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DIRECTORATE OF INTELLIGENCE

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China: Politics and Performance Curtail Economic Plans for 1987

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Summary

Leadership disagreements over the pace and direction of economic reform have combined with problems in China's economic performance last year to force changes in economic policy and plans in 1987. Beijing's agenda includes increased emphasis on grain production, more subsidies to workers, and focusing on enterprise efficiency instead of on price reform and the bankruptcy law. The remedies proposed in March at the National People's Congress, however--with significant retrenchment from original plans--will probably not prove as effective as Beijing hopes. We do not expect Beijing's policy adjustments to create new problems in the Sino-US relationship, but pressure to correct trade deficits could aggravate existing frictions. Delegates to the Joint Commission on Commerce and Trade in April can expect pressure on bilateral trade issues, and may also hear contradictory views on China's reform policies.

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This memorandum was prepared by [] Office of East Asian Analysis. Information available as of 30 March 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economics Assessments Branch, China Division, OEA, []

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Politics, Performance Put Reformers on the Defensive

December's student demonstrations and the 16 January ouster of Party General Secretary Hu Yaobang brought into the open increasingly contentious leadership disagreements over economic policy. Premier and Acting General Secretary Zhao Ziyang is trying to shield reforms from assaults by party ideologues. But under pressure from conservative party officials uncomfortable with market-oriented policies and because of widespread official concern over budget deficits, declining foreign exchange reserves, and other economic problems, policymakers began to modify reform policies in late 1986. Reforms that would have had the heaviest impact on workers--reductions in urban food and housing subsidies, price reform, and bankruptcy legislation--were put on hold at least partly because of a fear of worker unrest in the wake of student demonstrations. Price subsidies, which reformers had begun phasing out last year, are now scheduled to increase. And although the use of market incentives in agriculture was reaffirmed in China's annual guidance on rural policy, reformers decided to increase state investment because of conservative charges that agricultural infrastructure and development in some areas have been neglected.

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The View From the Top

At the National People's Congress in March, Zhao, State Planning Commission head Song Ping, and Minister of Finance Wang Bingqian presented a carefully balanced picture of economic performance in 1986 in what we believe was Zhao's attempt to restart Beijing's stalled reform program. But he also, in our view, was trying to mollify the concerns of orthodox party officials.

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Song Ping's speech on China's economic and social development cited a number of accomplishments for 1986, including higher grain production; more reasonable industrial growth rates (figure 1); progress on priority construction projects; and improved supplies of consumer goods accompanied by slower inflation in retail prices. Song also raised several problems, however: low priority construction projects that drained off scarce financial and material resources; consumer demand growing too fast, with wage growth outpacing productivity gains; factories producing too many low-quality, unwanted goods; and continued budget and trade deficits.

