sector development and reform is the supervision capacity of PBC and other authorities, crucial for effective management and macroeconomic supervision. Although actions to relieve bottlenecks in auditing and accounting have been taken, it will be some time before sufficient supervision capacity is in place. In the mean time China's authorities could make use of foreign expertise in this field, and if necessary, restrict the establishment of new financial institutions.

2.35 The role of PBC would have to be reformed in various ways in order to turn it into a real central bank instead of the hybrid it is today. This requires the complete separation from PBC of all non-central bank functions, and especially the profit-making activities such as ownership of securities companies and mutual funds. These activities derive from the profit retention system for PBC, and this should be abandoned, with profits being remitted to the Ministry of Finance. The functions and number of branches of PBC should be reduced considerably, and it would be desirable to reorganize the PBC branch network into a limited number of regional branches, following the model of the US system. Surplus branches and staff could be spun off into a new commercial bank. This would therefore represent a significant restructuring of the People's Bank. The restructured PBC should focus on its primary role as a central bank: the maintenance of price stability and the associated preservation of value of the currency, and the promotion of the highest rate of growth compatible with this.
2.36 It is therefore a matter of urgency for an appropriate Central Banking Law to be passed soon, which incorporates these principles. Such a Law should also reinforce the autonomy of the central bank, by creation of a Monetary Board to guide its work.

The Government Reform

2.37 The government recognizes the need to pursue, in parallel with economic reform, the restructuring of the government in order to make it more compatible with the operation of a socialist market economy, and less interventionist in enterprise management. This reform has not proved to be easy and government interventions in enterprise operations continue to be pervasive.

2.38 The clear objective of the government reorganization is to separate the government’s administrative functions from its economic functions. The main economic functions of the government are to conduct macroeconomic policy, prepare sectoral and regional development plans, and provide social services. Therefore, the government reorganization plan aims to strengthen macroeconomic management and social functions, while diminishing and streamlining the role of line ministries/bureaus.

2.39 The second objective of the reorganization is to improve the administrative efficiency of the government and to clarify the responsibility of each level of the government in order to reduce functional overlaps. Finally, an equally important related objective is to reduce the overall size of the government, as the growing administrative expenses of all government levels, especially of the local government level (e.g., the county level), have been a major factor accounting for the fiscal deficit. It is expected that 20-25 percent of government employees, about 2 million, will leave the government sector after the reorganization.

2.40 The government hopes to complete the reorganization within three years. In 1993, the major work of the reorganization will be the central government agencies. In 1994, the reorganization will be extended to the provincial level and in 1995, it will be further extended to the lower levels of government, such as prefectures and municipalities. Once the government reorganization is completed, the civil servant system will be implemented and the wage system will be reformed. The wages of the civil servants and the school teachers will be increased substantially this year, for which the central budget has made allocation of Y 4 billion.

40/ Chinese economists would draw an analogy of this reform to dismantle the temple so that the monks could then finally be dismissed from the temple. In many past attempts at restructuring the government, the "temple" had not been abolished, only that monks had been dismissed. Eventually, monks found their way back to the temple, thus defeating the reform.
2.41 Remaining Challenges. The government reorganization plan as so far announced 41/ will facilitate the integration of the domestic market. But it has not gone far enough in two key respects. First, it has made only modest strides in diminishing the power of line ministries, and this is not conducive to enterprise reform.42/ Second, the administrative structure in the sphere of macroeconomic policy coordination, social sector policy integration, as well as sector policy formulation remains to be clarified. Of particular importance is the fact that no single agency has been made responsible for macroeconomic policy formulation, and, indeed, this has been made less clear by the elevation of the Economic and Trade Office to the level of Commission. The experience of 1992 shows how critical this function can be, and this should be addressed as soon as possible.

2.42 Since one quarter of the government employees are expected to leave their offices as a result of the government reorganization, the reassignment of the large number of government staff will be a challenge. It is expected that some will work in the companies that will be separated from the line ministries or bureaus, some in the tertiary sector, and some reassigned to lower levels of government to strengthen tax administration, market regulation, and other proper functions in order to provide better governmental services, and some through attrition or early retirement. While no clear program has yet been defined, it is to be hoped that the government will adopt a "market-friendly" rather than a planning approach to these reassignments. It should also be noted that for the institutional changes described in this report to be effective, it would require a well-functioning and well-qualified public sector, which will need to be adequately compensated. Increasingly, government will need to compare the remuneration it is offering with salaries being offered in the non-government sector.

