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Shirley

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From: China Division

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

28 March 1986

China: The Year in Review

Summary

Economic considerations dominated China's political agenda in 1985 to an unusual degree. Buoyant after the October 1984 party meeting that endorsed urban economic reforms, Deng Xiaoping and his supporters within the Chinese leadership sought to make 1985 the "Year of Reform," carrying out controversial new economic policies and seeking to improve and consolidate their hold on the levers of power. 25X1

But economic policies did not fulfill the reformers' expectations, and they even exacerbated a number of China's existing economic problems. The government was rocked by soaring inflation, an overheated industrial sector, a sharp trade deficit and diminished foreign currency reserves, a 7-percent dropoff in grain production, and a growing corruption problem, all of which gave political critics of reform the opportunity to renew their attacks at mid year. 25X1

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Despite the increased pressure, Deng and his allies were able to bring off a significant political victory at the September Conference of Party Delegates. At that meeting, Deng managed to secure the retirement of numerous members of the party's conservative Old Guard--including 10 members of the Politburo--and replaced them with younger, better educated leaders more committed to the principles of reform. Party conservatives nonetheless remain a formidable force. Party reformers have recovered somewhat from the political difficulties of last year, but the complexity of the economic problems that face China has evidently made them more cautious, and they have set as their goal for 1986 "consolidation and digestion" of reforms already undertaken, and economic stabilization. 25X1

Economic considerations played a major role in China's foreign relations as well, although strategic concerns remain the central focus. Chinese leaders expressed satisfaction with the "stable" nature of relations with the United States, which permitted a 25-percent increase in bilateral trade (to about $8 billion). No major trade or political issues emerged in 1985, although the usual problems of Taiwan, textiles and technology transfer remain in dispute. 25X1

Last year saw a concerted attempt on China's part to test the new Soviet leader's interest in rapprochement: anti-Soviet polemics were reduced, and the level of official contact between the two governments was raised somewhat. Gorbachev did not offer any significant concessions on the fundamental issues dividing the two sides, however, and, by the end of the year, the atmospherics had cooled noticeably, with the Chinese refuting Soviet claims that relations were improving. Economic relations between China and the Soviet Union continued their slow trend of improvement in 1985, with bilateral trade approaching $2 billion. 25X1

Domestic Politics

Last year, the first full year in which to measure China's performance under economic reform guidelines and policies, was a trying one for China's reform leadership. Starting off the year full of enthusiasm for the economic reform policies approved at the landmark Third Plenum of the 12th Central Committee (October 1984), party leaders went from ebullient confidence to gnawing doubt and defensiveness to stiff determination as they watched the economic, political, and social effects of their policies. Having based their political philosophy on their ability to bring about economic improvement, party reformers, led by Deng Xiaoping, were bruised by accusations from conservatives last summer that they mishandled economic policies in 1985. Although the problems did not prevent Deng from making important political gains at the Party Delegates conference held in September, they clearly were enough to slow the momentum of political and economic reform. 25X1

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Deng Xiaoping, 82, is still the linchpin of the political system in China, and concerns about the state of his health emerged when Deng stopped making public appearances for a two-month period in late 1985 and early 1986. Deng showed up for Chinese New Year in his home province of Sichuan, but speculation about him and possible succession changes intensified last year. Deng himself evidently helped fuel the rumors at mid year, when, according to Hong Kong publications, he developed a "second stage" succession package. According to the unsubstantiated account, at some point in the next two years, the following leadership changes will take place: Deng will resign as Chairman of the party Military Commission, and will be replaced by Hu Yaobang; Hu Yaobang will give up his post as General Secretary of the party to Secretariat Standing Secretary Hu Qili; President Li Xiannian will retire and his job will be taken over by Premier Zhao Ziyang; Zhao will be succeeded as premier by one of his younger Vice Premiers, Li Peng or Tian Jiyun. [redacted] 25X1

Although the changes were not put into effect at the September Conference of Party Delegates--as some had speculated--Deng did bring off a major political realignment at that meeting, a rejuvenation of the party's leadership that is consistent in intent with the "second stage" succession scenario. At the Central Committee plenum that preceded the Delegates Conference, 65 elderly members of the Central Committee resigned, including 10 members of the Politburo and one of six members of the crucial Politburo Standing Committee. The full Delegates Conference then chose 91 new Central Committee members, preparing the way for the "election" at the ensuing Central Committee plenum of six new Politburo members and five additional members of the Secretariat. [redacted] 25X1

Generally speaking, the leadership changes shifted the balance within all the leading party organs in favor of those associated with reform. Almost all of the Politburo retirees were considered "conservative" on reform issues, and seven of them were representatives of China's armed forces, which sometimes has been viewed as being in opposition to Deng's reforms. Most of the new leaders meet Deng's succession criteria of younger, better educated, professionally qualified, and politically reliable (read non leftist). Within the Politburo in particular, the addition of Hu Qili, Tian Jiyun, Wu Xueqian, and Qiao Shi appears to significantly strengthen the reform group within the leadership. New Politburo members Yao Yilin and Li Peng, although they publicly support and administer reform policies, seem to lean toward Politburo Standing Committee member Chen Yun, who emerged last year as reform's principal detractor. [redacted] 25X1

Deng by no means swept away all opposition to his programs at the party meetings. The strongest voices in the conservative cause, in fact, maintained their party positions: Chen Yun and Li Xiannian on the Politburo Standing Committee, Peng Zhen and Hu Qiaomu on the Politburo, and Deng Liqun on the Secretariat. It also appeared that Deng had to compromise on some personnel issues, on the pace of implementation of reform policies, and on the ideological tone of the party's programs. Deng's own speech to the assembled delegates stressed some conservative themes, including the need to improve the knowledge of Marxist theory within the party. Deng also had to sit through a bitter diatribe from Chen Yun, who made his complaints about some aspects of reform completely clear, and implicitly warned Deng not to try to stifle dissent within the party. [redacted] 25X1

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In the period leading up to the conference, leadership tensions had been quite high, and we believe this was a factor in the way Beijing handled economic policy during the middle part of the year. China's leaders were confronted with a considerable amount of bad news during the late spring and early summer: high industrial growth rates, a startling increase in the money supply and capital construction expenditures, urban food price inflation, skyrocketing imports and a downward plunge in foreign exchange reserves, a gloomy agricultural forecast, and a host of corruption scandals, many of them involving the Special Economic Zones. Reform critics seized on these and other issues and, in our view, forced the reformers into a defensive position. This accounts for, among other things, Deng's statements in July that the SEZs were "experimental," and could fail. [redacted] 25X1

Since the party conference, reformers have continued to be defensive in their speeches and articles about economic policies, but less, we believe, because they fear conservative attacks, and more because the policies themselves have been flawed, or incorrectly implemented. Moreover, reformers such as Tian Jiyun and Wan Li have begun openly to rebut the criticisms leveled at reforms by conservatives last year, particularly on such issues as grain production and rural industry, and the linkage between reform policies and corruption. In sum, we believe the reformers have regained the initiative as a result of the changes brought about by the Party Delegates Conference, but will not use it to push through any controversial new reforms. Instead, they have declared 1986 to be a year of "consolidation and digestion" of reforms already undertaken. [redacted] 25X1

Foreign Policy

China increasingly is tailoring its foreign policy to serve its economic modernization drive. This is reflected in Beijing's efforts over the past year to improve relations with both Washington and Moscow. Relations, however, continue to be closer and smoother with the United States. Indeed, the Chinese continue to regard the United States as an important strategic shield against Soviet military pressure as well as a key source of investment capital and technology. [redacted] 25X1

Chinese leaders repeatedly stress that Sino-US relations are "stable"--reflecting their interest in seeing the economic relationship in particular continue to grow. Bilateral trade jumped last year by more than 25 percent, from $6 billion to about $8 billion, according to US customs statistics. Direct US investment also increased to just over $1 billion--most of it in offshore oil exploration and drilling. Economic ties are likely to geta further boost as a result of recent US efforts to streamline COCOM procedures for handling Chinese requests for licenses for Western technology. US exports of advanced technology in fact rose to $500 million in 1985 and almost certainlywill increase again this year. [redacted] 25X1

