CHINESE ECONOMIC REFORM FROM 1979 TO 1989: FROM THE DEATH OF MAO TO TIANANMEN

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It is impossible to properly understand the Chinese economy today without first understanding its history. Tomás Campbell provides an excellent account of Chinese economic reforms after the death of Chairman Mao, giving a context for China's economic performance today.

Introduction

In May 1977 death hung over Tiananmen Square. The Mausoleum of Mao Zedong had just been completed and inside the man himself, founding father of the People's Republic of China and its leader for a quarter-century, lay in a coffin of crystal. His death and the subsequent arrest of the Gang of Four, including his wife, ushered in a new era for the Chinese economy, with reformers seizing control of the Communist Party of China (CPC) and changing its ideology from the one of class struggle, which had been apparent during the Cultural Revolution, to one of economic development (Xu, 2011). This ideological shift was consolidated in the Third Plenum of the 11th CPC Central Committee in December 1978 with the adoption of the policy gaige kaifang – literally 'reform and opening up' (Zhu, 2012). In practice, these reforms amounted to the 'four modernisations', namely: the decentralisation of economic administration; the adoption of market mechanisms; the wider use of indirect, economic tools rather than administrative commands; and, the partial liberalisation of private business activity (Imai, 1985). There is no historical precedent for what followed. In 1978 Chinese GDP was 13.6 per cent that of the USA, by 1990 that figure had doubled to 27.9 per cent; by 2004 it stood at 64 per cent and by 2016 the Chinese economy is forecast to be the largest in the world (Brandt and Rawski, 2008). This paper seeks to explain the role that monetary policy played in this remarkable transformation during the early years of reform, from 1979 to 1989, predominately through discussion of the banking sector's development, while also giving consideration to the impact of the opening of the economy to foreign capital and the reform of the price system.

Reform of the Banking System

From 1950 until 1978 China's financial system consisted of a solitary bank, the People's Bank of China (PBOC), which was central government-owned and controlled under the Ministry of Finance (Allen et al., 2008). It simultaneously acted as a commercial bank, a savings bank, and the central bank, virtually single-handedly administering the entire banking system (Imai, 1985). Its primary function was to support the physical production plans drawn up by the government, and to this end, it formulated cash and credit plans to control cash flows in consumer markets and transfer flows between its local branches (Allen et al., 2008), ensuring there was adequate credit and currency in the economy to fulfil production schedules while holding prices stable (Imai, 1985). Credit was virtually non-existent outside of the enterprise sector (De Wulf and Goldsbrough, 1986) for fear that any growth in the currency in circulation would increase demand and bring about inflation (Imai, 1985). Before reform, monetary policy served no allocative function in China (Feltenstein and Farhadian, 1987).

With the aim of turning the PBOC into a separate central bank, a major process of banking system decentralisation commenced in February 1979 with the reestablishment of the Agricultural Bank of China (ABC) (Imai, 1985), a specialised bank operating, unsurprisingly, in the agricultural sector of the economy. In April of the same year the State Administration of Exchange Control assumed responsibility for administering foreign exchange functions, and by October the China International Trust and Investment Corporation had been set up to channel foreign funds into domestic projects. The China Investment Bank, established in 1981, would serve a similar purpose (ibid.).

By the end of 1979 the PBOC had departed the Ministry of Finance and become an independent entity (Allen, 2008), and in 1980 local branches were given greater autonomy. Their key target became the difference between the level of deposits and the level of credit outstanding, which allowed branches that attracted more deposits to extend more credit rather than remitting their surpluses to a higher level of the bank. Furthermore, because a large portion of credit expansion would return to the same bank in the form of further increased deposits, multiple expansions of credit could come from an initial increase in deposit holdings (De Wulf and Goldsbrough, 1986).