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41/ The plan of the government reorganization is the following: (a) At the central level, seven ministries will be dissolved, they are (i) Ministry of Energy, (ii) Ministry of Machine-building and Electronics Industry, (iii) Ministry of Aerospace Industry, (iv) Ministry of Light Industry; (v) Ministry of Textile Industry, (vi) Ministry of Commerce, (vii) Ministry of Material and Equipment; (b) There will be six new ministries to be set up at the central level, they are (i) State Economic and Trade Commission (based on the Economic and Trade Office of the State Council); (ii) Ministry of Power Industry; (iii) Ministry of Coal Industry; (iv) Ministry of Machine-building Industry; (v) Ministry of Electronics Industry; (vi) Ministry of Internal Trade, which is the combination of the Ministry of Commerce and Material and Equipment. (c) The name of the Ministry of Foreign Economic Relations and Trade is changed to the Ministry of Foreign Trade and Cooperation. (d) The other 34 existing ministries will remain unchanged. (e) In addition to the 41 ministries, there will be 18 central government agencies directly attached to the State Council, such as the State Tax Bureau, State Administration of Industry and Commerce, and State Administration of Exchange Control.

42/ During this transition, some line bureaus are being transformed into corporations, but only in name; many still retain their old governmental functions in the newly created corporation. Some have even formed enterprise groups to take control of the enterprises under their supervision. Some of these enterprise groups have taken over the sales and procurement rights which had already granted to enterprises by recent reforms. This is clearly counter to the spirit of the reorganization.
Enterprise Reform

Ever since the focus of China's reform shifted to the cities in 1984/85, enterprise reform has been the key reform area, but recent developments have hastened the need for enterprise reform. Subsidies to SOEs have created a significant fiscal burden for the government, and the poor performance of many basic industries is constraining development, creating bottlenecks and producing efficiency losses for the economy. The reform is designed to make the state-owned enterprises operate as independent economic entities in the market economy, being fully responsible for their losses and profits. The goal is thus to increase the efficiency of the operations of the SOEs through their corporatization, but without going as far as the privatization route being pursued by many other countries in transition.

2.44 The Chinese strategy in enterprise reform aims to achieve the separation of the "dual rights." This means that the management autonomy of an SOE should be protected while the state, as the final owner of the asset, exercises its ownership rights over the SOE. Under the prevalent contract responsibility system (CRS), a typical SOE manager is supervised by the relevant line bureau according to a host of performance indicators. However, under this system, dilution of enterprise management autonomy by bureaucratic power has been extensive, which has reduced the effectiveness of the CRS in achieving the aims of the reform. The last 12 months has seen the biggest step forward in enterprise reform for many years, and the creation of a conceptual framework for future enterprise development that offers great scope. We consider here progress in four areas: granting enterprise autonomy; the share-holding system; bankruptcy, mergers and enterprise groups; and private sector development.

2.45 Granting Enterprise Autonomy. In July 1992, the State Council published "The Regulations for Transforming the Operating Mechanism of the State-Owned Enterprises," which were designed to protect through law the autonomous rights of SOEs in fourteen key areas. Since then, central government departments under the State Council and local authorities have enacted supplementary implementing regulations. By

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43/ The number of industrial SOEs within the budget subjected to financial losses had been reduced to below 30 percent in 1992 from one third in 1991. The better performance of SOEs was due a large extent from the economic boom in 1992. In reality, the true losses of SOEs are impossible to estimate due to the lack of transparency of the Chinese enterprise accounting system.

44/ State ownership dominates key sectors such as energy, steel and transport.

45/ These management rights are: (a) production management and decision-making powers, (b) the right to decide prices, (c) the right to sell products, (d) the right to purchase goods and materials, (e) import and export rights, (f) the right to make investment decisions, (g) the right to determine application of reserve funds, (h) the right to dispose of assets, (i) the right to operate joint ventures or undertake mergers, (j) the right to hire workers, (k) the right to determine personnel management, (l) the right to determine distribution of wages and bonuses, (m) the right to decide the organization of internal units, and (n) the right to refuse proration (demand for resources from government departments).
March 1993, 28 out of the 30 provinces and autonomous regions had published implementation regulations to grant enterprises autonomous management rights.

