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ECONOMIC REFORM AND THE OPENING OF THE CHINESE ECONOMY TO INTERNATIONAL TRADE AND FINANCE

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I. Introduction: Patterns of growth, trade and finance

The expansion of China's participation in international trade, since the beginnings of the reform movement in 1978, has been one of the most remarkable features of its remarkable transformation. It would have been plausible to have expected in 1978 that there would be a strong overall response to reforms that provided significant incentives for increased efficiency in production and new investment. It would have required unusual prescience to have predicted the 9 per cent average annual rate of growth of GNP that has been achieved. Chart 1, presenting the levels and annual growth rates in GNP from 1951 to 1993, shows a highly uneven, sawtooth pattern of growth before 1978, with the big declines in 1960 and 1961 associated with the Great Leap Forward and the effects of the Cultural Revolution in 1967 and 1968. As the Cultural Revolution faded and the economic reforms began, the growth rates rose and became less variable.\(^1\) However, Chart 1 also shows the higher inflation rates associated with the post-reform growth.

It would have been even more difficult to foresee in 1978 the subsequent dynamics of China's foreign trade. While GNP was growing at the 9 per cent rate from 1978 to 1994, exports grew at a rate of about 14 per cent and imports grew only slightly.

\(^1\) The levels and growth rates before 1978 were based on estimated, "National Income," which includes only material product. After 1978, the growth rates are based on GNP estimates.
slower at the average rate of 13 per cent per year. The annual growth rates of exports and imports are shown in Chart 2. They are obviously much more variable than the GNP growth rates. While the variability persists after 1978, export growth was monotonic and only once, in 1982, was there a year-to-year decline in imports.

Chart 3, which provides quarterly detail on foreign trade and the trade balance, also shows clearly that, although the growth in trade has been impressive, the course has not been a smooth one. In the late 1980's, China's trade balance passed through a difficult period, but the problems did not spin out of control. Again in 1993, there were large deficits, which were quickly and strongly corrected. In 1994 and currently China is building up large foreign exchange reserves.

These results are so extraordinary as to generate a natural skepticism, which is nourished by the lack of a detailed description of national accounting methodology in China and unavailability of crucial details. Nonetheless, if the achievements are only two-thirds or three-quarters of the official numbers, they would still be astonishing.

The successes contradict several customary generalizations about transition economies and large developing countries, for example: that the transition from central planning to market orientation cannot be made without first passing through a difficult period of economic disorganization and, perhaps,
decline, that very large economies have so much inertia that they cannot transform themselves and grow rapidly, and that the share of international trade in very large economies cannot grow quickly due to the difficulties of penetrating foreign markets on a large scale. They are, therefore, worthy of close examination, of which this paper is only a beginning.

There are serious obstacles to the explanation of economic policies and events in China. While there has been public commentary on current economic issues, there has been no public debate by policymakers or extensive domestic analysis of alternative policies. In addition, the publicly available data are limited, both with respect to coverage and periodicity. For example, there are annual, but not quarterly estimates of the major components of the national income and trade and payments accounts. Other useful information, for example with respect to the volumes of trade at different exchange rates, when there were multiple rates, is not available.

Yet the major features of China's trade and payments policies can be discerned, even if robust quantitative behavioral relations cannot always be estimated. The first step in the process of explanation will be to provide a brief overview of Chinese international trade and payments policies from the successful Communist revolution to the beginning of the economic reform process in the late 1970's. The object is not simply to provide historical background. That is available in
Source: World Bank

GROWTH RATES OF GNP AND ITS COMPONENTS, 1979-1992

Year
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992

Percent
-5.00
0.00
5.00
10.00
15.00
20.00
25.00

- Real GNP Growth
- Agriculture
- Industry
- Services
several excellent surveys.\textsuperscript{2} Rather, this brief review is intended to help demonstrate that the approach to managing foreign trade that was followed in the first thirty years of the People's Republic of China has shaped subsequent decisions in important ways.

The trade and payments policies followed in the economic reform period beginning in the late 1970's will then be taken up. It will be argued that the direct controls that were initially employed, which were an inheritance of the pre-reform period, were an inadequate set of tools in the new environment. Subsequently, the direct controls have been augmented, though not fully replaced by exchange rate policies. Macroeconomic policies have also had a role, although it will not be possible to determine the extent to which their use has been motivated by international payments exigencies.

II. Pre-reform international trade and payments policies

After the success of the Communist revolution and the founding of the People's Republic of China, its international economic policies were dominated for at least thirty years by the goal of self-reliance. While this was never interpreted as complete autarky, the aspiration for self-reliance profoundly shaped trade policy, especially with the market economies. In particular, it was thought that international prices, being

shaped by imperialist and monopolistic forces, should not be allowed to interfere with rational domestic economic planning.\(^3\)

The extreme control exercised over international trade with market economies was typified by the semi-annual Canton Trade Fairs. These provided virtually the only contacts by western businesses with Chinese trade officials.

China's foreign trade in the pre-reform period was a small part of the Chinese economy.\(^4\) It has been argued persuasively, however, that since trade was the source of critical capital equipment that formed the basis for much of China's growth through the middle 1960's, it played an important role. It also provided some raw materials that were unavailable in China.\(^5\)

Imports in the pre-reform period are conventionally described as having been concentrated in the, "four waves." The first wave is dated from 1956 to 1960, when average imports doubled, as compared to the previous four years. The imports were dominantly capital goods, particularly of complete plants,

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\(^3\) World Bank (1988), pp. 95-98. This is of some interest, in view of more recent argument that Chinese exports reflect its international comparative advantage.

\(^4\) See H. Harding (1987), p. 22. The interpretation of the trade/national income ratio is somewhat uncertain, since the national income concept used omits measures of services, that are considered unproductive in Marxist ideology and are not included in the net material product. In addition, the prices used in the estimates of all the components are arbitrary in relation to the real scarcity prices of the economic allocations.

from the former Soviet Union, but also from the centrally planned economies of Eastern Europe. They were financed by exports of consumer goods and minerals, as well as by Soviet credits. These imports dropped drastically following the deterioration of Chinese-Soviet relations and the abrupt withdrawal of Soviet technicians in 1960.6

Subsequently, after the disaster of the Great Leap Forward was recognized, there were large scale imports of foodgrains in 1961 and 1962, but total imports were at a much lower level than previously. Exports held up somewhat better, as China repaid its loans from the Soviet Union.