The final step in the PBOC's establishment as an independent central bank came in January 1984 with the formation of the Industrial and Commercial Bank of China, which took charge of the PBOC's remaining commercial operations (Imai, 1985). At the same time, specialised banks operating in specific sectors, such as the ABC, were allowed to transfer funds between their branches in different regions in response to credit demand (De Wulf and Goldsbrough, 1986). Furthermore, in 1986 two universal banks were allowed to compete with the specialised banks in all areas of activity, and a number of new banks were formed at local and provincial level; the competition bringing with it further efficiency improvements (Bléjer et al., 1991).

Alongside its decentralisation, the banking system became the major source of enterprise funding during this period, credit supplanting budgetary grants. By 1984 60 per cent of investment was being financed through credit, that is to say, outside the state budget, up from 35 per cent in 1979 (De Wulf and Goldsbrough, 1986). Specialised banks took advantage of their new authority as financial intermediaries by selecting loan items which promised large economic returns (Imai, 1985), though it is worth noting that due to the distortionary effects of the price system, profitability was not always a reliable indicator of a project's costs and benefits to society (De Wulf and Goldsbrough, 1986). Nevertheless, the efficiency of the use of funds was somewhat improved. Another factor to bear in mind is that during the early days of banking reform the boundary between the political and economic spheres was rather permeable, and provincial government officials often applied pressure on local bank branches to provide loans that suited their political agenda in one way or another (Bléjer et al., 1991). Finally, and again because the price system prevented the efficient working of interest rates, preferential borrowing rates were given to high-priority sectors starting in 1981 (Feltenstein and Farhadian, 1987; Imai, 1985).

As credit began to proliferate through the economy, the PBOC began to control credit expansion by more indirect instruments such as reserve requirements and interest rates (ibid.). As discussed above, interest rates were not as effective a tool as they might be due to the price system, while reserve requirements were set at extremely high levels – up to 40 per cent in the case of savings deposits (Imai, 1985). Administrative commands had not gone away, however, and credit ceilings remained in place, though they were not always rigidly enforced and at times were significantly overshot. They would, however, be reemphasised during periods of monetary tightening. During such times credit would go to priority areas first, a euphemism for state enterprises, so it was predominately non-state entities, which had started to emerge with the reforms, that bore the brunt of credit contraction (Bléjer et al., 1991).

Given the rapid expansion of credit and China's inexperience operating the tools to moderate it, it is perhaps no surprise that inflation started to become a serious issue in a nation that had lived for decades under a fixed-price regime. From 1978 to 1984 the broad money supply increased by 268 per cent, while inflation across the same period was a mere 20 per cent, if official figures are to be believed. Inevitably, this led to enormous pressure on demand – people had much more money to spend while prices had increased only marginally – which found some relief in a rapidly deteriorating trade balance, the current account deficit increasing from 2 billion yuan in 1978 to 24 billion yuan in 1985, but not enough to stave off inflation (Feltenstein and Farhadian, 1987).

To understand exactly how Chinese monetary officials attempted to combat the emerging problem of inflation, it is useful to look at their response to a specific inflationary episode. In 1979 and 1980 inflation started from large and unexpected budgetary deficits, 17.1 billion yuan in the first year and 12.8 billion yuan in the second. These deficits were primarily the consequence of reform measures aimed at improving living standards, such as wage increases, the state paying higher prices for agricultural goods and reductions in taxes. Both deficits were primarily financed by borrowing from the PBOC in the form of overdrafts, 9 billion yuan in 1979 and 8 billion yuan in 1980. Adding further inflationary potential, the rest of the 1979 deficit was paid for by spending 8 billion yuan in accumulated past surpluses (Imai, 1985).

In order to combat inflation, credit ceilings were more stringently enforced and the savings rate was increased three times, in the Aprils of 1979, 1980 and 1982, in the hope of curbing sharp rises in demand for consumer goods (ibid.). More significantly, 1981 saw the introduction of treasury bonds. For the first issue, state-owned firms and collectives were forced to buy up a certain quota of the bonds based on their profits from the previous year, so it was essentially a form of enforced saving (De Wulf and Goldsbrough, 1986). The following year, however, eligibility to purchase treasury bonds expanded to include private individuals, and from 1982 to 1984 about half of the annual bond issue of 4 billion yuan was bought up by households, who were strongly motivated, no doubt, by the generosity of their return – 9% in 1985. Also by 1985, the value of the issue had risen to 6 billion yuan and treasury bonds had begun to serve an increasingly important role not only as a means to fight inflation but also as a source of government funding (ibid.). Reflecting this, in 1987 the government began to issue bonds whose proceeds were earmarked for capital spending in priority areas (Bléjer et al., 1991).