2.46 These Regulations and their fourteen rights are a major breakthrough in enterprise reform policy in China. However, because of the lack of progress on the reform of government functions (see para. 2.36), bureaucratic interference in enterprise management is still widely reported and remains an outstanding issue for enterprises. Enterprises still find it difficult to obtain autonomy in four areas: investment, import/export, personnel, and excess levies and taxation by supervisors. During the Eighth National People's Congress convened in March 1993, the government announced as its main goal in this area to see a complete implementation of the Regulations by the end of 1993. If the laudable goals of this reform are to be realized, strong central action will need to be taken to ensure that the implementation is successful, given that several interest groups—notably line ministries—will be negatively affected.

2.47 Shareholding Companies. The second reform approach in separating the "dual rights" is the forming of shareholding companies. The shareholding experiment started as early as 1984. Since its early days this has been a popular form of reform experiment, largely because it provides a way to mobilize capital. Lately, the authorities have tended to stress the other, even more important role that can be played by the shareholding company of offering an effective way to separate the dual rights of managers and owners. In a shareholding company, the manager is appointed by and responsible to the board of directors, rather than the government bureaus. Second, a shareholding company operates under normal tax rules and is taxed at the standard 33 percent rate, rather than the contract-based tax arrangement that operates under the CRS. Both these factors reduce the scope for government intervention in the management of SOEs to a significant degree. The legal status of such companies was considerably enhanced by the issuance by the System Reform Commission in May 1992 of the "Views of Standards for Limited Share Companies," and similar "Views" for limited liability companies.

2.48 Shareholding company experiments were given a significant boost in 1992 as a result of the enhanced reform. In 1992, 400 additional enterprises have been transformed into shareholding companies or limited liability companies. The shareholding experiments have shifted from the earlier concentration on smaller SOEs to large and medium enterprises in order to make the experiments more meaningful. By the end of 1992, there was a total of 3,700 shareholding companies, 86 percent of which had issued shares only to their staff and workers. Only 2 percent of the shareholding companies (54) had issued shares through China's two stock markets, in Shanghai and Shenzhen.

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46/ At present, the corporate income tax is 55 percent. Thus the conversion of a SOE to a shareholding company implies a reduction of the corporate income tax. However, a shareholding company is also required to pay debt-service after the tax, instead of before the tax as for contract-based SOEs.

47/ Such "Views" are, of course, far short of laws, but nevertheless are a useful stop-gap that is taken seriously. For a wider discussion, see N. Lichtenstein "Enterprise Reform in China: The Evolving Legal Framework," forthcoming.
2.49 Because of the lack of a nationwide legal and regulatory framework to guide the development of shareholding experiments and stock markets, the government has followed a cautious approach in expanding these experiments. While working to develop regulatory bodies, the government has strictly limited both the number of companies that can be listed in the stock exchanges by each locality (usually one or two) and by the amount of shares issues (¥5 billion for 1992). The government does not plan to open another new stock exchange soon, despite strong lobbying by local authorities. In addition, only central government and provincial government have the right to approve the establishment of new shareholding companies. While shareholding companies appear to be the wave of the future, the experiments have so far been limited to SOEs with relatively good performance. Therefore, this reform has so far had little, if any impact on the loss-making, inefficient SOEs.

2.50 Remaining Challenges. Further deepening of enterprise reform is critical for the creation of the market economy, not only to improve efficiency and reduce loss-making, but also to provide the microeconomic foundation for macroeconomic management and the market economy itself, through creating enterprises more responsive to the signals provided by indirect economic instruments, such as the interest rate and other prices. The major, unsolved problem of enterprise reform is how the state, as owner of state assets can effectively supervise the operation and management of state assets. The state has not resolved the issue of how its interests as owner should be represented and protected, without resort to exercise of bureaucratic power. Moreover, no system has been developed to transfer state shares to other agents, including to other state-owned entities. At present, government ownership rights and supervisory responsibilities rest with the State Asset Management Bureau (SAMB). However, since its inception in 1987, the SAMB has not played an effective role.