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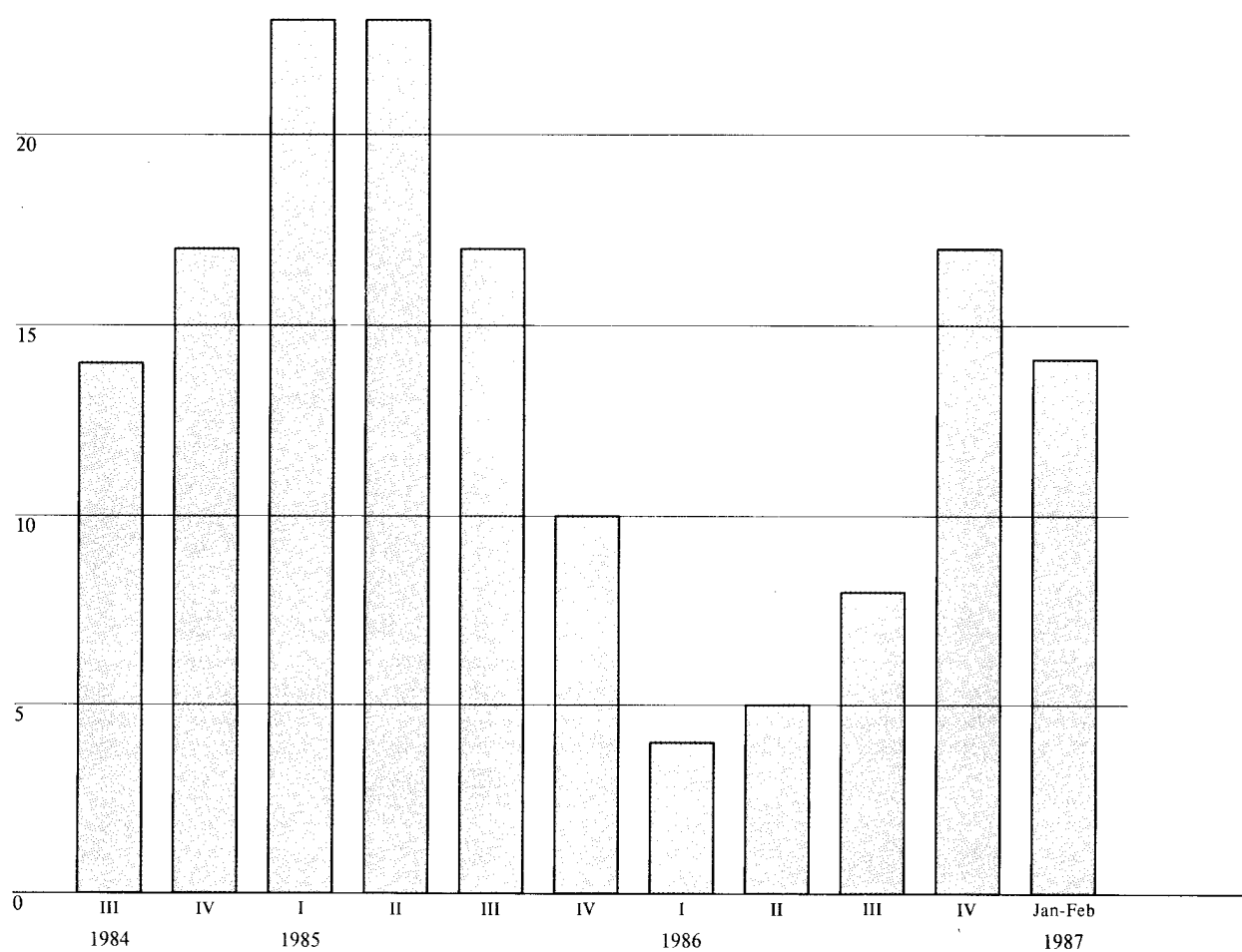
Wang Bingqian echoed Song's concern about deficits in his presentation of the draft 1987 budget, noting that China, which enjoyed an \$880 million surplus in 1985, suffered a \$1.9 billion deficit in 1986. According to Wang, the leadership had expected a balanced budget, but even midyear indications that a deficit was possible did not allow Beijing time to implement measures that might have kept the budget in balance.

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Figure 1
China: Growth in Industrial Output by Quarter,
in Annualized Percentage Rate

Percent
25



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Wang also noted the rise in foreign borrowing--to triple its level in early 1985--and announced that borrowing would double again in 1987. Although China's indebtedness is still relatively low for a developing country, the increase in foreign borrowing and the drop in foreign exchange reserves (figure 2), are, we suspect, a source of concern for the leadership.