Capital equipment, again in the form of complete plants, dominated the brief second "wave", from 1964 to 1966, with Japan becoming the primary source. The end of this phase coincided with the beginning of the Cultural Revolution. The beginning of the next "wave" in 1973, was related to the waning of that eruption and was called the "four-three programme", related to the target of spending $4.3 billion over four years, again,

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6 Although a number of factors have contributed to the deterioration of Chinese-Soviet relations, it is not possible to assign relative importance to them. The factors usually mentioned include disagreements over sharing the burden of the Korean War, disagreement over the sharp policy change in the Great Leap Forward and the disregard of Soviet advice, competition in third countries and ideological differences. In any case, there was an abrupt withdrawal of Soviet technicians and Chinese imports from the Soviet Union dropped sharply; Chinese exports were reduced less drastically, as the Chinese debts were repaid and Chinese trade was re-oriented to capitalist economies.
primarily for capital equipment. The last "wave", in 1978, was short-lived, but unique in that it marked a first turning to the West for capital and technology.

The change in the direction of trade through these various waves and in the reform period are shown in Table 1. The abrupt drop in imports from the former Soviet Union in the early 1960's and subsequent growth in imports from Japan and the EEC is quite clear. The changes in exports are less abrupt as Chinese exports to the former Soviet Union were maintained for some years to repay the credits that had been extended.

It is clear, from various sources and the manner in which trade was determined, that trade policy was "import-driven", with export levels being determined by the import targets. Import and export targets for particular commodities and manufactured products were determined as part of the overall planning process by the State Planning Commission and the Ministry of Foreign Trade. The imports desired, of capital equipment and particular commodities, were quite specific, as were the export targets. The import and export targets were then handed to the twelve Foreign Trade Corporations (FTCs), that were established soon after the formation of the People's Republic and through which virtually all foreign trade was "canalized". These corporations were the sole participants

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(in millions of US dollars and in percent)

Table 1

Direction of Trade: 1960-1993

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<thead>
<tr>
<th>Year</th>
<th>US Value</th>
<th>%</th>
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allowed in international trade and acted to sell the exports and buy the imports in types and quantities specified by the plan, although, over time the FTCs came to have some leeway with respect to export composition.

Although the imports targeted by the PRC were quite specific, the "airlock" imposed between foreign suppliers and domestic users appear to have worked against their efficient procurement. There are reports of significant inefficiencies and incompatibilities arising due to the lack of direct contact between suppliers and users.⁸

It is also interesting, in view of the role of Hong Kong in China's trade after 1978, that Hong Kong always had a significant presence in China's trade. Yet after having a major role in channeling imports into China in the early 1950's, Hong Kong's importance in China's trade declined drastically until the reform period began.

Since domestic prices were distorted and government subsidies covered the deficits of the FTCs, there is no reason to believe that the composition of imports or exports was determined by domestic comparative advantage as revealed by prices. In effect, although for somewhat different reasons than those of other developing countries, China followed an intensive import substitution policy, which was intensified by the U.S.

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embargo imposed after the Korean War. In the early 1950's foodstuffs and tobacco were by far the most important components of exports, with the textile shares in exports growing slowly in this period. In the agricultural disaster of the late 1950's and after, the exports of foodstuffs declined and textiles and footwear took over the leading role.

The FTCs were required to buy goods for export and to sell imported goods at domestic prices. Import and export values were, of course, determined at international prices. The yuan was, by general consensus, overvalued for much of the pre-reform period. When foreign prices were converted into domestic prices, the revenues from exports did not offset the costs of imports in yuan. The difference was covered by government subsidies to the FTCs at levels that implemented the import targets.

As a result between 1948 and 1978 the foreign exchange rate played no role in equalizing demands and supplies of foreign exchange. The balancing mechanism in the foreign trading process was government subsidies. Since exports were import driven and the government subsidies covered any shortfalls, there was never an apparent balance of payments crisis in the pre-reform days. Yet there are no official data on reserves before 1977, so one cannot be sure.

III. An Overview of the economic reforms since 1978

A great deal has been written about the economic reforms in
China, so that it is neither necessary or appropriate to give a detailed description of those reforms here. Yet a brief summary will provide a useful reference. There was discussion of economic reform in the early 1970's, even before the death of Mao Tse Tung and the arrest of the Gang of Four, but political uncertainties impeded any substantial changes. The changes began, however, as the Cultural Revolution came to a unambiguous end. With the ascendancy of Deng Xiaopeng a relatively clear and consistent line emerged, which, though sometimes questioned and modified, has never been reversed.

Perhaps it was necessarily so, that the initial major reform was in the agricultural sector, but in the manner in which it happened it appears somewhat accidental. Provincial officials, trying to improve conditions in a lagging region, agreed to a departure from collectivized farming and to permit households to assume responsibility for the cultivation of particular plots of land. The households were allowed to retain the surpluses of their production above a required levy. The response to the incentives was immediate and very strong, so much so that the experiments were repeated and the "household responsibility system" was, subsequently, made into official policy.

A number of other important reforms were then instituted,

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often piecemeal, sometimes experimentally, and were extended if successful. A dual price system was created for a number of commodities, with a share of these goods being sold in uncontrolled markets and a share being transferred at official prices. The dual price system has been extended to more and more commodities and the number of commodities for which there is a commitment to an official price has been steadily reduced. It has been estimated that prices of about 65 per cent of goods were completely market-determined by 1993.10

Although the devolution of economic power to the provinces has been an important part of the reform program, this process started as early as the late 1950's and continued, with some reversals. Important new powers have been granted to these levels of government during the reform period and include the establishment of new enterprises and the undertaking of new public investments and extension of control over existing state owned enterprises (SOEs). To a considerable extent, the "decentralization" of decision making that has been accomplished is not the transfer of power to market mechanisms, but rather a shift of responsibilities from the central government to provincial governments. This, itself, was important, however, because the provincial governments have been more flexible, more experimental, and more susceptible than the central government

10 World Bank (1994b)
to economic pressures originating in markets.

While nothing as successful as the agricultural household responsibility has worked in the state industrial enterprises, a responsibility system was also created for most of these enterprises. These firms have also been allowed to retain profits above fixed levies. That has, however, not resulted in the elimination of inefficiencies and the SOEs continue to require large subsidies from government budgets. The most successful development in the manufacturing and service sectors have been the township and village enterprises (TVEs). They have grown from virtually nothing to currently account for an estimated 40 per cent or more of industrial production and, perhaps, an even more substantial portion of the service sector. The TVEs transact in uncontrolled markets with private firms, with private consumers, with other TVEs, with SOEs and in international markets.