The US-China military relationship is developing at a gradual pace but has hit some snags along the way. The United States has taken some initial steps to assist China with military modernization. A key component of that assistance--the sale of an avionics package for the Chinese F-8 fighter--is now before the US Congress for

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approval. But Chinese demands that Washington give private assurances that visiting US warships would not be carrying nuclear weapons forced the US Navy last spring to postpone indefinitely a planned port call to Shanghai. 25X1

The differences over the port call appear to reflect an increasing reluctance on the part of some senior Chinese leaders to have China identified strategically with the United States--lest that complicate Chinese efforts to improve relations with Moscow and compromise China's more independent foreign policy posture. Over the past year or so, and especially since the accession of Soviet General Secretary Gorbachev, Beijing has made several symbolic concessions designed in part to test the new Soviet leader's interest in seeking a rapprochement with China. In addition to referring once more to the USSR as "socialist," and Soviet leaders as "comrades," the Chinese have cautiously agreed to reestablish some long-severed ties--trade union and parliamentary relations. They have stopped short of agreeing to restore formal party-to-party ties, presumably hoping to extract a significant Soviet political concession in exchange. 25X1

Thus far, Moscow has been unwilling to offer such a quid pro quo. At the recent Soviet party congress, Gorbachev reiterated the standard Soviet line of offering to improve relations with China as long as it was not at the expense of any third party--a not very veiled reference to Soviet allies in Vietnam, Afghanistan, and Mongolia. As a result, progress toward an expansion of political relations appears to have stalled once more over China's demands for satisfaction on the so-called "three obstacles"--that is, that the Soviets either withdraw their forces from Afghanistan, cease their support for Vietnam's occupation of Cambodia, or substantially reduce Soviet forces along the Sino-Soviet border, including those in Mongolia. 25X1

After months of muting their criticism, the Chinese in fact have increased the volume recently of their attacks on Soviet foreign policy. They also have rebuffed Moscow's efforts to pin down dates for the exchange of visits by Soviet and Chinese foreign ministers, which Beijing agreed to in principle last fall. It would appear that the Chinese are trying to exploit the Soviets' interest in the visits to induce Moscow to adopt a somewhat more flexible approach to some of the security issues that divide them. 25X1

Sino-Soviet economic relations continue to improve. Over the past three years, bilateral trade has increased substantially, approaching $2 billion. The Chinese and Soviets are moving ahead, for example, with plans for the Soviets to help modernize some factories they built in the 1950s, and to build several new projects. Even if political relations remain stalemated, the Chinese probably calculate that expanding economic ties will help to keep tension with Moscow manageable, and will give them access to some useful Soviet technology. 25X1

China's relations with Western Europe, Japan, and much of the Third World also are being shaped increasingly by economic considerations--that is, the desire for markets, raw materials, technology, and investment capital. In the case of Western Europe and countries around China's periphery, strategic considerations of course still weigh very heavily. The Chinese continue to strongly support Pakistan and the Afghan resistance as well as Thailand and the Cambodian insurgents as a means of keeping the

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Soviets and their allies in check. By the same token, they remain supporters of a strong NATO as a counterweight to the USSR. In Northeast Asia, Beijing would like the United States and Japan to make some overtures to North Korea to help China counter the recent increase in Soviet influence in P'yongyang. Chinese leaders continue to urge Washington in particular to agree to hold tripartite talks with North and South Korea as a means of reducing Moscow's ability to exploit tensions on the peninsula. 25X1

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Subject: China: The Year in Review

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

28 March 1986

The Chinese Economy in 1985: An Overview

Summary

In 1985, Beijing confronted numerous problems arising from the implementation of economic reforms. Poor weather and confusion surrounding new agricultural policies caused China's grain output to fall for the first time in five years. Industrial output, spurred by greater use of economic incentives and relaxed central controls, grew more rapidly than Beijing intended--worsening longstanding bottlenecks in the economy. Inflation tripled, while the balance of trade worsened sharply and foreign exchange reserves declined. [redacted] 25X1

Despite these problems, China's economy registered some significant gains--including an 11-to-12-percent increase in real GNP. Energy output increased by over 8 percent, largely because of production incentives, increased state investment, and technology acquisitions. Despite inflation, workers experienced an improvement in their standard of living. Finally, government revenues increased over 20 percent in 1985, and Beijing claimed success in narrowing its budget deficit. [redacted] 25X1

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Agricultural Performance in 1985--Mixed Results

After three consecutive years of record harvests, grain output fell 7 percent in 1985--a result of reduced acreage, flood damage, and confusion over new reforms that eliminated grain quotas and replaced them with a market-oriented contract system. Rapidly developing rural industries also pulled peasants away from less lucrative grain production. Reform leaders maintain, however, that surpluses from previous years will more than make up for the shortfall. The decline in grain output was offset somewhat by increases of 10 to 30 percent in the production of meat, eggs, milk, vegetables, and oilseeds. 25X1

Industrial Performance--Overly Rapid Growth

China's industrial output increased 18 percent last year, according to Chinese statistics. This continued a trend of double-digit growth in industrial production that began in 1983 and accelerated in the second half of 1984. During the first half of 1985, industrial output expanded at a 23-percent annual rate, but efforts to cool the economy reduced the growth rate to 10 percent by the end of the year. 25X1

Rural industry was the most rapidly growing sector of China's economy in 1985. According to a Chinese press report, the output value of rural factories shot up by 35 percent and constituted almost a third of total industrial production. 25X1

In light industry, buoyant consumer demand sustained a boom in the production of electrical home appliances. Output of building materials, heavy equipment, and machinery generally increased more than 15 percent during the year, while production of rolled steel increased about 9 percent. 25X1

We believe that rapid industrial growth has been caused by skyrocketing investment spending--up by 35 percent in 1985--and a surge in wages and bonuses for industrial workers. Successful rural reforms have increased the availability of raw materials for industrial use, while boosting rural incomes and fueling consumer demand. Rapid industrial growth also has been facilitated by industrial reforms, particularly those allowing enterprises to sell overquota production at prices above the state-set levels. To a lesser extent, rapid growth last year was due to the technical modernization of some segments of Chinese industry. 25X1

Burgeoning Trade Deficit

Loosened central oversight of foreign trade and a surge in investment and consumer spending led to a flood of imports--up more than 50 percent last year, according to Chinese customs data. Because of strong domestic demand, Chinese exports increased by only 6 percent--leaving Beijing with a 1985 trade deficit of $14.9 billion. Because of the deficit, China's foreign exchange reserves fell 25 percent between September 1984 and September 1985, and China devalued its exchange rate about 15 percent during the year. 25X1

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Improved Budget Outlook

Strong industrial growth, rising prices, and increased tariffs on some imports pushed up government revenues by over 20 percent in 1985, despite media reports of widespread tax evasion. Although statistics on government spending have not yet been released, Chinese press reports indicate that Beijing believes the budget deficit was eliminated last year. Chinese accounting practices, however, record Chinese foreign borrowing and government bond sales as "revenue." As measured by Western standards, China's 1985 budget may still have had a deficit of over $3 billion. [redacted] 25X1

Problems Associated With Rapid Growth

Although Chinese leaders tout rapid growth as an indicator that industrial reforms are working, they are concerned that a continuation of the fast-paced expansion will exacerbate longstanding economic problems, heighten social tensions, and undermine reform efforts. [redacted] 25X1

Despite sharp increases in the production of coal, oil, and electricity last year, energy supplies in China are strained. Additions to the transportation network have not kept pace with the growth in industrial output, and the system remains seriously overburdened. Chinese media report that factories still must suspend production occasionally because of shortages of electricity and delayed shipments of raw materials. [redacted] 25X1

Chinese media reports also suggest that key reform goals, such as improvements in industrial efficiency and product quality, are being undermined by the rapid growth. Beijing acknowledges that higher output in some cases is caused not by efficiency gains but by the use of large amounts of inputs. Press reports also suggest that rapid growth is wearing out equipment at excessive rates, increasing occupational hazards in factories, and generating higher levels of environmental pollution. Moreover, according to Premier Zhao Ziyang, recent output levels were possible only because China imported large amounts of raw materials. [redacted] 25X1