2.51 The key to enterprise reform still seems to lie in the clarification of property rights. This is an area in which the government has yet to develop an effective approach, although it is understood that regulations are under preparation. Such a policy should take account of the four following considerations:

(a) For most ordinary production enterprises, there would be considerable gain to be made from the corporatization of the state-owned enterprises under an appropriate and unified framework of corporate law. This would need to be accompanied by the creation of suitable ownership institutions to represent the government interests in state assets, with such institutions having profitability

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48/ Shanghai and Shenzhen experiments are guided by local regulations. New national regulations were issued by the State Council on May 3, 1993 to govern stock issuance.

49/ China's Securities Law, which is being drafted, is expected to provide the legal basis for the state shares to be exchanged in the stock market.

50/ For a good example of the SAMB's bureaucratic approach, see "Trial Measures for the Registration and Administration of Property Rights of State-Owned Assets," issued May 11, 1992.
and maintenance and growth of asset value as their sole targets. However, while holding companies and group companies are but two options for such institutions, there are a wide range of options available, including mutual funds, ownership by pension companies or banks (including in debt-equity swaps) and investment banks. This suggests scope for a wide range of experiments in this area to find suitable models for China.

(b) While it is critical to remove the oversight function from the existing industrial bureaus (para. 2.36), there are a number of enterprises, notably those in a strong monopoly position and those producing public services such as water, which may continue to need significant government regulation. For these types of enterprise, a form of performance contracting would seem to be appropriate, overseen by a central enterprise oversight organization, with a small, highly qualified staff. Such an organization would also be able to supervise the effective granting to enterprises of the "fourteen rights".

(c) For a wide range of other enterprises, including, but by no means limited to most small SOEs, diversification of ownership should be undertaken, including sale or lease to nonstate industries, individuals and to joint ventures or wholly foreign-owned companies.

(d) The success of these policies would seem to depend on two pre-conditions: there should be an accelerated development of an appropriate framework of law, notably a Company Law; and an improved data base is needed on the size, structure, nature and performance of the SOEs.

2.52 Bankruptcy, Merger and Enterprise Groups. China's Bankruptcy Law became effective in 1988, but bankruptcy has rarely been encouraged as a way to address the problems of insolvent enterprises. Rather, the state budget and the banking system have continued to shoulder a large portion of the losses of SOEs in order to minimize the risks to social stability that could arise from converting disguised into open unemployment. However, there was some increased activity in the bankruptcy area in 1992, there having been virtually no cases during the rectification period of 1988-91. The largest bankruptcy case happened in November 11, 1992, involving one of the ten largest needle-knitting enterprises in China. The bankruptcy folded an enterprise of 42 years of history and laid off a staff of three thousands, including the head of the factory and the secretary of the party. In Shenyang, 28 enterprises declared bankruptcy in 1992 involving 2 SOEs and 26 collective enterprises.

2.53 The government sees mergers and the formation of enterprise groups as preferable to closing down inefficient enterprises, with strong enterprises taking over the

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51/ There are successful examples of such organizations in, for example, South Korea and Pakistan.

assets and social responsibilities of the failing enterprise. According to preliminary statistics, there were about 4,000 mergers in 1992, involving over 8,000 enterprises. These have involved mergers between SOEs and between collectives, and but also some mergers between SOEs and collectives. In many cases, the government has played a significant role in arranging the merger.

2.54 Enterprise groups continue to be formed at a very rapid pace, on two levels. The State Council decided in 1992 to establish 55 state-level enterprise groups, and 51 have so far been formed. These large groups enjoy "separate planning status", and therefore significant autonomy. For example, 7 of these groups have been vested with full property rights over their assets, and this can be expected to be a route that will be chosen for other groups in the future as one option in state asset management. In addition to these large groups, there were another 1600 at various levels, but it is estimated that only 430 of these are real group companies, in the sense of an inter-mingling of assets, and the rest are business associations.