All of this has been facilitated in the special economic zones that were created, in which central and, to a considerable degree, even provincial planning have been completely eliminated. In some of these zones there is virtually complete reliance on market mechanisms for resource allocation and production of goods and services.

In spite of the major reforms, important rigidities

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11 See Table 3 below.
and inefficiencies persist. For example, the housing, education and welfare privileges of the employees of state enterprises and government agencies remain attached to their workplace, rather than being provided universally by government institutions or through markets. This not only reduces labor mobility, it creates difficult obstacles to reform of the enterprises, since they serve as distribution mechanisms for these important services.

From 1978 to the present there have been four waves of expansion that have generated inflationary pressures, with approximate dating in 1981, 1985, 1988-9 and currently. In the first three cases, deflation via overall growth slowdown was effective, the recovery was quick and growth was resumed rapidly.\(^\text{12}\) The current inflationary surge appears to have not yet yielded to policy, for reasons that remain to be investigated.\(^\text{13}\)

China's foreign trade began to expand rapidly as the turmoil created by the Cultural Revolution dissipated and new leaders came to power. Though it was not done without controversy, the argument that opening of the economy to foreign trade was necessary to obtain new capital equipment and new

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\(^{13}\) In July of 1995 there seems to have been a slackening in the inflation rate, although the indicators are still tentative.
technology was made official policy. This proposition was, in fact, a feature both of the program of Deng Xiaopeng and of Hua Guofeng, whom he displaced. Exports grew rapidly in the 1970's, even before the major domestic economic reforms had started. Subsequently, participation in foreign trade has been facilitated. Exporting firms have been allowed to keep larger and larger shares of their foreign exchange earnings, which previously had to be sold to the Bank of China in entirety. Special tax benefits and relief from other regulations have also been used to encourage foreign investment. The purpose is not only to supplement domestic investment, but also to obtain new technologies and management skills, which, in a central proposition of the reform movement, are recognized as essential to economic progress. Table 2 shows the totals, types and sources of foreign investment. The dominant role of Hong Kong in direct investment is clear, but this may be somewhat misleading as investors from other countries may use Hong Kong as a base. Hong Kong is also much less important than other countries as a source of loans.

The foreign trade and investment reforms were extraordinary departures from Maoist orthodoxy and are conventionally explained as an ideological shift. However, they may also have been the result of short term pressures. From 1977, the first year for which the IMF publishes data on China's foreign reserves, to 1978, those reserves fell by more than one third
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Note: Citi data is not available.

Table 2

**Foreign Investment by Source**
and the ratio of imports to reserves fell by more than 50 per cent. These changes, presumably, were echoes of the internal disruption created by the Cultural Revolution. The facts were, of course, known to the Chinese leadership and must have been a source of serious concern. For purposes of comparison, in 1978, India's ratio of foreign exchange reserves to imports was almost six times the Chinese ratio.

IV. Foreign trade planning in the reform process

The changing scope and intensity

The creation of an "open door" policy did not mean the end of foreign trade planning. Although Chinese policy became committed to the expansion of its international trade, the decision making processes and international trade mechanisms of the pre-reform period continued in full force for several years, to a modified degree for several more years and still continue to be evident in the licensing controls. It is impossible to determine the coverage of these controls, so a precise contrast with domestic policy cannot be made. There are frequent announcements of controls on imports and foreign investment, recently, for example, in the automobile and steel sectors. However, there are similar announcements with respect to domestic investment in some sectors.

There have, nonetheless, been several major changes in the procedures established in 1978 and 1979: in 1984-85, in 1988 and
There have been several motivations in the planning of foreign trade. First, the composition of trade has been managed to secure the imports deemed necessary for domestic consumption and production and to ensure that exports not compete with domestic demand to the detriment of growth. Secondly, market power in particular exports has been used to influence prices. Finally, trade management has been used to attain the desired overall balance.

The continuation of foreign trade planning has meant that, until recently, at least, the practice was maintained of using domestic prices for the purchase by the FTCs of the goods bought for export and for imported goods they sold. It may, to some extent, still be true, as will be discussed below. This practice also meant that international prices have not been fully translated into the domestic economy and significant state subsidization in the foreign trade sector has continued, for some imports and some exports. At the same time, international transactions outside of the state planning system has been growing. Most obviously, enterprises created by foreign investors have been exempt from the foreign trade planning and control mechanisms, although subject to some restrictions on their transactions in foreign currency. In addition, substantial amounts of other types of trade, particularly the

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trade of the township and village enterprises and private firms, has been relatively free. The clearest evidence is the existence of the "swap" markets for foreign exchange, that were created to facilitate transactions between earners and users of foreign exchange. The FTCs have been participants in these markets, but, if the FTCs had been the sole trade mechanisms, the markets would not have been necessary.\footnote{15}

Starting in 1979 the branch offices of the old FTCs were allowed to operate independently and provincial and ministerial foreign trading corporations proliferated. In addition provinces and enterprises were allowed to retain part of their foreign exchange earnings. Nonetheless, it was still true in 1981 that the FTCs under the Ministry of Foreign Economic Relations and Trade (MOFERT) carried on 91 per cent of the export trade and 87 per cent of imports. These proportions declined as the foreign trade operations of the provincial and ministerial FTCs and individual enterprises expanded and by 1984 exports and imports handled by the FTCs under MOFERT hand declined to 79 per cent and 65 per cent of total trade, respectively.\footnote{16}

\footnote{15} It is understandable that government authorities are reluctant to be explicit about the scope of the planned trade, the relative importance of the FTCs and the amounts of the state subsidies they require. Such subsidies are likely to be inconsistent with the rules of GATT and the new World Trade Organization.

Major changes in foreign trade control policies were made in 1984 and 1985. Provincial governments were, in general, allowed to hold back 25 per cent of their foreign exchange earnings, with some provinces permitting a higher retention ratio to local firms. Enterprises, which had earned and retained foreign exchange, were, themselves, allowed to use half of that amount. A classification scheme for imports was published, distinguishing "restricted" and "unrestricted" imports. All of the former were under the control of MOFERT, but goods in the unrestricted category could be imported by FTCs in other ministries and at the provincial level, as well as by MOFERT's FTCs, without licensing requirements. The result of these changes was to reduce the importance of the foreign trade plan, but it still continued to be the major factor in foreign trade policy and practice.

In the planning process the various FTCs submitted to MOFERT estimates of the exports they would generate during the coming year. In a process of iterative review, these were made consistent with import plans. A distinction was made between "command" and "guidance" exports. On the import side, there were further distinctions between "command", "priority investment" and other "priority" imports and other imports that require licensing.