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Economic Performance in 1986--a Statistical Summary

National Income	779.0 Billion Yuan	Up 7.4%
Agricultural Output Value	394.7 Billion Yuan	Up 3.5%
Grain Production	391.1 Million Tons	Up 3.2%
Cotton	3.5 Million Tons	Down 14.6%
Industrial Output Value	1,115.7 Billion Yuan	Up 11.1%
-Light Industry	532.4 Billion Yuan	Up 12.7%
-Heavy Industry	583.3 Billion Yuan	Up 9.6%
-Steel	52.1 Million Tons	Up 11.2%
Total Investment	296.7 Billion Yuan	Up 16.7%
General Retail Price Index		Up 6.0%
Urban Workers Cost-of-Living Index		Up 7.0%
Total Trade	73.8 Billion US\$	Up 15.1%
-Imports	42.9 Billion US\$	Up 1.6%
-Exports	30.9 Billion US\$	Up 13.1%
Trade Deficit	12.0 Billion US\$	Down 24%
Average Annual Cash Wage	1,332 Yuan	Up 16.0%
-After inflation		Up 8.4%

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The Policy Response and Its Impact

Beijing's agenda for coping with economic difficulties in 1987 reflects the retrenchment in the reform program, although many aspects of the program, including opening to the West, will continue. Priority will be given to increasing enterprise efficiency--which enjoys widespread support--rather than riskier and more innovative reform initiatives. At the same time, however, the leadership projects a \$2.16 billion deficit--up 14 percent from 1986--as it tries to minimize the potential for worker unrest and finance subsidies and investments in critical areas.

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Figure 2
China: Foreign Exchange Holdings

Billion dollars
 25

20

15

10

5

0

S O N D J F M A M J J^a A S O N D J F M A M J J A S
 1984 1985 1986

Total foreign exchange holdings

Bank of China holdings

State balance

^a From July 1985, Bank of China totals include Chinese holdings of foreign government securities, such as US Government Treasury bills.

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Specific Targets for 1987

Song Ping's speech included specific targets for various sectors of the economy:

Agriculture

- Grain output of 400 to 405 million metric tons, up about 3 percent, equalling 1984's record output.
- Overall growth in agriculture of 4 percent.
- State investment in agriculture up 670 million yuan to 2.4 billion yuan.

Industry

- Overall industrial growth of 7 percent.
- Updating 20 percent of China's light industry product line.

Living Standards

- Enforcing family planning guidelines.
- Increasing worker wages by 14 billion yuan, or 8.4 percent, to 180 billion yuan.
- Retail sales to rise 12.1 percent, to 555 billion yuan.
- Inflation lower than 1986 level of 6 percent.