2.55 The publicity attached to shareholding companies has tended to distract attention away from the growing role of enterprise groups within the Chinese economy, and the value of assets within these groups far exceeds the value of assets in the shareholding companies. However, this is an area in which the government is still trying to manage the economy through planning means, as it has a very strong hand in the formation of such groups. Rather, the government should be adopting the more market-oriented approach of focusing on creating the legal framework under which enterprises can voluntarily form such groups, and register the new corporations, as well as addressing the difficult question of the appropriate tax treatment of such groups in the future.

2.56 Privatization and Private Sector Development. China's privatization of SOEs was initiated by Shenyang in 1986. Since then privatization has spread to other parts of the country, but the government has restricted it to small industrial and commercial loss-making SOEs. The 14th Party Congress legitimized privatization by endorsing the sale and lease of small SOEs to private enterprise and collectives. The 14th Party Congress also gave a green light to the further development of the private sector. A number of provincial and municipal governments have begun to enact special regulations to encourage the development of the private sector, especially in fields such as exporting, technology, and the tertiary industry. Hangzhou, Suzhou, and Shenyang municipal authorities have opened private enterprise development zones and offered preferential policies to encourage location of private enterprises in the zone.

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53/ In October 15, 1992, a private entrepreneur from Zhejiang province bought six state commercial outlets valued at $254,000 from Chaining Municipal Government. This entrepreneur was later elected in January 1993 to the Political Consultative Group of Zhejiang province. This is the obvious case of political endorsement of his success.

54/ In another instance, one of the largest machine tool factories based in Dalian, Chaining province, has encountered the defection of a team of chief engineer, chief financial officer, and engineers in the factory. The defected team formed with a TVE a new machine tool factory competing head-to-head with
By the end of 1992, China had 139,000 private owned enterprises. The total registered capital of private enterprises amounted to $3.8 billion (Y 22.1 billion) percent and 67.1 percent, respectively, over the previous year. The private sector employment is 23.1 million, an increase of 26 percent over 1991. Private enterprises were mostly engaged in building, commerce and service industries. Private enterprises are concentrated in Guangdong, Zhejiang, Liaoning and Shandong provinces. At the beginning of 1993, the State Administration for Industry and Commerce announced that the government will further ease restrictions on the scope of business and operations and simplify the approval and registration of private enterprises. It is expected that private enterprises will gradually move into productive sectors.

Remaining Issues. The recent acceleration of the development of the private sector is very welcome. However, three issues continue to merit attention: widening the scope for privatization of SOEs, or, more generally, diversifying the ownership structure of SOEs; ensuring that the private sector receives equal access to credit resources, if necessary through the temporary creation of special windows; and third, by ensuring that the private sector has equal (but voluntary) access to government services, such as technology acquisition and export promotion.

Social Sector and Wage Reforms: Delinking Enterprise Social Functions

To improve efficiency, state-owned enterprises must be able to respond to market signals by adjusting the size of their operations, adding or shedding labor as necessary. Enterprises operating in a market economy are not normally burdened with the provision of social services, and the maintenance of full employment in the way that Chinese enterprises are, and reforms are necessary to change the present system in China. For this to happen, restrictions on labor mobility must be removed by delinking worker access to housing and welfare benefits from lifetime employment in a particular work unit. State-owned enterprises must also be relieved from the heavy welfare burden in providing their employees with subsidized housing, social security, health care and other benefits. Finally, by introducing market-oriented reforms in social sector, there would be more efficient and equitable distribution of social services than currently possible under the rigid administrative system. Three aspects of reform are briefly addressed here: housing; social security and health finance; and labor and wage reforms.

Housing Reform. The provision of urban housing has generated large subsidies since urban households have been required to devote less than one percent of monthly incomes to cover the costs of their rental housing. This is not sustainable and is the much bigger machine tool factory from which the team had departed. This so called "two machine-tool factory incident" has been a hotly discussed subject in major economic papers for few months.
one of the prime factors motivating reform. It is expected that the objectives of the housing reform program \(^{55}\) would be achieved over three phases.