The "command plan" exports were specific with respect to physical quantities of the particular goods. There was
centralized allocation of particular inputs to producers, who were required to meet quotas for delivery to the designated FTCs for export. These mandatory exports have been estimated to have accounted for 60 per cent of total exports in 1986. With respect to exports under the guidance plan, targets were expressed in value terms and there was greater variety of practice. Yet in some provinces guidance plan exports were converted into command exports. There also appears to have been differences in practice among the provinces in the extent to which contracts were made at official prices or at international prices. In some sectors the FTCs financed export firms and procured goods at negotiated "internal" prices. This indicates the variety of commercial practices that began to flourish during the reform period and that existed side-by-side with relationships between official institutions and enterprise that antedated the reform period. Exports under the guidance plan are estimated to have been 20 per cent of total exports in 1986. In that year, twenty per cent of exports are estimated to have been "above plan". Those, presumably, reflect the buoyancy of the export system and the difficulties in harnessing it within the plan framework.

On the import side, seven types of raw materials remained under centralized control; these were the "command imports". "Priority investment projects" included centrally financed projects and imports of major and complete plants that received
central recognition. "Other priority imports" are described as being determined on an, "ad hoc," basis. These three categories of imports are estimated to account for 70 per cent of total imports. Planning for "other imports" consisted of general guidelines for licensing, with the convention of approval for imports for which financing is available.

The foreign trade planning process was, subsequently, supplemented, implemented by a system of duties and licenses for both exports and imports. Export licensing, introduced in 1980, has been used to manage the prices of primary commodities sold primarily in Hong Kong and Macao, again to exploit China's market power in these commodities in the two areas. Export taxes are also used for this purpose, as well as to limit the exports of goods for which there are domestic shortages. Import licensing is used to control expansion of production capacity for certain types of products beyond what is deemed economically or socially desirable, smuggling and imports of consumer luxuries. Import duties are applied to most goods both to raise revenue and as a means of domestic protection.

The 1988 reform reduced the importance of the foreign trade plan with respect to the composition of exports and imports. The coverage of both mandatory plan and priority plan exports was reduced, the former by about half, to 21 commodities, and the latter by about a quarter, from 120 to 91 commodities. However, foreign trade planning continued in a different
framework and with different instruments. A system of three year foreign trade contracts was introduced in which targets were established by MOFERT, the Ministry of Finance and the State Planning Commission for each of the provincial level administrative units and the national FTCs. These units then entered into agreements with MOFERT which, except for command imports, specified in value terms their export targets, the share of their foreign exchange earnings to be channeled to the central government and the central government's commitment to cover losses on export sales with subsidies.

Another major modification of the trading system occurred in 1991, when the contracts were converted to annual agreements and the terms of the contracts were to be developed in negotiations, based on proposals by provincial authorities and enterprises. Currently, while increasing amounts of trade are uncontrolled, a system of overlapping direct controls has evolved for some types of imports that continues the canalization and regulation through specific FTCs and licensing. Specific import controls were also used for protection of domestic industry. Of the 32 per cent of total imports subject to canalization in 1992, two thirds were mandatory imports and one-third in the other import category.\textsuperscript{17} General import licensing is managed by the Ministry of Foreign Trade and

\footnote{17 World Bank, (1994), p. 64.}
Economic Cooperation (MOFTEC), the successor to MOFERT. This licensing applied to about a quarter of total imports in 1992.\(^{18}\)

China's tariffs have become a sophisticated system of protection with rates that are among the highest among developing countries, but which are also distinguished by their relatively high variance, indicating the specificity of their targets. Tariff exemptions and exceptions are so extensive that tariff collections were only 5.6 per cent of the value of imports in 1991, although, in 1992, with roughly the same tariff rate, the trade weighted mean tariff was 31.9 per cent.\(^{19}\)

Overall, it is clear that for much of the period since reform, China has managed its foreign trade system actively, rather than leaving it to internal and external enterprise initiatives, although in the last 3 to 5 years the extent of that management seems to have declined. Since we do not know the degree of the government's commitments to its targets, it is impossible to know how successful the management has been. If targets have been missed, we cannot identify and give relative weights to the contributing factors. Without more information with respect to domestic supply conditions, it is impossible to know whether foreign trade created or avoided bottlenecks. Domestic prices do not give clear signals.


\(^{19}\) World Bank (1994), p. 56.
It has been argued that trade policy in China after 1979 was, "driven more by export possibilities than import requirements. It was a top-down process until 1979, but became more of a bottom-up process, with estimates of export availability and import needs made at the local level." This assessment suggests a mercantilist policy designed to accumulate foreign exchange reserves. While there have been periods of substantial reserve accumulation, these have usually been followed by reserve decumulation. There is, consequently, no long record, as, for example, in Japan and Taiwan, to support the diagnosis.

Without knowing details of the planning process, it is difficult to assign priorities to the either the export or the import plan. We do not know to what extent provincial authorities assigned priority to exports to earn foreign exchange in order to import or made import plans relying on central determined allocations of foreign exchange to make payments. In particular, it is hard to believe that the central authorities thought that the export plans of enterprises, which have relatively little knowledge of international economic conditions, foreign exchange rate pressures and domestic macroeconomic policy, would provide a secure basis for export projections and, therefore, for centrally determined import

policies.  

The breakdown of foreign trade management in the late 1980's  

The large trade deficits of the late 1980's are evidence that trade management system did not avoid very severe balance of payments difficulties in that period. Chart 4 supplements the previous evidence and shows that the ratio of China's non-gold international reserves to imports fell drastically from 1984 to 1985 and 1986, before they began to recover slowly. It has been asserted and is plausible that the trade deficits were, to some extent, the result of the intentional reduction of foreign exchange reserves. This was reinforced by the increased freedom that was given to provincial authorities to borrow abroad. However, the urgent actions in 1985 to reduce the deficits suggest strongly that intentional international reserve reduction cannot account fully for the very rapid increase in the trade deficits. What did go wrong then? Either imports grew more rapidly than expected or exports grew more slowly.