Beijing intends increased competition between state-owned enterprises to spur improvements in product quality. The shortages caused by strong demands for consumer goods and construction materials, however, have actually eased pressure on firms to maintain quality standards. Press reports emphasize that low product quality remains a serious problem throughout the economy. [redacted] 25X1

Although output grew rapidly in 1985, it was not sufficient to meet the strong demand for consumer goods, equipment, and building materials. China's retail price index showed prices rising 8.8 percent, triple the rate in 1984. We believe Beijing is especially concerned that rising prices will jeopardize popular support for economic reforms. Although large increases in wages and bonuses have cushioned the impact of higher prices for some consumers, a jump in retail food prices has caused widespread complaints among urban residents, and the rising cost of living apparently was a factor in student protests last fall. [redacted] 25X1

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Measures To Slow Growth

After industrial output increased at a 23-percent annual rate during the first quarter of 1985, Beijing implemented a combination of market-oriented macroeconomic adjustments and administrative controls. China's 1985 budget, announced last April, called for narrowing the budget deficit by slowing the growth of government spending. In particular, Beijing ordered a 10-percent cut in administrative expenditures. Beijing also began pursuing a tight money policy.

- In April, Beijing raised interest rates on time deposits and on loans for working funds. In August, Beijing boosted rates on capital construction loans and again hiked time deposit rates.

- To soak up excess currency, Beijing set aside $2 billion in foreign exchange reserves to be used to import scarce consumer durables, and the Ministry of Commerce was ordered to mark down prices of overstocked domestic commodities and increase sales to the public. 25X1

Many of the administrative controls were employed through China's banking system.

- China's central bank was ordered to set and enforce quarterly credit limits for its branches and the specialized banks.

- Banks were ordered to stop offering loans to inefficient enterprises and to firms that produce poor-quality products.

- Banks were prohibited from extending credit for capital construction projects whose spending exceeds the state quota or for projects not listed in the state plan.

- To prevent indiscriminate increases in wages and bonuses, enterprises were required to place wage funds in special accounts to be monitored by the banks. Apparently, the payroll accounts of some units were frozen. 25X1

Although industrial production has slowed since July 1985, recent statements by Chinese leaders suggest that Beijing remains very concerned with inflation, excessive investment spending, and its large trade deficit. We believe Beijing will continue to tighten control over credit and capital construction this year. 25X1

Readjustment and Consolidation

Deng Xiaoping and other top Chinese leaders remain committed to reform, despite the economic dislocations in 1985. The economic problems, however, have forced Beijing to slow the pace of reforms. In major speeches early this year, Chinese

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leaders called for a period of consolidation and adjustment in the reform program. Premier Zhao Ziyang stated recently that no major price reforms would be implemented in 1986, and, in his speech to the national party conference in September 1985, he suggested that Beijing might need a two-year readjustment period to perfect macroeconomic control techniques.

We believe Chinese leaders realize that some reforms--such as relaxing price controls or allowing wage funds to rise with enterprise profits--might be destabilizing in an inflationary economy, and that they must improve their ability to use indirect economic levers, such as taxes and interest rates, to regulate the economy. In our view, the two-year time frame mentioned by Premier Zhao probably is a guideline for the readjustment period. We expect Beijing to move ahead with key reforms as soon as it is confident that capital construction is under control and that it has improved its economic regulatory mechanisms. [redacted] 25X1

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DIRECTORATE OF INTELLIGENCE

28 March 1986

China's Foreign Trade in 1985 and Prospects for 1986 [redacted] 25X1

Summary

Over the past year, Beijing has tightened its control of the foreign trade apparatus, largely in response to declining foreign exchange reserves and a sharply rising trade deficit. High demand in China's industrial sector, however, will keep imports high, while increasing protectionism in the West will continue to dampen export growth. Moreover, lower prices for petroleum and petroleum products--which represent approximately one-fifth of the country's export revenues--will decrease Beijing's foreign exchange earnings. In an effort to narrow its trade deficit, we believe Beijing will continue to exert more control over its foreign trade as a means of reducing imports in the face of expected low export growth. We believe, however, that the impact on US exports to China will be marginal. [redacted] 25X1

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After more than five years of progressive liberalization of many foreign trade practices, over the last year Beijing has begun to reimpose selected central controls over foreign trade. The reassertion of control by the Ministry of Foreign Economic Relations and Trade (MFERT) is apparently in response to a 25-percent decline in foreign exchange reserves between September 1984 and September 1985, and to the leadership's concern about a growing trade deficit. Although Beijing's current level of foreign exchange reserves is sufficient to cover three months' imports, Chinese officials prefer to maintain a five-month foreign exchange reserve cushion. 25X1

One Step Back for Decentralization

Recentralization began with MFERT regaining control over the establishment of new trading organizations. China's open-door policy had given rise to a proliferation of import-export companies, many of which lacked the necessary skills for conducting trade. As a result, foreign and domestic traders encountered considerable confusion. Moreover, the competition among the many Chinese entities--both national and provincial--authorized to trade had initiated a price war, driving down the prices of China's exports and dampening foreign exchange earnings. Under the new guidelines, a new organization may be approved only if its business scope does not overlap existing companies and the new firm has qualified personnel. 25X1

In another move to strengthen management over foreign trade, last spring MFERT implemented a system of licensing imports and exports. Initially export licenses were required for 30 products; later the list was trimmed to 15 key export products. Last fall, however, Beijing broadened its export license requirement to 151 items, covering almost every major product the country exports. Import licenses were also imposed to dampen the flow of incoming goods--many of which China could produce domestically--and to conserve foreign exchange. In addition, in the past year Beijing announced changes in its customs regulations--increasing some tariffs to protect infant industries from imports, reducing import duties on some goods including raw materials and high-technology items, and abolishing nearly all export duties. These measures will help reduce the variation in local assessments of duties and licenses, which had caused confusion among foreign traders. 25X1

Despite these measures, China posted a record $14.9 billion trade deficit last year, according to Chinese customs statistics. Imports soared more than 50 percent in 1985 as rapid industrial growth and high consumer demand--sparked by an increased money supply--led to sharply higher purchases of raw industrial materials and consumer durables. Although petroleum export revenues increased, earnings by other major exports--such as textiles and apparel--were sharply lower and, according to Chinese data, overall export earnings rose by only 6 percent. 25X1

The Search for New Export Markets

Developing New Partners. While Beijing recorded only a marginal increase in exports to its major trading partners (Hong Kong, Japan, and the United States), its

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exports to the Soviet Union, Latin America, and Eastern Europe showed substantial increases. We estimate that exports to the Soviet Union increased more than 35 percent over 1984, along with an additional 22-percent increase in goods to Eastern Europe. Exports to Mexico and Chile more than tripled in 1985, reflecting Beijing's strong interest in developing ties to Latin America. 25X1

Hong Kong continues to be China's largest export market, accounting for more than one-fifth of China's total trade. Beijing has actively pursued closer economic links to promote the territory's stability and prosperity. Moreover, China is particularly in need of a host of services that Hong Kong can provide--financial, trade, and shipping. Earlier this year, Hong Kong opened an office in Beijing to further promote trade--its first official representation in China--with a second office scheduled to open in Shanghai before yearend. 25X1

Moving Into New Commodities. Although grain output fell 7 percent, China became a net exporter of grain last year, almost tripling grain export levels to over 9 million metric tons. Imports--15 percent of which were from the United States--totaled about 5.4 million metric tons. Corn constitutes nearly half of China's grain exports with the balance in soybeans and rice. Sales to Hong Kong, the Soviet Union, West Germany, the Philippines, and Singapore account for more than half of China's grain sales. 25X1