2.61 The first phase (1990-95) is focusing on solving the problems of the "housing poor" through an emphasis on expanded resource mobilization for construction of new housing, rather than on changing the housing allocation system. Consequently, rent reform is very conservative, with rents raised to cover only replacement costs (i.e., the three factors of management, maintenance and depreciation). The second phase of reform will see the achievement, by the year 2000, of five-factor rent (i.e., three factors plus interest and property tax). Only in the longer term, i.e., the third phase, will rents reach market rates, and the provision of housing services be fully commercialized. Most Chinese cities are now embarked on the first phase of housing reform through rent increases.\(^{56}\)

2.62 The housing reform plan suffers from several serious shortcomings. First, emphasis on expanded resource mobilization for financing new housing units has led to some cities adopting forced savings mobilization schemes at below market interest rates, further taxing enterprises and workers. Second, to generate additional funds, new and old housing are sold at deep discounts at the cost of work units which originally financed the housing. This not only propagates the dependency of workers on their work units to provide low cost housing, but also creates ambiguous property rights since work units selling housing below cost will retain partial ownership.\(^{57}\) Finally, rent increases so far are also too modest to significantly reduce distortions in consumer choice. Individual purchase of owner-occupied housing is therefore not expected to be high during the near- and mid-term until rents reach reasonable trade-off thresholds, and there is a legal framework defining poverty rights.\(^{58}\)

2.63 Social Security Reform. China has been distinctive in the extent it relies on enterprises to deliver social security benefits to their workers. Although benefits are regulated by state guidelines, enterprises pay for them and manage their delivery to workers. As such, this system imposes a burden on enterprises and makes it hard for some enterprises to stand on their own without subsidies. Additionally, tied as it is to the work unit, the social security system restricts labor mobility and hence, limits the ability

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\(^{55}\) The fundamental objectives of China's housing reform are to alleviate housing shortages, improve housing conditions, shift housing costs towards consumers, and develop a real estate industry. These objectives were stated in a State Council Circular published in June 1991.

\(^{56}\) Rent increases are partially compensated by wage supplements drawn from the enterprise wage fund.

\(^{57}\) In certain cases, the work unit retains partial ownership right of the discounted housing units for a only limited period, say five years. The property rights issue should disappear in the course of time.

\(^{58}\) The World Bank supports China's housing reforms in six cities. In the Bank project, an accelerated rent increase program would be implemented in the areas under the project. The project will set up joint stock companies to take over the responsibilities of operation, maintenance and procurement of housing. A housing finance system will be established to provide mortgage loans at market rates to the joint stock housing companies for new rental housing, and over time, to individuals wishing to purchase housing.
of enterprises to adjust the size of their operations and labor force as needed to improve efficiency. Finally, the enterprise-based system also affects the adequacy and equity of social security benefits. State-owned enterprises have traditionally provided their workers with the most comprehensive benefits; other enterprise types have provided less complete benefits, while some kinds of workers are not covered by social insurance at all.

2.64 Efforts have recently been accelerated to set up the various pieces of a social safety net covering a larger part of the population. In April 1993, the State Council approved and issued the "Regulations of the Unemployment Insurance System." The framework for establishing a more comprehensive old-age pension insurance system was announced by the State Council in October, 1991. There are now 85 million covered by old-age pension systems, and there are 17 million pensioners. Although central guidelines for the establishment of a health insurance system have yet to emerge, some local governments have begun experiments in risk-pooling and to contain escalating health care costs. A high-level leading group was formed in late 1992 to coordinate the work of drafting national guidelines for reforming the health care financing system. The thrust of reform will be on the establishment of a health insurance system for all urban workers, the introduction of cost containment measures, and restructuring of the hospital payment system. This, obviously, will be a big step from the experiments in risk-pooling for catastrophic illnesses and copayment systems, currently being undertaken by a handful of cities and/or provinces. The most pertinent task ahead however, is how to expand the coverage of health insurance to the more than 900 million rural inhabitants in the country.

2.65 Reform efforts have been impeded by the present fragmented management structure for social security. At the policy level, there is separate decision-making by the various ministries responsible for different population groups. For example, the Ministry of Labor (MOL) is responsible for the benefit of enterprise workers in the urban formal sector while the Ministry of Civil Affairs (MOCA) looks after the rural population. The recent government reorganization considered, but did not resolve the question of centralizing management over social security.