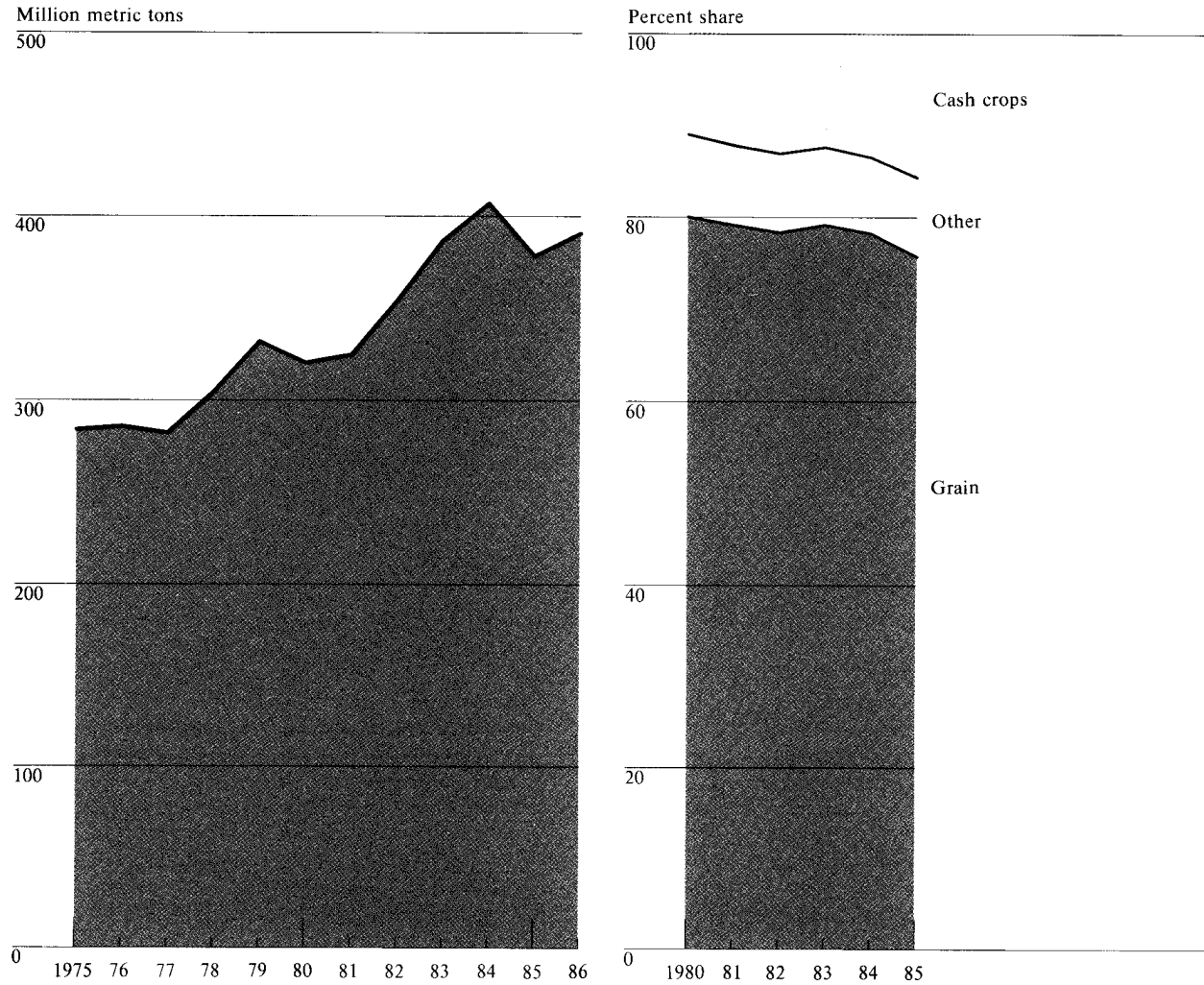
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We suspect Beijing's policy mix for 1987 is likely to fall short of the mark. In our view, the problems are worse than the speeches admit, and probably will not improve significantly this year. Specifically, we do not expect the policies enumerated in March to be sufficient to effectively cope with the budget deficit, inflation, and grain shortfalls. Indeed, measures designed to ease financial concerns among workers and factory managers will, we believe, only add to Beijing's woes by increasing expenditures for price subsidies and bailouts of floundering enterprises.

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Figure 3
China: Grain Production and Shares of Sown Area



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Budget Deficits

Beijing's budget deficit in 1987 may well exceed projections:

- The leadership's control of expenditures is inadequate. Expenditures last year ran 7 percent over budget, largely because of excessive capital construction--despite Beijing's toughest effort in years to slash investments. The policies designed to cut construction this year--review of existing projects, cancellations and postponements of nonpriority items--have already been in force for several months with limited success.
- Based on past performance, the leadership's projections of at least some budget components are unrealistic. For example, the \$2.16 billion deficit estimated for 1987 assumes no growth in capital construction--overly optimistic in light of Beijing's poor record controlling spending last year. We also suspect that planned reductions totaling almost \$1 billion in renovation expenses and government administrative expenses are unlikely.

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Moreover, the true size of the budget deficit is masked by Chinese bookkeeping procedures. By western calculations, China's deficit last year was \$3.9 billion, not \$1.9 billion and this year the deficit would rise 58 percent to \$6.16 billion. The Chinese, however, count foreign borrowing as revenue in the budget; when Beijing doubles its borrowing abroad this year, it will lower the deficit a corresponding amount, showing only a 14 percent rise. Likewise, bonds issued domestically--such as a planned 10 billion yuan issue this year to finance priority capital construction projects--are considered revenue, and reduce the deficit even while they increase indebtedness.