Although revenues from exports of petroleum and petroleum products jumped 25 percent in 1985, Beijing's search for new export markets will intensify this year as China feels the effects of lower oil prices. For the past six years, petroleum and petroleum product exports have accounted for roughly one-fifth of total export earnings, amounting to nearly $6.4 billion in 1985. If Beijing carries out its promise to hold oil export volume at the 1985 level in support of OPEC's attempts to shore up oil prices, China could lose at least $1.6 billion in foreign exchange earnings this year.[1] 25X1

For the next few years, we expect manufactured goods to provide the largest source of export growth as the Chinese substitute sales of processed goods for raw materials wherever possible. In addition to the higher value-added earnings that processed goods command, this strategy is also directed toward compensating for the increase in volume quotas developed nations impose on imports from China. The Chinese are also attempting to increase their gains from trade by moving into exports that reflect their comparative advantage in labor-intensive manufactured goods. For example, earlier this year, Beijing announced its plan to export $1.5 billion worth of carpets in the next five years and established the China Carpet Import and Export Association to coordinate international sales. 25X1

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[1] This assumes that oil prices will average $18 per barrel in 1986 and that petroleum products--nearly 20 percent of China's oil-related export volume--will earn approximately 25 percent more per barrel than crude. 25X1

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Implications for the United States

China has little chance of turning to alternative commodities to compensate for the expected drop in oil export revenues--attempts over the past several years to diversify exports have met with limited success. Hence, Beijing will probably focus on slowing runaway imports. We believe much of the slowdown in import growth will be effected through stricter foreign exchange controls, including an additional curtailment of the purchase authority previously granted to local traders under decentralization. Beijing will also continue other restrictive measures such as import licensing and selective tariff increases. According to Hong Kong press reports, Beijing's attempts to conserve foreign exchange are driving some small, marginal Chinese import-export companies out of business. These same sources caution that, because of foreign exchange shortages, China may also renege on negotiated contracts--similiar to the cancellations of grain and synthetic fiber contracts that occurred in 1983. 25X1

We believe that tightening import restraints will change the composition of China's purchases over the next year. Restrictions are already in place on commodities that China can produce domestically, including such consumer durables as color televisions, refrigerators, radios, and motor vehicles. But Beijing will also need to cut deeper into its import shopping list. We believe these cuts will begin with capital equipment purchases for postponed or cancelled government projects. 25X1

We believe, however, Beijing will continue to encounter problems slowing economic growth and therefore will achieve only moderate success in reducing industrial and capital equipment purchases. Consequently, the effect on US exports to China, more than one-third of which are machinery and transport equipment, will be marginal. Moreover, demand for raw materials and chemicals--which represent an additional 25 percent of US exports to China--probably will also be sustained. 25X1

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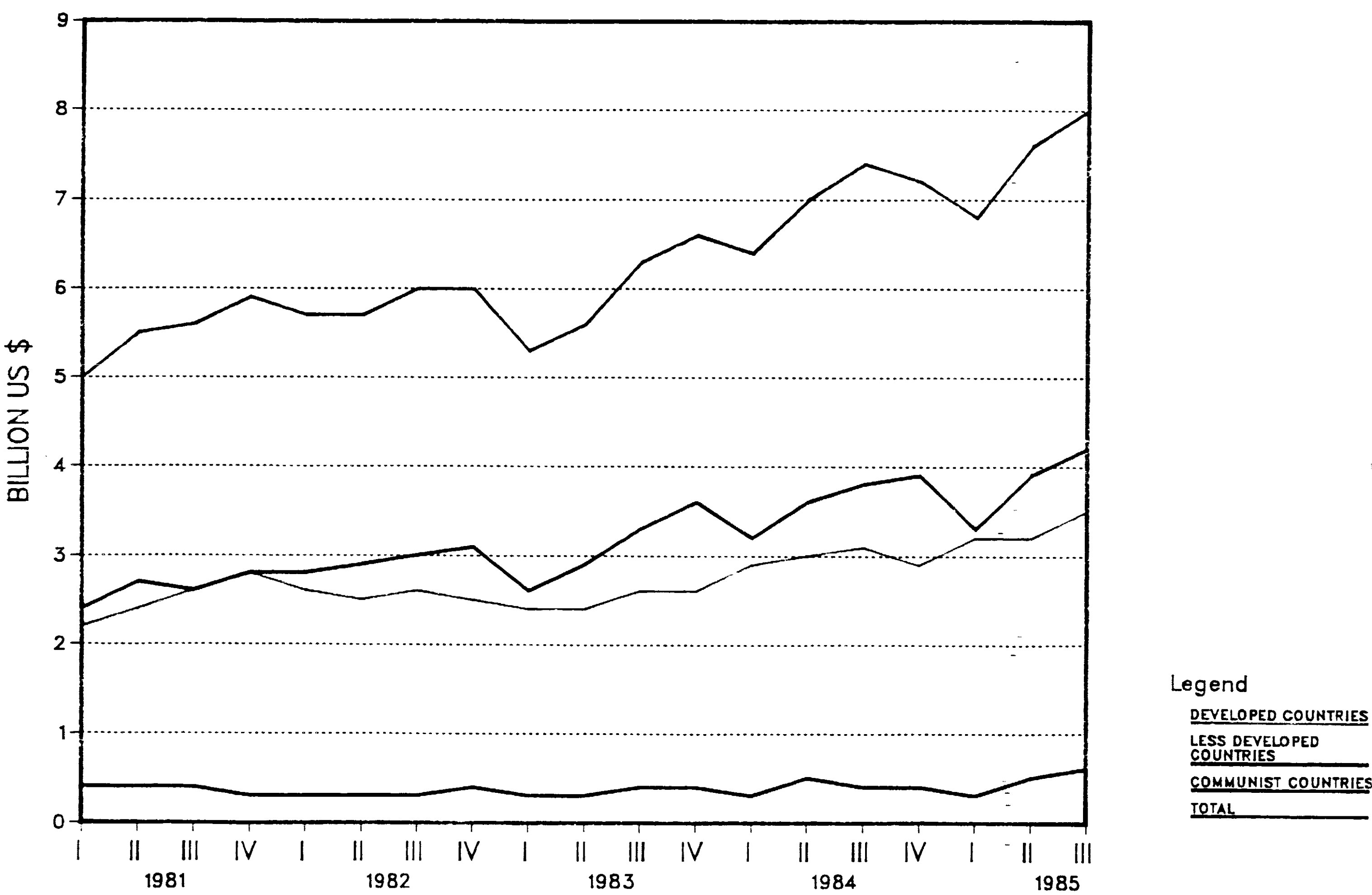