Chart 2 shows that imports, measured in yuan, more than doubled from 1984 to 1985.\textsuperscript{21} While part of this reflects yuan depreciation and inflation, it is clearly not a sustainable

\textsuperscript{21} There is a puzzle in the data for exports in the mid-1980's. As noted in the text, exports grew by 40 per cent in yuan terms as reported in the Chinese Statistical Yearbook and according to IMF statistics. However, the growth rate of exports measured in US dollars was about 5 per cent. Again, using IMF data, about 15 percentage points is due to depreciation of the yuan, leaving to price inflation a rate that seems on the high side.
Chart 4

Source: IMF

Graph: Ratio of Reserves to Imports, Percent

Year

1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993

0 10 20 30 40 50 60 70 80 90

Ratio of Reserves to Imports, Percent
pattern. To some degree the growth in imports reflects the expansion of the domestic economy, yet it is also true that, starting in 1985, there was a long term change in import ratios. Although the growth in imports virtually stopped in 1985 and 1986, import levels did not decline. The import/GDP ratio moved to a distinctly higher level and has not, subsequently, returned to the pre-1985 ratios. In fact, after some reduction of the trade deficits in 1987, they expanded rapidly again in 1988 and 1989, before being brought under control in 1991 and early 1992. Subsequently, in 1993 and 1994 imports have again risen rapidly.

Some more light is thrown on the matter by an examination of the composition of imports during the surge of 1985. While there was general growth, imports of three types grew much more rapidly than other types: tobacco, clothing and machinery. Tobacco imports are a small part of total imports, so their growth is not responsible for the big increase in the trade deficit. Still their growth is puzzling. These imports did not substitute for domestic tobacco, because, in the same year, its production also expanded strongly. It appears that the Chinese government simply made it possible for the population to begin smoking more.

It is somewhat easier to explain the growth in clothing imports and that growth does, in fact, help explain a puzzle. In the mid-1980's the Chinese people were changing their clothes rapidly: from the conventional blue jackets and trousers to
varied colorful individual attire. There was a small mystery as to how it was accomplished so quickly. The import numbers help clear this up.

It is the third category of machinery imports that is most revealing with respect to the sources of the breakdown of the foreign trade management system. These imports grew most rapidly in 1984 and 1985 and maintained their relative position in 1986. Machinery imports are not spur-of-the-moment decisions. Either as new capacity or replacement of old capacity, the use of new machinery requires planning which requires time. In addition, while some types of machinery can be purchased "off the shelf", much of it is built to order. Machinery is relatively heavy and shipment by air is expensive, so that, more than most other types of goods, it tends to be shipped by sea. All of this means that the rapid growth in machinery imports in 1985 should not have been a surprise.

It is also possible that the growth of exports was overestimated, since exports did grow more slowly from 1984 to 1985 than from 1983 to 1984. It seems implausible that the authorities would have accepted a projection of a roughly 60 per cent growth in exports in one year, from 1984 to 1985, which would have matched the actual increase in imports. Although the mid-1980's were a period of economic expansion in China's major markets, China's exports were becoming less attractive because of its domestic inflation. Alternatively, the use of resources
for domestic production and consumption in China became more attractive than exports. There is evidence for both of these explanations. As indicated in Chart 1, overall growth of real national income accelerated in 1985 to over 13 per cent from 10 per cent in 1984. Price inflation also accelerated to almost 12 per cent, as measured by the consumer price index, from 2.7 per cent in 1984.

It is most plausible that the extraordinary expansion of imports occurred as a result of the changes that were made in 1984 in the foreign trade management system that eliminated quantitative controls for about 35 per cent of imports.\(^\text{22}\) That contributed to the rapid expansion of imports, especially machinery imports, in 1985 and the consequent large deficits. This appears to be the kind of mistake that the system should have been most able to avoid. In this sense, therefore, the system failed. Moreover, the trade management system was not able to bring the deficits under control until 1987 and then for only one year, before they expanded again in 1989 and 1990. In order to understand the changes that did occur and the control policies that came to be used, it is necessary to consider macroeconomic and foreign exchange rate experience in China.

V. Macroeconomic and exchange rate policy

We cannot know the economic decision making process within

the Chinese government, but it is clear that the period starting in 1984 or 1985 was a period of new departures in policy, whose lack of coordination, as suggested above, had some adverse effects. The new policies implemented in late 1984 reduced the range and power of the direct controls over foreign trade as well as direct economic management of the economy in general. Existing foreign trade enterprises were made into independent entities, provincial authorities and provincial enterprises were given new authority to engage in foreign trade and the agency system was adopted with users of imports responsible for their own accounts. For many types of goods and in some regions, the guidance provided by the central government seems only to have been indicative and not compulsory. For other types of goods and situations, specific targets were maintained. While the huge trade deficits of 1985, led to a partial reversal of these policy changes, their essence remained and they were subsequently extended.

The policy changes of 1984, of course, necessitated new emphasis on and use of indirect macroeconomic instruments of both domestic and foreign trade policy. The fact that the trade balance deteriorated so quickly and to such an extent in 1985 and could not be substantially reversed quickly suggests that effective macroeconomic policy instruments were not in place when the quantitative controls were reduced, if not eliminated. However, under the pressure of events, there was rapid recourse
Public finance and fiscal policy

This is not the place to explore all of the issues of public finance and fiscal policy in China, rather, the emphasis will be on their use to affect China's foreign economic policy. There is evidence that Chinese authorities, while not Keynesians, have been aware that tax and expenditure policies have macroeconomic effects, but there is something paradoxical in the fact that fiscal policy is not a readily available tool of macroeconomic policy in China. It might be thought that in a one-party state, this could be a relatively flexible policy instrument. Yet, although China is a one-party state, it is a many-province-power country, and the political power of the provinces has always been substantial.

While the devolution of power from the center to the provinces began in the 1950's, it remained true until 1980 that all tax revenues were forwarded to the central government before being reallocated to the provinces. Starting in 1980 the provinces were allowed to retain all of certain types of tax revenues and a part of other types, while a third type was remitted to the central government. That resulted in a substantial redistribution of revenues among the provinces, with the wealthy provinces being the major beneficiaries, but with the center maintaining considerable control over the revenues of some provinces, such as Shanghai.
This system was revised in 1985 and a new one that provided different schedules of remittances for different provinces was created. In 1988 a system of three-year "contracts" was instituted with separately negotiated agreements between the central government and the provinces for the collection and return of funds. These procedures have subsequently been revised again with the central government regaining more control of revenues. Nonetheless, since 1980, the ability of the central government to exercise macroeconomic fiscal policy, if it so desired, has been substantially reduced.

The government expenditure budget has all the components that one might expect, but there are significantly different relative magnitudes as compared to market economies. Many expenditures relating to social services appear directly in relatively small amounts in the central and provincial government budgets, as many of these services are provided by enterprises or local governments. That includes housing, education, and medical and other social services. On the other hand, the economic ministries, though much reduced in their responsibilities, as compared to the pre-reform period, still have much greater scope than in market economies. In addition the government investment budget includes a larger share of total investment than in market economies.