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Grain Production

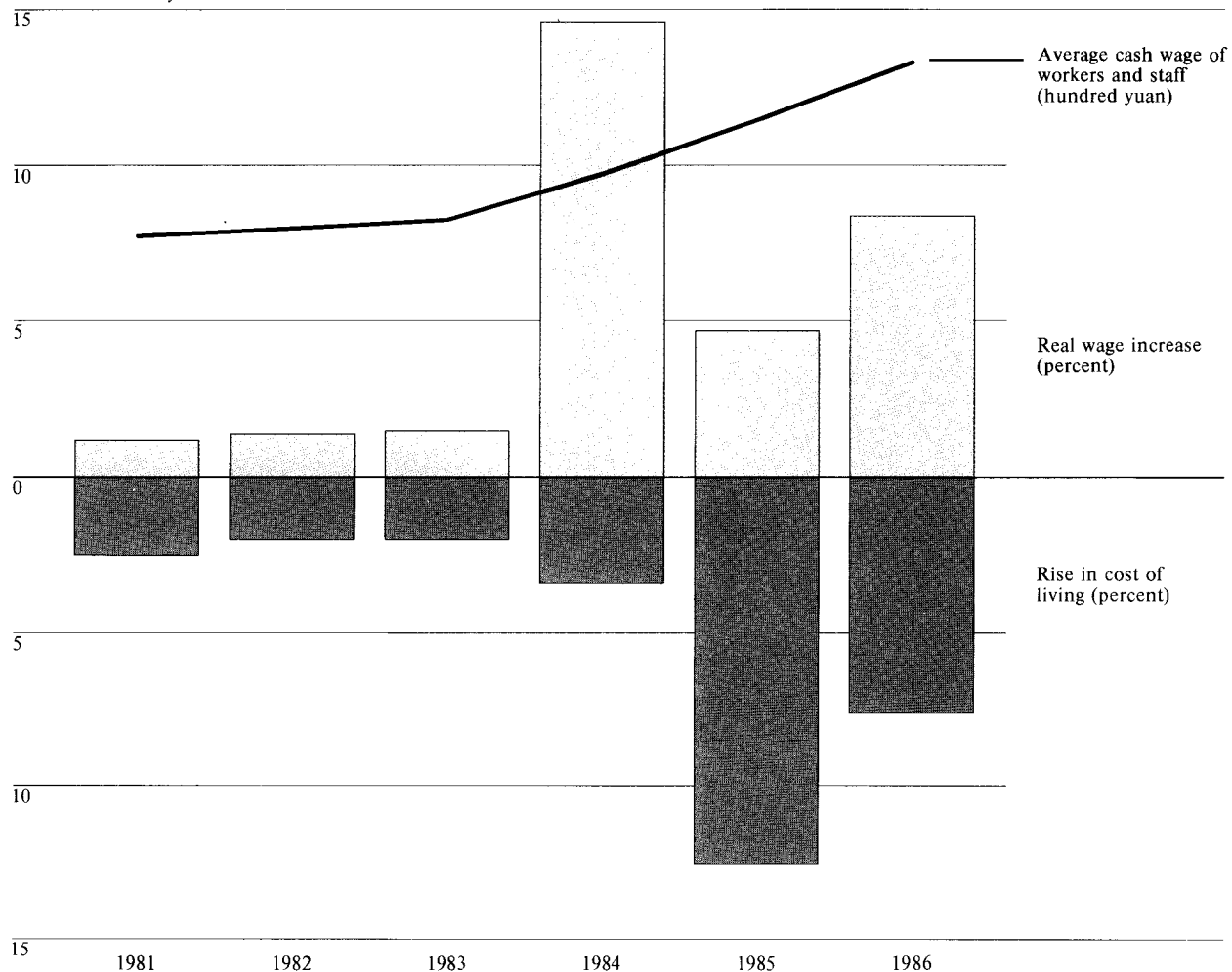
Beijing's call for grain production equal to 1984's record output depends, according to Vice Premier Tian Jiyan, on the "mercy of heaven"; indeed, we believe it out of reach because of poor weather this winter--including drought in many prime agricultural areas that will affect both summer and fall harvests--and a downward trend in sown acreage devoted to grain (figure 3). Because of the weather, incentives such as priority access to loans, fertilizer, and diesel fuel in exchange for grain output commitments may have little effect on actual grain production levels.