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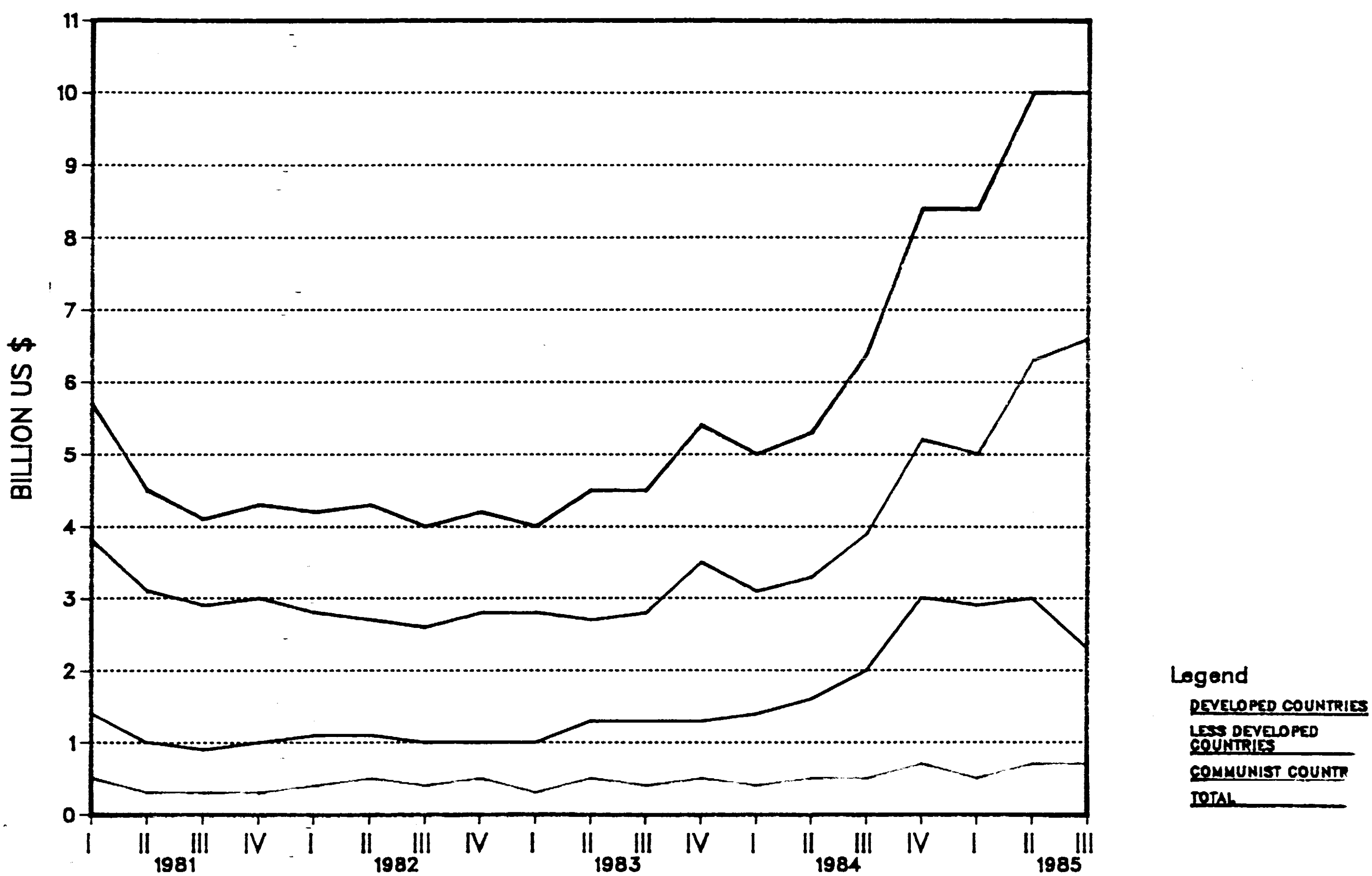

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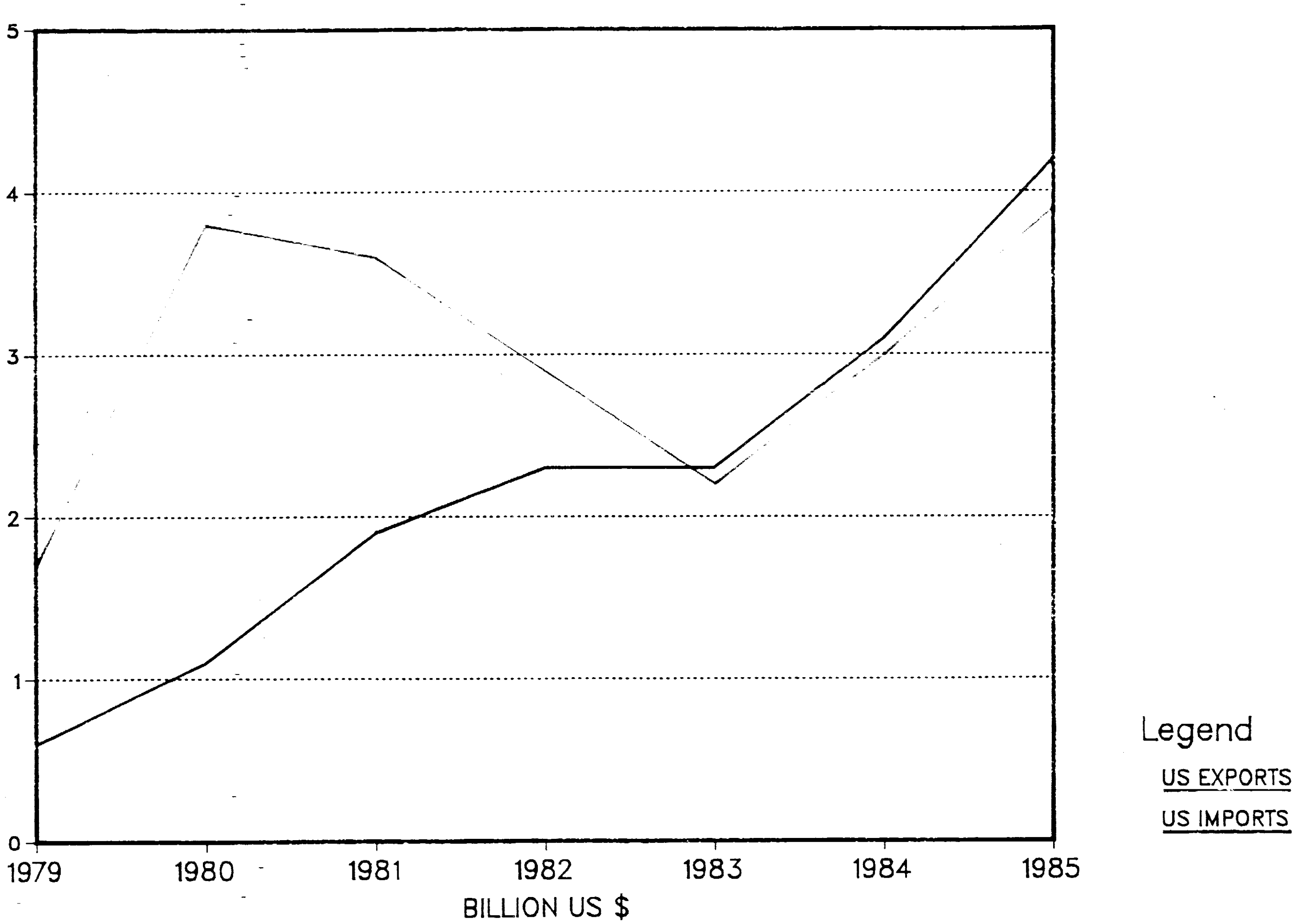

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China's Foreign Trade in 1985 and Prospects for 1986 [redacted] 25X1

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

28 March 1986

Foreign Investment in China: Impact of New Regulations 25X1

Summary

Since 1979 more than 5,000 joint ventures, cooperative enterprises, and businesses wholly owned by foreign firms have been established in China. By the end of 1985, we estimate that total paid-in foreign investment in these enterprises reached $5.4 billion. We believe that through the Seventh Five-Year Plan (1986-90) Beijing will continue to seek higher levels of foreign investment, although changes in Chinese regulations may work against small investors. In addition, the drop in oil prices will probably delay further investment in China's oil industry. 25X1

How Much Foreign and US Investment Now?

Foreign investment in China has been growing rapidly over the past five years. According to China's Ministry of Foreign Economic Relations and Trade (MFERT), between 1979 and 1985 Chinese authorities granted approval for nearly 2,300 joint ventures and over 3,700 cooperative enterprises. In addition, there were 30 offshore oil

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This memorandum was prepared by Office of East Asian Analysis. 25X1
Information available as of 28 March 1986 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, China Division, OEA, 25X1

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exploration and exploitation projects[1] as well as 120 wholly owned foreign enterprises. According to MFERT, by September 1985 paid-in foreign investment totalled $5.4 billion. 25X1

25X1 total US investment in China as of last December was about $1 billion, $600 million of that in oil exploration. US firms also are involved in some 100 joint equity ventures with investments of about $150 million. The balance of US investment is probably in cooperative enterprises. 25X1

Driving Forces Behind Foreign Investment in China

Hong Kong is responsible for roughly two-thirds of all foreign investment in China and as much as 80 percent of all joint equity venture projects. Hong Kong businessmen find China, especially neighboring Guangdong Province, an attractive place to invest partly because of family ties and other personal linkages. In addition, China has designed some of its investment incentives--such as establishing the Shenzhen special economic zone adjacent to the Hong Kong border--specifically to attract Hong Kong investment. Potential investors, faced with a 3.4-percent unemployment rate that makes enterprise expansion difficult within Hong Kong itself, find China's labor costs--one-third lower than Hong Kong's--especially attractive. 25X1