In any case, as shown in Chart 5, it is difficult to make a \textit{prima facie} case that the government budget has been used for
countercyclical economic policy. Prior to 1978 the government usually ran a small surplus overall. Taking into account the large government direct investments, there was, in fact, an important contribution to national savings. For most of the years since 1978, the government has run deficits, but these have remained in the range of slightly more than 2 per cent of GNP. It is possible that 1985 is an exception, since that was the year with the smallest government deficit. In the Chinese official statistics the swing from deficit in 1984 to surplus in 1985 was almost one per cent, large enough to have a perceptible effect on total aggregate demand. The deficits in 1991, 1992 and, budgeted for 1994, were noticeably above the average levels. In particular, in 1993, there was a 20 per cent difference between the budgeted and actual deficits, indicating in another way that government attempts to control expenditures were ineffective at the same time that its public stance was strongly anti-inflationary. Interestingly, over the period during which government savings have been falling, private savings have been rising rapidly, thus becoming the major source

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23 The percentages are taken from IMF calculations, which have consolidated budgets at all levels and revised them to the definitions of the IMF's Government Financial Statistics. The IMF's estimates of deficits are generally about twice the deficits reported in official Chinese statistics. The differences are mainly due to revision of the Chinese government practice of treating some borrowing as revenues, debt repayment as a current expenditure and shifting of revenues and subsidies of state enterprises among government accounts.
Growth of Real GNP, 1951-1993 (in Millions of Yuan)

Government Budget Surpluses or Deficits

Source: IMF

Chart 5
of support for the high rates of investment.\textsuperscript{24}

The financing of the government deficit has changed substantially over time. Foreign borrowing has emerged as a major source of funds since the early 1980's, accounting, subsequently, for a fifth to a third of all borrowed funds. Borrowing from the People's Bank of China has usually been the major source of debt finance. In the late 1980's the government started selling bonds directly to the banking system, some of which were resold to the households and enterprises, who also purchased some bonds directly from the government.

The indirect macroeconomic effects of the government debt would be expected to occur through the monetization of the deficit. Although this undoubtedly occurred, the direct connection has not been a consistent one, in part because of the increasing resort of the government to bank and public placement of its bonds. Chart 6 shows the annual government deficits and changes in the money supply, money velocity and inflations rates, using both the definitions of the Chinese government and the IMF definitions. The eye can pick out the closeness of the relationship between government deficits and changes in the money supply until the mid-1980's, after which the direct correlation no longer exists.

But government current deficits are not the only source of

\textsuperscript{24} See F. Modigliani and L.S. Cao (1993) for an explanation.
increases in the money supply. As noted above, the PBC has had difficulty in imposing credit controls and reserve requirements on the banking system, which has operated with substantial excess reserves. Thus, the banking system, itself, in responding to the demand for loans, has had ample opportunity for money creation.

**Monetary policy**

In such circumstances, it would have been natural for the central government to have relied more heavily on monetary policy, but this, too, has been a blunt instrument. The People's Bank of China (PBC) has not been a true central bank; only in March, 1994 was a bill passed, giving it a central bank structure. In particular, the power at the center has been sharply circumscribed by the principle of "dual leadership", which links the provincial banks to the provincial governments. That, and the close links between the provincial Communist Party organizations and the provincial governments, have given those governments substantial power over operations of the PBC within the province. Only in 1988 was the headquarters of the PBC given the power to appoint the presidents of its provincial branches. It might be inferred that such appointments were subject to political interactions of the center and the province.

It is interesting to note that, after the appointment of Zhu Rongji to vice-prime minister in 1993, with the announced
responsibility of bringing inflation under control, one of the first actions was a reorganization of the PBC, to give more control to the center. The fact that the process of implementation has been a long one suggests the difficulty that the center has had in actually exercising control in this arena.

Monetary policy was intended to be implemented through the annual credit plan, which, first, applied only to the universal and specialized banks in China, but which, since 1988 has been extend to direct financing by enterprises and non-banking financial institutions. This annual credit plan is part of an overall macroeconomic program, which is subject to central monitoring. The major instrument for its implementation has been credit ceilings set quarterly as well as annually and for specific types of credit, e.g. fixed investment and working capital, as well as the totals. Since the late 1980's, reserve requirements and administered interest rates have also become monetary policy tools, though both have limited effectiveness. That is true of reserve requirements because of high levels of excess reserves in the banking system. Interest rates have modest effectiveness for several reasons: soft budget constraints of state enterprises and difficulties in supervising their administration.

It is common among western economists to complain about the lack of sophisticated tools at the service of monetary policy in China. However, the tool of direct control of the volume of
credit can be an effective instrument. Direct credit controls have been a powerful and flexible tool of monetary policy in many countries. In Latin America, they were the most common monetary instrument for many years until the 1980's. There are, no doubt, inefficiencies in their use, as compared to monetary instruments that operate through the interest rate, but there is little doubt as to their potential effectiveness.

It cannot be presumed, however, that the effects of additions to the money supply in China correspond to analogous changes in market economies. There are no national financial markets through which changes in the money supply would affect interest rates. While there are local markets, which are increasingly interconnected, those are relatively recent developments, and are limited in scope and intensity. Moreover, while the ventures of private and cooperative enterprises might be affected by the interest charges on their bank loans, it is less obvious that this is true for state owned enterprises. Their bank loans may be negotiated through the intermediation of the central government or provincial government ministries. This may be also true in practice of some loans to private and cooperative enterprises.

The problem in the use of direct credit controls in China has been the difficulty of enforcing them. The provincial branches of the NBC have not, perhaps until recently, been willing or able to resist the pressures of local enterprises,
backed by the provincial governments, for credit, even when that meant breaking through their credit ceilings. The substantial bank excess reserves facilitates their lending and the difficulties of controlling credit advanced by the rapidly growing non-bank financial institutions have compounded the problem of credit controls.  

Exchange rate policy

Exchange rate policy in China has also been complicated by special administrative and political conditions. Before the reforms, all foreign exchange earnings were collected by the central government and reallocated through the NBC. Although there was, nominally, one exchange rate until 1981, the multitude of special provisions for balancing trade, in effect, created many different rates. For example, as noted above, the Foreign Trade Corporations were required to procure goods for export at domestic prices and sell imported goods also at domestic prices. Since their losses on these transactions would be covered by subsidies from the government budget, the effective exchange rate was different from the nominal rate. As the reform program progressed and the FTCs were made

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25 See W. Tseng, *et al.*, for discussion of the constraints on use of credit controls and assignment of the problems of monetary policy to the lack of market-based instruments of monetary policy.