2.66 At the level of implementation, provincial and even municipal governments are given the autonomy to "adapt" national guidelines to local conditions. In 1992, there was a significant expansion in pooling of social security funds. Practically all municipalities have established funds, some covering private enterprises. This proliferation of social security schemes, however, makes the evolution of a national system difficult in the future. Unless there is a national system or at the least, administrative norms and standards for social security, benefits will not be easily portable, thereby restricting labor mobility. In

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39/ Although the coverage and eligibility criteria of unemployment insurance have expanded since 1986, the system has yet to be fully used, as evidenced by the low level of benefit claims in most cities. Open unemployment remains low despite reports of the high proportion of redundant workers within loss-making enterprises. Instead of being retrenched, surplus labor is redeployed to subsidiary companies, or are retained at partial pay within the enterprise. The unemployment insurance fund has been mainly used for training/retraining of workers, and for job creation and enterprise development.
particular, it is critical to establish national guidelines for funds management, to ensure that these funds are protected and not treated as supplementary budget funds.

2.67 The fragmented nature of the management system has also been an impediment to wider risk-pooling, whether it be for old-age pensions or for health insurance. This poses a major problem to cities with an aging urban work force because the rural-urban separation precludes the broadening of the contribution base through bringing in younger workers from rural townships to the older urban pool. One of the major tasks ahead in social security reform is therefore, to establish a unified management structure for social security that allows for maximum risk-pooling, and is able to takeover from enterprises the management and delivery of social security benefits.

2.68 Labor and Wage Reforms. The labor and wage reforms were designed to grant more autonomy to enterprises in managing their work force and to break the "three irons." It is only since the March 1993 NPC that this aspect of reform is firmly back on the agenda, primarily in response to the perceived need to reduce overmanning in SOEs. Key to reforming the labor system is the labor contract system. In the beginning, the labor contract system covered only new hires, but this reform was later extended to cover permanent workers as well. There are now (end-1992) 25 million contract workers, accounting for 16 percent of all urban workers. In contrast, efforts to restrain wage growth in SOEs have had an opposite effect, increasing sharply the nonwage proportion of wages, and tying workers more closely to their existing enterprise.

2.69 If the labor reforms are to be successful, the reform program in this area must become more market-oriented. This means that the government should genuinely grant to enterprise management the power over wage determination. Second, it implies that the role of government should focus on making labor markets work, rather than direct employment creation. This, in turn, implies a new role for the Labor Service Companies, focusing on information exchange and matching demand and supply of labor, replacing its past enterprise and employment creation function. Together with related social sector reforms, this would pave the way for a later real liberalization of labor markets.

Price Reforms: Replacing the Plan

2.70 Recent Price Reform. A well-functioning and freely determined price system is at the heart of the resource allocation mechanism of a market economy. China's reform in the price system has come a long way. Through the gradual and steady reform in the price system, the market mechanism now plays the major role in determining commodity prices. Comparing 1992 with 1978, the government mandatory pricing in retail sales had been reduced from 97 percent to 10 percent, in retail sales of agricultural and sideline

60/ These are the iron chair (position), iron wage, and iron rice bowl.

61/ There are now over 13,000 "employment centers" at the present time, according to the SSB.
products from 94.4 percent to 15 percent, and in sales of production materials from 99.7 percent to 20 percent.\[^{62}\]

2.71 Government also began to address the remaining major challenges of grain and energy price reform. For grain, both procurement and selling prices were increased on April 1, 1992 by 15 and 45 percent, respectively. One quarter of all counties in the country experimented with the full liberalization of grain prices, including, in May 1993, Beijing. As these experiments have been completed successfully with little if any social impact, this can be expected to be generalized very soon. Coal prices for mandatory production—still about 35 percent of total production—were raised 27 percent to Y 71 per ton, and price ceilings on above-plan output were lifted. In addition, the volume of coal under the mandatory plan was reduced by 200 million tons to 350 million tons. Effective crude oil prices were increased 9 percent to Y 310 per ton. Within the plan for oil (about 136 million tons), there are two prices "low regulated" and "high regulated." The oil price increase is being made by moving oil from the "low" to the "high" price, the former being Y 204/ton, and the latter Y 500/ton. Prior to 1992, 86 million tons was "low," and this was reduced by 16 million tons in 1992, and by a further 40 million tons on April 1, 1993. Finally, railway freight prices were increased 35 percent to Y 0.0385 per ton kilometer in June 1992. As noted earlier (para. 1.50), price reform accounted for more than two thirds of the increase in the retail price index in 1992.