China has also improved its investment environment by developing its legal infrastructure. In 1983, Beijing began to enact scores of laws to attract or protect the foreign investor. In September of that year, China issued regulations to clarify its 1979 law governing joint ventures. The new rules offered longer tax holidays, increased opportunities to sell the output of the venture in the domestic Chinese market, and gave more decisionmaking autonomy to the venture. In early 1984, China exempted joint ventures from import duties and abolished selected taxes on ventures that import advanced machinery and technology. In April 1984, the National People's Congress formally ratified the leadership's decision to open 14 additional port cities and Hainan Island to foreign investment, giving entrepreneurs many of the advantages available in the Special Economic Zones. However, the central government has since withdrawn plans to invest heavily in infrastructure in these areas. 25X1

In May 1984, Beijing extended the maximum limit of the term of joint ventures from 30 to 50 years, giving the foreign investor more time to recoup its investment and make a profit. In December of that year, China also joined the Paris Convention for the protection of industrial property rights thereby easing concerns of investors about pirating protected technologies. 25X1

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[1] We count only 25 offshore contracts total. MFERT may also count areas where bids have closed but no firm contracts have been signed. 25X1

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Last year, Beijing revamped its tariff regulations, lowering duties on raw materials and high-technology items and gave special tax reductions and exemptions to joint ventures and projects in Special Economic Zones. The State Council also eased regulations for high-technology joint ventures giving them more discretion over the level of their reserves and greater access to domestic markets. [redacted] 25X1

Investment in the Seventh Five-Year Plan

China will continue to try to attract foreign investment throughout the Seventh Five-Year Plan but with a few modifications. Priority will be given to the development of natural resources, transport, upgrading existing enterprises, and tourism. Because of foreign exchange difficulties, however, China has revoked some of the autonomy allowed local planners. Beijing also is instituting regulations to prevent foreign exchange loss in certain types of investment. For example, wholly foreign-owned ventures will be required to export part or all of their product; officials stress that this rule is not intended to limit foreign investment but to stem foreign exchange loss. [redacted] 25X1

Beijing is also implementing internal regulations designed to limit the share of borrowed funds that can be used to finance small investments. The rule permits no debt for any investment less than $3 million; Beijing believes low levels of equity have been a major cause of bankruptcies. The limitations could undermine plans of small investors who lacked sufficient financial resources to cover the cost of their venture but hoped to profit from China's growth in the late 1980s. [redacted] 25X1

Of special interest to the United States over the past few years, investment in oil exploration probably will slow as long as oil prices remain low. This will adversely affect the total share of future US investment in China inasmuch as oil represents two-thirds of all US investment in China and has been the one area where US firms have been dominant. This, too, is more likely to affect small, independent firms that have insufficient financial resources to survive until oil prices rise again. [redacted] 25X1

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Typescript "Foreign Investment in China: Import of New Regulations [redacted] 25X1

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Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

28 March 1986

China's Energy Picture in 1985: Good Performance, Uncertain Prospects 25X1

Summary

China's energy sector turned in a strong performance in 1985, with record production of coal, oil, and electric power. Energy growth of 8 percent, supplemented by improved efficiency and conservation, helped sustain China's double-digit industrial growth last year. Nonetheless, chronic problems with power shortages and coal transport continued to disrupt the economy, and offshore oil exploration showed little promise of providing a new long-run source of supply. 25X1

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China's future energy prospects are further clouded by budget and foreign exchange problems that may reduce funds needed for expansion. Planners are taking a hard look at planned "big ticket" items like the civilian nuclear program and the Three Gorges dam, and have already cancelled a major coal venture with Japan. In the short run, US exports to China of energy technology and equipment may be hurt by these cutbacks, but the United States is likely to remain China's principle foreign investor in the energy sector and a key source of energy technology crucial to its modernization. 25X1

Growth, but Problems

Last year's energy growth of 8 percent (down slightly from 9 percent in 1984) was enough to sustain an 18.4-percent increase in China's gross industrial output (see table 1). Even so, the Chinese claim that one-fifth of their industrial capacity is idled by chronic power outages. Industry is using energy more efficiently, but these advances are more the result of better resource management than of technological improvements. Because these are largely one-time gains, China's ability to maintain double-digit industrial growth with single-digit energy growth remains highly doubtful. 25X1

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Table 1. China's Energy Production in 1985

	1985	1984	Growth (%)	Share of China's Energy (%)
Total energy*	840	780	7.8	100.0
Coal (million metric tons)	850	789	7.7	72
Oil (million barrels per day)	2.496	2.286	9.2	21
Natural gas (billion cubic meters)	12.86	12.43	3.5	2
Electric power (billion kilowatt hours)	407.3	377.0	8.0	**
Of which:				
Hydropower (bkwh)	91.0	86.8	4.8	5

* In million tons of coal equivalent, or standard coal; it is equivalent to 1.4 tons of coal, .014 b/d of oil, 752 cubic meters of natural gas, or 2,421 kwh of electricity.

**Electric power's share of China's energy is included under primary sources--coal, oil, and hydropower.

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Last year's runaway industrial growth--which taxed domestic resources and contributed to a drain in China's foreign exchange holdings--threatens Beijing's ability to expand energy supplies. Indeed, despite the high priority the Chinese have given the energy sector over the past few years, proposed energy investments face stiff competition from other rapidly growing sectors of the economy for scarce state funding, foreign exchange, and building materials.[1] With less money likely to be available, China will be forced to weigh carefully decisions on expensive, long-term projects such as nuclear plants and the massive Three Gorges hydroproject against the construction of cheaper, coal-fired power plants that are faster to build. China may also have to cut imports of Western technology that are critical to its efforts to expand oil and coal production. Transport improvements--essential to moving energy to consumers--could also be hit by the budget and foreign exchange crunch. The net effect of lower

[1] The funding shortage will be exacerbated by the drop in world oil prices, which could cost Beijing $1.6 billion in earnings in 1986.

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investments in energy and related transport projects over the longer run would be to impose further constraints on economic growth; similar cuts in 1981 dampened later energy output and economic growth and are still being felt. 25X1

The United States--which to date is China's largest foreign investor in the energy sector and a key supplier of energy-related technology--is likely, in turn, to be affected by any cutbacks.[2] In fact, the United States already appears to be out of the running in supplying China with nuclear power plants, despite passage of the nuclear cooperation agreement. We still expect US firms to account for a major share of China's energy-related imports for some time. Just as China presses Japan to meet US levels of direct foreign investment, however, it will continue to prod the United States to match Japan's lower-cost project and equipment financing. 25X1

Coal: Reforms Bolster Growth

We believe that reforms in mine ownership, wages, and prices have been the primary reasons for the strong growth in China's coal output. Beijing's decision in 1983 to allow individuals and collectives to mine coal did much to encourage peasants, eager to profit from small-scale industries, to increase production. Last year, 62,500 such small mines produced about one-fourth of China's coal; another quarter came from medium-sized mines owned by provinces or localities, and China's large state-owned mines produced the remaining half. According to preliminary figures issued by Beijing, production last year at small- and medium-scale mines grew two and a half times faster than at the state mines, largely because of the opening of 12,500 new small mines. 25X1

At all levels, the use of piece wages and special bonuses continued to improve productivity. Beijing has also raised the average price of coal to encourage production. While the official price of coal remains low, prices are negotiable for above-quota production from large-scale state mines and for all coal from smaller mines. 25X1

[2] The United States is the largest foreign investor in China's energy sector. China's two biggest joint ventures--the Pingshuo open-pit coal mine and the offshore natural gas field near Hainan -- both involve US firms. The United States also has provided key energy technologies that helped China to find more oil and accelerate oil production, to upgrade hydro and thermal power plant construction and operation, and to develop safety procedures for new nuclear plants. 25X1