An unconventional rationale for the development of those instruments is that they would not be subject to the local political pressures that now constrain the use of direct controls.
individually responsible for their own losses, the importance of this source of subsidies declined. Other sources of subsidies for foreign trade, that, in effect, create a wedge between the actual and the effective exchange rate remain. For example, as noted above, provincial officials have been influential in gaining loans for local enterprises, bypassing credit rationing and interest rate constraints.

Nonetheless, the foreign exchange rate is unique among macroeconomic and foreign economic policy tools in China in that it appears to be entirely under the administrative control of the central government. That should make it a more flexible tool, which, as will be shown, has sometimes been the case.

At the beginning of 1981 a single exchange rate, below the official rate, was created for the internal settlement of foreign trade transactions. That still left a multiple exchange rate system for external transactions until 1984, when a single rate was established. This did not last long in the face of rapidly growing deficits and, in 1986, a dual exchange rate was created, with an "official" rate being pegged to the dollar. Starting in 1985, some enterprises, particularly those created with foreign funds, and some provincial governments were allowed to retain a part of their foreign exchange earnings. This system was gradually extended and Foreign Exchange Adjustment Centers (FEACs) were established in 1986 in which these retentions could, initially, be purchased by foreign funded
enterprises, at prices set within the FEACs. This created an "unofficial" flexible exchange mechanism, although we do not know the extent to which the government intervened in this market. The exchange rate determined in the FEACs was always at a premium in relation to the official rate, with the premium sometimes quite large. After 1986, there were a number of minor adjustments in the official exchange rate with a major devaluation in December, 1989, when the value was reduced by 21 per cent and again in November, 1990, when there was a 9 per cent devaluation.

Access to the FEACs was extended in 1988 to all firms with foreign exchange earnings or retention quotas and extended still further in 1990 and 1991, with individuals being allowed to buy and sell in computerized trading.

On January 1, 1994 a single exchange rate was established at the rate then prevailing on the swap market and the retention system was eliminated except for foreign enterprises. Foreign-funded enterprises operate under special rules that permit them to retain all of their foreign exchange earnings but require them to obtain approval from the State Administration for Exchange Control (SAEC) for purchases and sales of foreign exchange. The role of the SAEC in approving transactions by domestic enterprises has been eliminated. It is still true that receipts of foreign exchange from sales abroad by domestic enterprises must be sold to designated financial institutions.
For trade not subject to quotas, licensing or automatic registration, foreign exchange can be purchased by importers by presenting commercial invoices or bills. Purchases of foreign exchange for controlled imports requires the appropriate approvals.

Exchange rate determination is now a managed float. The People's Bank of China announces a rate at the beginning of each trading day and intervenes in the market to keep the rate within 0.3 per cent of that rate. Since the unification of the exchange rates, the yuan/dollar rate has remained virtually stable at about 8.7 yuan per dollar until the present. Chart 7 shows the time pattern of the real exchange rate since 1981.

The present system for the determination of the exchange rate is similar to that in a number of market economies. A significant difference remains because important amounts of foreign exchange continue to be allocated by licensing and permits. That, too, is to be reduced in importance by an agreement with the United States in October, 1994 in which China will eliminate most of its quota and license controls over a five year period.

Assessment of China's trade policy

China has become a much more open system over the last twenty years and much more is known about it than previously by outsiders. Nonetheless, there are still features of its economy and its economic policy that remain somewhat opaque. In
particular, with respect to foreign economic policy, it is impossible for outsiders to know the extent to which direct interventions and indirect policies of various types remain important. So assessments must remain tentative.

The composition of exports and imports

There have been great changes in China's foreign trade policy since the economic reform programs began, from its original character as a planned, managed, canalized and controlled system. Yet it would not be accurate to describe the current system as completely free. A substantial amount of trade continues to be canalized through the FTCs and subject to supervision. A number of centrally imposed licensing and quota requirements for particular goods persist.26 In addition there are trade restrictions imposed by provincial officials, which are acknowledged, but not completely codified and, therefore, difficult to assess. It is still not uncommon to read that some Ministry has decided that imports or exports of a particular good must rise or fall or reach a specified target. Presumably this is not wishful thinking and actually represents a policy which the Ministry is able to implement.

Licensing continues for a large share of China's imports, estimated to be 30 per cent in 1993, to provide protection to

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26 The goods subject to export licensing has been estimated to account for 48 per cent of total exports in 1993. See W. Tseng, et al., (1994), p. 5.
domestic sectors, for overall plan implementation and as a means of achieving overall balance.\textsuperscript{27} There is also a comprehensive tariff system, with an average unweighted tariff of 40 per cent, with an elaborate system of duty exemptions, which provide a mechanism of control. The central and provincial governments have a direct role in the import of certain products such as staple foods and petroleum.

Charts 8 and 9 indicate the composition of China's imports and exports. Clearly "heavy manufactures", which are mainly capital equipment, have dominated imports, except during the drought and famine years of the Great Leap Forward in the early 1960's, when food imports became of greater importance. It is also striking that the capital imports from the former Soviet Union and Eastern Europe were replaced quickly by imports from non-Communist countries. On the export side, food exports were the most important single component until 1978, again, except for the Great Leap Forward period. Since then light manufactures have become the leading export.

It has been argued that China's international trade has reflected, although perhaps not completely determined by its comparative advantage in labor intensive products. There is an apparent transparency in this argument. Much of the growth of exports has been facilitated by Hong Kong, whose enterprises,

\textsuperscript{27} W. Tseng, \textit{et al}, p. 5.
one would expect to be quite sensitive to international prices. Moreover, a careful investigation of the labor intensity of its exports supports the inference.28

The argument poses a puzzle, however. As noted earlier, the distorted prices of the pre-reform period could not have guided exports along lines of comparative advantage. After the reforms, the liberalization of prices has been gradual and their relationship to real costs must remain doubtful, especially in the state owned enterprises. While it is true that wages have been freed from most controls in the Special Economic Zones and in some sectors, wages in state owned enterprises are still not market-determined. The scope for market pricing has steadily expanded, but for most of the reform period, and even now, important inputs are still subject to price controls. Moreover, we know that, although to a decreasing extent, trade has been canalized through the FTCs and their trade losses have been covered by the government budget.

How is it possible, then, that China's real comparative advantage could have become manifest and determined trade patterns, when most prices have been distorted for most of the reform period and trade has been subject to somewhat arbitrary practices? It is hard to explain this, except by denying it. But, if it is denied, how then can one explain the composition

of Chinese exports?