As a side note, nongovernment financial assets were virtually non-existent at this time. Starting in 1985, enterprises were allowed to issue bonds to fund investment but their high yields made them an attractive alternative to traditional saving and caused a savings outflow, which proved their undoing. In order to curb this deposits flight, enterprises were subsequently required to obtain PBOC permission before a bond issuance could be held (ibid.).

Throughout the early period of reform, monetary policy was never under tight control. This can perhaps be seen most clearly by the rapid growth in money supply in early 1985, which came in response to increased demand from enterprises after they had been awarded greater autonomy over their affairs, directing their own investment and awarding bonuses for the first time. By the middle of the year this surge in the money supply was beginning to fuel inflation so the PBOC tightened policy, predominately through stricter credit ceilings. However, concerns arose that tight policy was causing economic slowdown and easy policy soon made its return, growth in broad money supply standing at about 30 per cent for most of 1987 and 1988 (ibid.). On one level, these rapid vacillations in policy could be viewed simply as the result of bank managers gradually becoming familiar with their new monetary tools (De Wulf and Goldsbrough, 1986), but, on a deeper level, they also reflected a fundamental debate within the CPC hierarchy about whether price stability should be prioritised at the cost of slower growth, or if growth should be pursued as rapidly as possible no matter how high inflation might become (Bléjer et al., 1991). It was a debate that would take until the end of the decade to be settled.

The Role of Foreign Capital

It was not just economic power that was decentralised during the reforms; political power was increasingly delegated to the regions to direct their own affairs. Indeed, the Chinese use the term fangquan rangli when referring to the early reform period, which roughly translates as 'decentralisation of authority and retention of profits', highlighting the importance with which the devolution process is regarded (Naughton, 2008). Competition between the regions was encouraged, with local governments keen to develop faster than their neighbours due to the fact that rankings of regional performance were a key element in the promotion prospects of a subnational government official. Career aspirations aside, the increased autonomy of local government was a source of incentive in itself (Xu, 2011).

As a consequence of regional competition, and in a clear break from its insular past, starting in 1978 China began to pursue foreign capital by opening its economy up for foreign investment and borrowing (Bléjer et al., 1991). Today China holds the largest reserves of foreign exchange in the world, by a considerable margin, and is one of the biggest recipients of foreign direct investment; in 1978 it had negligible reserves and virtually no foreign investment (Xu, 2011). The pace and scale of the transformation is staggering.

The transformation finds its origins in regional economic competition, specifically the establishment of Special Economic Zones (SEZs) for foreign investment in 1980. Foreign direct investment was initially restricted to these SEZs, with their preferential tax rates and tariff regimes, which only permitted certain types of activity within them, typically as joint ventures with the Chinese government. They were a controversial innovation at first, many within the CPC opposed to them on ideological grounds, but proved to be hugely successful, and in 1984 the scheme was rolled out more widely in response to fervent demand from local officials for SEZs to be developed within their regions (Bléjer et al., 1991). Interestingly, much of the early success of the SEZs can be ascribed to the marriage of low-cost Chinese venues and labour with the market knowledge and entrepreneurial experience of ethnic Chinese investors from Hong Kong and Taiwan (Brandt and Rawski, 2008).

The Overhaul of Fixed Pricing

One final shift in monetary policy in the early reform period worth discussion is the evolution of the pricing regime. Prior to reform almost all prices were controlled by the state and infrequently adjusted, so they reflected neither relative scarcities nor prices on international markets (Bléjer et al., 1991). Prices could often be years outdated and by

1983, due to rising input costs, subsidies had come to represent 20 per cent of all government expenditure (Feltenstein and Farhadian, 1987). The system of dual-pricing, introduced under the reforms to increase economic efficiency, brought market forces into the lives of Chinese households and businesses for the first time in a generation, while managing to avoid the political problems associated with privatisation (which threatens livelihoods) and full price liberalisation (which would require an end to subsidies) (Brandt and Rawski, 2008).