2.72 The government future price reform plan focuses on further rationalization prices of crude oil, coal, power, and transport. For crude oil, the plan is to continue to raise the plan prices to the international level. For coal, the plan is to gradually liberalize the price. In the case of power, the price is to be based on costs, which would be rational after the coal and oil reforms. Finally, the railway tariff will be raised to finance railway investment.

2.73 Although the government has not declared the completion date of the price reform, commodity price reform can now take a lower profile in the reform agenda, although continued attention to reforms in the key areas of energy, grain and transport reform will remain a priority. It should be stressed that concerns about inflation should not slow down progress in price reform. Indeed, continued price reform, especially for energy products, would help to curb excess demand. However, much remains to be done to foster market development and regulation. Partly, this requires liberalization of transport allocation, one of the least reformed areas of the economy. Second, it requires some investment in market infrastructure such as storage facilities. Third, it requires an improved regulatory framework, including a competition law, which is lacking. In this

regard, however the creation of the new Ministry of Internal Trade is to be greatly welcomed.63/

Legal Reform

2.74 The government recognizes the urgency of establishing the legal framework to support the development of the market economy. However, the legal process has been unduly lengthy and, as a result, a range of important economic legislation has yet to be produced. Several laws are either in the drafting stage or are pending approval by the National Peoples Congress, including the Company Law, the Individual Income Tax Law, and the Securities Law. Other important laws that are being drafted include the Central Bank Law and the General Banking Law (PBC), the Budget Law (MOF), the Fair Competition Law (Ministry of Internal Trade), and the Anti-Dumping Law (Ministry of Foreign Trade and Economic Cooperation). The NPC will in future take on the role of drafting economic legislation, instead of limiting itself to solely reviewing the legal initiatives of the government. The process of expanding the legal framework in the economic sphere in China is one that merits support, as China can usefully benefit from international experience in this regard.

In Conclusion

2.75 This chapter has reviewed the range of economic reform challenges facing the government at the present time, and the programs that China has formulated to address these issues. The success or failure of the government in implementing reform is critical to the future path of the economy, and this is explored further in chapter 4 of this report. This reform program is clearly in a process of evolution as the government adapts its intentions more clearly in the direction of market-based solutions to its problems. Indeed, what is most encouraging about the present situation in China is indeed that the hard questions in the area of reform are now being faced squarely. In 1992, the impetus of reform was expressed primarily as a rush to develop. Now that this rush to develop has revealed many of the deeper structural problems of the economy, these are beginning to be addressed.

2.76 Many of China's successful reforms in the past were based on lessons learned from experiments or reform initiatives at the local level, and consisted of decentralizing decision-making power to lower levels, including local governments, enterprises, and ultimately individuals. These approaches may be less successful if applied to reforms in the fiscal, financial, and foreign exchange systems. On the contrary, locally based reforms in the areas of macroeconomic management carry the risk of localization of macroeconomic policies. It will be important to refute the widely held notion in China that centralization of authority is contrary to reform, and that all decentralization is good for reform. A key challenge will be to overcome local opposition in this regard, and to unify

63/ These issues will be dealt with in depth in a forthcoming World Bank study on the development of China's internal trade.
views in favor of an aggressive program to strengthen macroeconomic management capability, for a failure to manage the economy and avoid inflation is the single largest threat now to the overall success of the reform program. Strong reforms in the three key areas of fiscal, financial and trade reforms should now be taking center stage in the overall reform effort.

The second overall issue in reform is now in a range of areas to reform the role of government, and this theme has recurred in several of the reform issues addressed in this chapter. It arises most obviously in the question of the reorganization of the government, and the twin challenges of creating the macroeconomic institutional framework while dismantling the planning system remnants. But it also emerges in many other areas: creating labor markets instead of enterprises; regulating competition instead of prices; managing health insurance instead of health care; building roads instead of factories; and enforcing laws and regulations rather than plans and targets. The market economy does not necessarily require less government, just different government, and in many reform areas, that is the challenge to be addressed.
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