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Last June, China signed a $650 million joint venture with the US firm Occidental Petroleum to jointly develop the world's largest open-pit coal mine--Pingshuo--located in Shanxi Province. The project, which will produce 15 million tons a year beginning in 1988, would have been signed several years ago, but the declining international price of coal made financing difficult. Falling prices also recently contributed to Royal Dutch Shell's cancellation of an open-pit mine project in Shandong Province, and to Japan's indefinite postponement of another large open-pit mine planned for Inner Mongolia. If international prices stay low, China may find it difficult to market its coal abroad, and could be forced to dip into its foreign exchange reserves to pay off foreign investors. 25X1

Oil--Offshore Exploration

Foreign oil companies exploring China's offshore basins began trial production of oil from offshore wells in 1985, with commercial production and export scheduled for later this year. Even so, offshore efforts continue to be a major disappointment for China's long-run energy planning. The Chinese originally hoped to find a 1 to 2 million-barrels per day (b/d) supply offshore, both to meet growing consumption and export needs and to offset expected eventual declines at mature onshore fields. Production this year will reach only 20,000 b/d, from sites developed by the Japanese in the Bohai and by the French in the Beibu Gulf. In the absence of a now-unlikely major find, we believe China will be lucky to eventually produce one-tenth the amount it anticipated offshore. 25X1

The big financial losers in the offshore effort, of course, are the foreign oil companies who bore all survey and exploration costs, spending almost $2 billion. Three US firms found oil, but all will carry out more drilling before committing themselves to commercial production. Most firms fared much more poorly; China had to give some unsuccessful participants additional acreage to keep them from quitting. 25X1

China in 1985 offered for bid a second set of exploration blocks, before foreign interest had waned any further. Of the 19 blocks available, contracts have been signed for six of the more promising areas. Declining world oil prices and continued poor showings from first round drilling are, however, likely to dampen Western enthusiasm and leave most of the remaining blocks unsigned. 25X1

Onshore Oil

China's 9-percent increase in crude oil production during the past year came as a result of new finds, improved recovery techniques, and greater productivity at existing onshore fields. The Shengli oilfield, located in Shandong Province, has made particularly impressive production gains and provided almost 40 percent of last year's total growth. The Chinese predict that Shengli's major new finds will double the field's production by 1990 to 1 million b/d. Over 50 Western technicians are working at Shengli to find and develop new wells. 25X1

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Recent discoveries on the periphery of several existing fields led Beijing to predict that China's oil output will grow by 5 percent per annum through the current Seventh Five-Year Plan, reaching 3 million b/d in 1990. We believe China can reach this goal, but sustaining it will require additional new finds to replace declining production at older fields. 25X1

China's ambitious oil production goals hinge on maintaining output at China's largest field, Daqing, a mature field in Heilongjiang Province. Almost half of China's current oil supply is produced at Daqing. We believe production at Daqing could start declining in the next few years, despite recent Chinese claims that they can sustain Daqing's current production for another 10 years. 25X1

In March 1985, China opened 1.83 million square kilometers in 10 southern provinces to oil exploration by foreign firms, in the wake of the offshore program's disappointing results. The areas Beijing opened have few existing fields and are largely unexplored. An Australian consortium signed the first--and to date only--onshore oil exploration contract in May 1985 for an area on Hainan Island. In July China opened its first onshore basin to international bids--the Subei Basin in Jiangsu Province. Meanwhile, Beijing continues to contract with foreign firms, including ones from the United States, to provide seismic survey crews and equipment to search for oil in China's northwest. 25X1

Almost all of China's increased oil production last year was exported as either crude oil or petroleum products. We estimate that China exported 580,000 b/d of crude oil and 120,000 b/d of petroleum products in 1985, worth $6.4 billion, almost 25 percent of China's exports. Beijing has nearly doubled the volume of its crude oil exports in the last two years by undercutting OPEC prices, marketing aggressively, and conserving domestic supplies. But in February, China announced that it will freeze the volume of its oil exports at the 1985 level to help support the falling international price of oil. If China sustains a freeze and crude oil prices average $18 per barrel, we believe China's foreign exchange earnings from oil could decline by $1.6 billion this year. 25X1

Electric Power: Shortages Force Equipment Imports

Faster power growth in 1985 stemmed from improved coal shipments to power plants, good rainfall in hydropower areas, and accelerated power plant completions. Nevertheless, chronic shortages remained serious as the economic policies encouraging industrial growth collided with inadequate power capacity--fallout from ill-conceived investment cutbacks in the early 1980s that slowed power plant construction through 1984. 25X1

China added 6,100 megawatts of new capacity in 1985, the most in one year since the late 1970s and the direct result of power budget increases of 25 percent in 1983 and 35 percent in 1984. About 90 percent of the new plant capacity came from thermal plants in the power-starved east and northeast, many brought to completion ahead of schedule. 25X1

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Hydroplant construction problems--only one major generator became operational in 1985--have forced Beijing to emphasize construction of coal-fired plants that are cheaper and faster to build, even though they are more expensive to operate. China's ability to supply power generation equipment is still not up to the task, however. China's three major power equipment factories have all imported US technology but are still unable to meet demand. Meanwhile, China has said it will import 10,000 MW of thermal generators over the next five years, over half of its planned capacity additions. Reportedly, China will buy up to 6,000 MW of these imports from the USSR and Eastern Europe as part of its efforts to expand trade with the Soviet Bloc. [redacted] 25X1

Beijing already recognizes that even these additions will not solve the power crises in its eastern cities. In 1985, China established the Huaneng Energy Corporation to negotiate imports of complete power plants outside of the state plan. On 26 February, a consortium led by the US firm General Electric signed contracts in Beijing to provide Huaneng's first two whole-plant imports for Nantong in Jiangsu Province, and for Shijiazhuang, the capital of Hebei. The Chinese are unlikely to award all Huaneng contracts to a single source--and Tokyo is considering new low-cost financing so Japanese firms can improve their competitiveness--but prospects for additional US sales are excellent. [redacted] 25X1

China's Nuclear Power Program

Progress has been slow in China's efforts to begin commercial nuclear power production. In March, China signed letters of intent with France to supply reactors for its planned 1,800-megawatt nuclear plant at Daya Bay in Guangdong Province, but final contracts have not yet been signed. Work continues on a small (300 MW), domestically built reactor at Qinshan that relies substantially on components and technology imported from Japan and West Germany. Meanwhile, China has postponed or cancelled plans for additional nuclear plants at Sunan (Jiangsu Province), and in Liaoning and Fujian; China will probably scale back its plans to have 10,000 MW of nuclear power operational by the year 2000. [redacted] 25X1

New Priorities for Natural Gas

Natural gas production had its best year since 1980; the discovery of a massive offshore natural gas reserve by the US firm Arco bolstered China's interest in gas as a source of energy. The Chinese in 1985 signed a $500 million agreement with Arco--China's second-largest joint venture after Pingshuo--to develop the field off Hainan Island and bring the gas ashore. China expects the project to yield 3.25 billion cubic meters of gas per year--equal to one-fourth their current output--for about 20 years, beginning in 1992. Beijing also plans to accelerate growth of onshore gas exploration and production while awaiting development of the Arco find. China announced recently that it will double production by 1990 at gasfields in Sichuan Province, the source of half of China's natural gas. [redacted] 25X1

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China has also stepped up efforts to collect oil-associated gas at oilfields like Huabei and Liaohe and is adding to pipelines that transport the gas to eastern cities. China hopes to expand its use of natural gas at smaller power plants and in urban households for heating and cooking, to reduce coal consumption and urban pollution.