Perhaps unsurprisingly given the recurring food shortages of the pre-reform period, and also reflecting the cautious and incremental nature of reform, dual-pricing was originally an experiment limited to agriculture. Essentially, farming households were given grain quotas which they had to sell to the government at official prices. If they produced in excess of their quota, however, they were free to sell the remainder at market prices (Zhu, 2012). With this fresh incentive to be productive, agricultural output increased by 47 per cent from 1978 to 1984, while the share of the labour force involved in agriculture actually declined drastically during the same period from 69 per cent to 50 per cent, a massive reallocation of 49 million workers into other sectors of the economy (ibid.). Bearing in mind that average labour productivity was about six times higher in non-agricultural sectors than in agriculture at this time, it is little wonder that many identify the reform of agricultural goods pricing as the single most important driver of Chinese growth from 1979 to 1989 (ibid.).

Encouraged by the scheme's success in rural areas, officials extended dual-pricing to cover a wider range of products in 1984. Furthermore, for the first time prices of some products were allowed to be freely determined, while yet more could vary within official boundaries, so-called 'guided' prices (Bléjer et al., 1991).

In addition to enterprises now being able to sell their above-quota output at market prices, a new system of taxation was introduced in 1983 which saw them pay 80 per cent of their earnings, with whatever after-tax profit that remained retained for investment and workers bonuses (Imai, 1985). Replacing the previous system of full remittance of profits to the government, this system better aligned the interests of workers and owners, i.e., the Chinese state (Li, 1997). Prior to this, there had been effectively no link between individual productivity and remuneration (Bléjer et al., 1991).

Overall, from 1978 to 1988, the share of goods subject to mandatory pricing fell from two-thirds to one-third, and the remaining controls were reflected by production bottlenecks in areas such as energy and transport (ibid.). Following the inflation surge of 1987 to 1989 there was some retrenchment of price reforms as authorities tried to bring it down by tightening administrative controls (ibid.), but the overall picture in the first decade of reform was one of diminishing central price setting and gradual introduction of market-based signals.

Concluding Remarks

On the evening of 4 June 1989 death once again hung over Tiananmen Square, this time in the guise of hundreds of dead students gunned down by the military. None of them would be buried in crystal coffins. From 1979 to 1989, the programme of economic reform brought scarcely credible growth to the Chinese economy, but it also brought with it high levels of public corruption and several periods of rampant and sustained inflation. These were two of the things the students had taken to Tiananmen Square to protest about. The CPC had found what Friedrich Hayek had predicted, that central planning and individual liberty cannot go hand in hand (Hayek, 2005), and soon after the protests General Secretary Zhao Ziyang, his top advisors and the economic leadership were purged and replaced, though the general direction of policy remained stable (Naughton, 2008). One question had been settled, though: henceforth, the PBOC would prioritise price stability over economic growth (Bléjer et al., 1991).

Reform of monetary policy played a huge role in China's growth in the 1980s, most significantly with the overhaul of the banking system, but also with inflows of foreign investment and reserves, and the reformation of the price system. Market-orientated reforms in the 1980s were slow and cautious experiments, tried on small scales before being expanded or abandoned, painstaking, incremental steps that would occasionally be reversed, and this is still how market-based reform progresses in China today, some 25 years later. When the process of reform was just beginning, reformist leader Chen Yun compared the Chinese economy to a caged bird, the cage serving as a metaphor for the central plan. By expanding the size of the cage you improve the bird's capacity for flight (Brandt and Rawski, 2008). It is an image that neatly captures the essence of Chinese economic reform, its gradual introduction of market-based mechanisms. Today, nearly four decades on from when reform began, the Chinese cage stands on the cusp of being the biggest of all.

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