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Figure 4
Wage Increases for China's Workers:
Inflation vs. Real Wage Gains

Percent/hundred yuan



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Worker Incomes

Beijing's strategy for keeping a lid on inflation is to keep the growth in worker incomes below growth in worker productivity. Following 20-percent growth in wages in 1986, the Chinese hope to limit the increase this year to 8 percent, and thus about 2 percent after inflation. Given poor central control over factory allocation of worker bonuses, we believe a slowdown in the growth of wages may prove unachievable (figure 4). Even if Beijing succeeds, however, it has already announced plans to give with one hand what it holds back with the other: Wang Bingqian's announcement of intentions to increase price subsidies by 39 percent may cool worker dissatisfaction, but will also add to inflationary pressure by propping up workers' disposable incomes.

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Poor Results Overall

Of the four areas Song Ping emphasized for attacking China's economic problems in 1987, we believe the leadership strategy will prove ineffective in controlling either capital construction or worker incomes. Moreover, the lack of specific directives for industrial enterprises seeking to improve efficiency will work against significant improvements in productivity or tax revenues. Beijing can probably do a better job of directing imports to priority sectors, but success in this area will not make up for failures elsewhere.

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The ability of the conservatives to capitalize on these problems will depend on how well the economy performs. The leadership has deflated the budget issue somewhat by forecasting a larger deficit this year. Should the deficit or inflation prove an even greater problem than the leadership expects, however, we may see a renewal of conservative repudiation of market techniques and stronger calls for recentralization of control over bank loans, factory profits, and worker bonuses.

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Implications for the United States

Differences in Beijing over the direction of economic policy will probably complicate existing problems in Sino-US economic relations, rather than create new ones. Conservative attacks on reform policy could focus on such ongoing concerns as encouragement of foreign investment, membership in GATT, interest in foreign technology, and even promotion of study abroad.

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Although press articles and Embassy reporting thus far in 1987 indicate that reformers and conservatives alike realize the need for an "open door" policy in China's modernization, reformers are concerned that recent political events will lead investors to conclude that China's investment climate is unstable. The current debates, moreover, will, at least in the short term, make it difficult to offer new incentives to foreign investors. Without improvements in the investment climate, US firms--whose investments so far have been largely limited to offshore oil exploration and coal mining--will, we believe, remain cautious.

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We expect, moreover, that pressure from conservatives to correct bilateral trade deficits may aggravate existing friction with the United States over protectionism and other issues relating to China's balance of trade. Beijing's difficulties in joining GATT will be compounded by stalling on price reforms--China needs to improve its internal pricing mechanism to be able to prove its participation will be consistent with GATT organizational guidelines. [REDACTED]

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Because the US-China Joint Commission on Commerce and Trade (JCCT) meetings in Beijing closely follow the NPC, we expect US participants to hear carefully orchestrated assurances that China will maintain its open door policy, in keeping with Zhao's March speech. From Embassy reporting following meetings with various Chinese officials, however, we have noted an array of opinions regarding the strength or weakness of specific reform policies or of reforms in general. Therefore, we expect Chinese participants in various JCCT working groups to continue providing contradictory views on the pace and direction of China's economic reforms, they may be unwilling to discuss specifics. [REDACTED]

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