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DIRECTORATE OF INTELLIGENCE

28 March 1986

China: Policy Response to Economic Instability

Summary

Economic developments in 1985 highlighted the fundamental problem of managing an economy that is being transformed from a centrally planned system to one that mixes planning and market elements. We believe Beijing's response to the problems, particularly the absence of a reflexive clamp down on reforms, provides insight into the leadership's approach to economic policymaking, and reform prospects in general. [redacted] 25X1 25X1

A Fundamental Problem

As Premier Zhao Ziyang stated in a recent interview, one of the key problems Beijing's reform program faces is how to maintain economic stability while reducing direct government control over state enterprises. Reforms implemented in the past two years have significantly diminished administrative control over production, investment, and pricing decisions. Enterprises now retain a much larger share of earnings--which they can use for investment or worker remuneration--and are permitted to sell

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overquota production of industrial goods at prices above state-set levels. Price controls have been relaxed for some products, and more retail goods are marketed outside government-run commercial channels. 25X1

Although mandatory planning still plays an important role in China's economy, in our view, Beijing has given up an element of direct control over aggregate demand by allowing increased enterprise autonomy. Reformers hope to control aggregate demand, and maintain economic stability, by employing indirect economic levers such as interest rates, credit levels, and taxes. 25X1

We believe Beijing's ability to implement comprehensive economic reform depends on its success in using indirect economic levers in place of administrative directives. When reforms were launched in 1979, opponents warned that Beijing could lose control of the economy if the central planning mechanism was weakened--and argued that strict limits should therefore be placed on economic decentralization. Reforms proceeded, in part, because Chinese leaders became convinced that macroeconomic levers could be used to regulate economic activity occurring outside of the plan. 25X1

We believe economic developments in 1985 highlighted the fact that Beijing has not yet perfected a new macroeconomic control mechanism. A surge in investment, wages and bonuses, and credit that began in the middle of 1984 caused industrial output to shoot up at a 23-percent annual rate during the first half of last year. Efforts to cool the overheated economy gradually reduced the industrial growth rate, but inflation tripled and Chinese imports soared. At the beginning of 1986, Beijing was still concerned with overly rapid growth in credit, capital construction, and wage levels. 25X1

Party conservatives, who oppose some aspects of the pragmatic reform program, criticized reformers for the economic problems last year. The sharpest attack came at a party conference in September 1985, when Chen Yun, a Politburo Standing Committee member and the doyen of China's economic bureaucrats, warned that market forces were unreliable economic levers. According to Chen, "market regulation involves no planning, blindly allowing supply and demand to determine production...planning is the essence of macroeconomic control." We believe, that in a broader sense, Chen's argument carried the clear implication that economic reform was progressing too quickly and that there are limits on how far economic decentralization can go without threatening social disorder. In our view, reformers themselves recognized the need to improve economic controls and have therefore decided that major economic reforms will be put on hold until after 1986. 25X1

The Transition Process

In one sense, the potential for economic dislocations is endemic to the reform process. In the transition from a centrally planned economy to a more market-oriented system, Beijing must loosen some types of central controls before testing the economic levers slated to replace them. In our view, enterprises have been quick to respond to

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enhanced decisionmaking authority--such as the right to sell overquota production at market prices--but have not been as responsive to macroeconomic levers as Beijing expected. For instance, higher interest rates on loans do not effectively curtail borrowing by some enterprises that rely on the state budget for their operating expenses. Other enterprises have proved adept at evading taxes or raising funds for capital construction outside of the banking system. To increase the responsiveness of enterprises to economic levers, we believe Beijing must press ahead with industrial reforms--but further decentralization may temporarily increase economic instability. In our view, the conflict between enhancing enterprise autonomy and maintaining macroeconomic control will impart a pattern of rapid growth followed by government-induced retrenchment to China's economic performance. 25X1

Sources of Instability

We believe that policy errors, a one-sided grant of enterprise autonomy, and strong local pressures for rapid growth contributed to economic problems last year. 25X1 25X1

Policy Errors

A major source of economic instability was the 50-percent increases in currency in circulation and loans to industrial enterprises that occurred in 1984. In our view, the money supply surge was caused by errors in the implementation of new banking reforms. In 1984, Beijing granted increased autonomy to local banks and urged them to adjust their loan policies to support economic reform. Intense demand for funds by enterprises and local officials, and lax oversight and muddled accounting by the central bank, however, allowed credit to increase much more than Beijing intended. 25X1

One-Sided Enterprise Autonomy

Chinese press reports indicate that many managers have taken advantage of increased autonomy by excessively increasing capital construction and rapidly expanding wages and bonuses. In our view, this growth in investment spending and worker remuneration was another source of economic problems. Chinese reformers recognize that the grant of autonomy is onesided--managers have more flexibility in using enterprise revenues, but their decisionmaking is not yet disciplined by market forces. Because Beijing still subsidizes state enterprises that lose money, managers increase wages--or take more loans--without worrying about bankruptcy. We believe reformers recognize that bankruptcy is a necessary lever for restraining autonomous enterprises, but experiments with bankruptcy laws have been limited: a working group was formed only recently to draft bankruptcy laws. A major impediment to enforcing bankruptcy, in our view, is China's irrational price system, which makes it difficult to determine whether enterprises are losing money because of inefficiency, or because of low state-set prices.

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We believe the implementation of bankruptcy laws also will meet strong resistance from local officials who fear they will have to bear the economic--and political--costs of workers who lose their jobs when enterprises close. 25X1

Local Interests

We believe Beijing faces enormous pressure from workers, managers, and local officials for rapid growth. Promotion of "10,000 yuan households" by the media in 1984 and exhortations to get rich through hard work generated rising expectations among workers for an improvement in their standard of living. Rising food prices have intensified worker demands for raises, while the relaxation of state controls over some enterprises has weakened the ability of managers to resist them. 25X1

Given years of emphasis on meeting quantitative targets, many managers still believe that they must prove their competence by rapidly expanding enterprise production. To boost local revenues, low-level officials pressure enterprise managers to increase output and speed completion of local construction plans. Although downplaying the extent of the problem, recent editorials have warned that, if officials set unreasonable output targets, enterprise managers may resort to falsifying production data--making it more difficult for Beijing to judge how well control measures are working. We believe Chinese leaders are also worried that rapid growth of enterprises operated by rural towns has caused a proliferation of small, inefficient, and redundant firms that compete with state enterprises for funds and raw materials. 25X1

Beijing's Response to the Economic Problems

We believe that the political strength of the reform coalition and the increased economic sophistication of its leaders was evident in Beijing's reaction to the economic problems in 1985. Instead of halting the reforms and quickly damping the overheated economy by reimposing strict administrative controls--as they might have in the past--Chinese leaders implemented a combination of market-oriented macroeconomic adjustments and state directives that were designed to slow the economy gradually.

We believe Beijing's willingness to use economic levers to stabilize the economy was particularly significant. China's 1985 budget, announced last April, called for a reduction in the rate of growth of government spending and a 10-percent cut in administrative expenditures. Beijing also clamped down on credit and twice raised the general level of interest rates. Administrative directives were issued that required enterprises to place wage funds in special accounts to be monitored by the banks, and that prohibited banks from extending credit for construction projects not listed in the state plan. 25X1

During the year, Beijing began to recentralize some aspects of its foreign trade, and it ordered a halt in construction of some projects, but it did not backtrack on fundamental reforms. Despite surging consumer and investment demands, Beijing

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implemented planned hikes in urban food prices, and introduced--after a lengthy delay--new wage scales for teachers and government workers. At the national conference last September, the Chinese Communist Party formally made reform its primary economic goal for the five-year period beginning in 1986. Although Beijing recently announced that major economic reforms will not be implemented this year, we believe that some types of reforms, such as the removal of central government units from the direct management of enterprises, will proceed. 25X1

Improving the Mechanisms of Macroeconomic Control

To improve its ability to maintain economic stability with indirect economic levers, Beijing is increasing the powers of China's central bank and making greater use of taxes as regulatory tools. We believe Beijing has given the central bank expanded authority to administer China's specialized banks (such as the Agricultural Bank and the Industrial and Commercial Bank). For instance, the central bank's credit plan now includes the funds of all of the specialized banks, and the specialized banks no longer have overdraft rights with the central bank. Beijing recently announced a new tax scheme for individual entrepreneurs, and Chinese press reports suggest that in 1986 Beijing will increase enforcement of taxes on capital construction. Media reports also suggest that Beijing will boost taxes on rural industries, in part to slow their rapid growth. Beijing also is improving its ability to collect taxes from enterprises. We believe these changes in the banking and taxation systems will eventually provide Beijing with better economic levers. 25X1

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