The answer is relatively simple. What else could China have exported in quantity except petroleum, foods, particularly to Hong Kong, textiles and simple manufactures? The petroleum exports of the early reform period based on the crude oil reserves, were among the most immediately marketable of China's products. China has only recently developed the expertise and capacity to sell some capital goods in foreign markets. That is true also of sophisticated consumer goods, such as electrical consumer durables. In addition, because of its high rate of investment, China has chosen not to export any of the capital goods which might find a foreign market, but rather has kept those at home.

There is a sense, however, in which real relative factor scarcities have determined Chinese exports. Its manufacturing capacities reflect its relative scarcities. Because of its relative capital scarcity and relatively low levels of skill, much of its productive capacity is relatively labor intensive. This is particularly true of the township and village enterprises (TVEs) that have grown extremely rapidly since the beginnings of the reform and are now estimated to account for roughly 40 per cent of industrial production. Table 3 presents estimates of the share of the exports of the TVEs in total exports. As shown, the share increased five times between 1985 and 1990.
Table 3

Township and Village Enterprise Exports

<table>
<thead>
<tr>
<th>Year</th>
<th>Exports ($ billion)</th>
<th>Share of Total (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1.20</td>
<td>4.4</td>
</tr>
<tr>
<td>1986</td>
<td>2.67</td>
<td>8.6</td>
</tr>
<tr>
<td>1987</td>
<td>4.35</td>
<td>11.0</td>
</tr>
<tr>
<td>1988</td>
<td>8.03</td>
<td>16.9</td>
</tr>
<tr>
<td>1989</td>
<td>10.00</td>
<td>19.1</td>
</tr>
<tr>
<td>1990</td>
<td>12.50</td>
<td>20.2</td>
</tr>
</tbody>
</table>


The role of comparative advantage in determining exports is, no doubt, increasing as the scope of market determined prices increases. And, with the help of foreign investors, effective capacities in other types of goods are emerging and making their way into export markets.

Overall balance, macroeconomic and foreign exchange policy

Although a number of important direct and indirect interventions in international trade persist, there is no doubt that, as a result of the reforms, there is now a much greater reliance on macroeconomic and foreign exchange rate adjustments in China's foreign trade policy. The interventions and exchange rate adjustments appear to be used together, however, not always with full consistency. It does not appear to be the case that China has ever made a major internal macroeconomic adjustment,
motivated primarily by the need to correct a payments imbalance.\textsuperscript{29} On the other hand, international payments issues may have been a contributing influence in some macroeconomic adjustments, for example in 1988 and 1989. As noted above, in the late 1980's the foreign trade management system did not prevent a succession of years of substantial trade and payments deficits. Those were reversed in the 1990 and 1991, in spite of the considerable liberalization of trade practices. As shown in Chart 3, the trade and services account swung into deficit again in 1993, but that deficit was eliminated in 1994.

The primary motivation for changes in Chinese macroeconomic policy seems to have been domestic inflation. While domestic economic restraint or stimulation created through monetary policy has undoubtedly affected trade, it appears that greater reliance has been placed on the foreign exchange rate as an instrument of policy.

Estimated changes in the real exchange rate from 1981 to 1994 are presented in Chart 7, using the Chinese and the U.S. consumer price indices for the deflation. There was an effective real depreciation from 1981 to mid-1993, but, subsequently, as Chinese prices rose relatively rapidly, there has been a significant real appreciation in the yuan. As yet, that has not elicited an adjustment in the nominal rate,

presumably because of the excellent recent performance of Chinese exports.

The monthly data in Chart 7 on Chinese exports poses another puzzle. As the estimated real exchange rate has appreciated, exports have grown. What can account for this apparent paradox? The puzzle is interesting, because the answer might throw some light on trade conditions and exchange rate policy.

There are not many possible explanations of the puzzle:

(1) there may be a delayed reaction of exports to relative prices;
(2) there may be some offsets to import and export prices subsidies, that have made it possible for Chinese enterprises to continue to export at higher prices;
(3) the statistics may be incorrect.

Unfortunately, it will not be possible to make a definitive distinction among these alternatives, but some judgment can be applied. The first answer is not implausible. The "J-curve" response to currency depreciations has been observed in other countries at other times. It seems unlikely in this case, because such a large proportion of Chinese exports, textiles and toys, for example, faces strenuous competition and the demands for these goods must be very elastic and respond quickly to price changes. A second rationale for the first answer is that
domestic costs have not risen so much that Chinese exporters cannot still cover the variable costs of their exports by selling abroad. Finally, the first answer could be correct if the profit margins on Chinese exports have been very large. That would have made it possible to maintain the foreign exchange price, absorbing the increases in domestic costs. That pattern has also been observed, for example, in the past for other countries.

Taking up the second possibility, it is possible that enterprises have expanded exports, even at a loss, because of domestic offsets to the loss. For example, state owned enterprises and the Foreign Trade Corporations might have been exporting at losses, with the expectation that those would be covered by government subsidies. It is somewhat less likely that SOE managers would have done this in 1994, as compared to previous years, since, to an increasing extent, their own bonuses have been tied to their firms' profits. Nonetheless, it is possible to imagine a conjunction of circumstances that would have resulted in an increase in such practices. Since the allocation of foreign exchange is, to some extent, still restricted, there may be a scarcity value for foreign exchange which is above the official rate. That, in turn, could create a temptation which was not fully resisted. The same argument can be made with respect to the FTCs. Another type of export incentive might have arisen from a liquidity shortage, created
by monetary stringency. Export earnings, even at losses, could have been used to offset this monetary tightness.

Finally, there are at least two ways in which the Chinese statistics could be incorrect. First, there may just be mistakes as the result of incomplete coverage or errors in measurement of of exports and imports, although it is not clear why mistakes should take just the pattern shown in the data. A systematic type of error could have its source in the underinvoicing by exporting firms in 1993. Then, when the profits were repatriated in 1994, they would be reported as exports. That is made more plausible by the recognition that the unification of exchange rates on January 1, 1994 was an effective devaluation, which had been proceeded by speculation that some type of depreciation would take place. It would have been rational in such circumstances for exporters to have thought of taking advantage of a prospective depreciation by postponing repatriation of profits.

In any case, it is clear that Chinese authorities now consider the foreign exchange rate an important policy tool which is used with discretion, but strategically.

Implications of China's trade policy for participation in the World Trade Organization

This is not the place to attempt a review of the all of the issues related to China's potential role in the World Trade Organization (WTO), but some brief implications of the previous
discussion can be made explicit. Briefly put, questions about China's entry into the WTO have arisen because its management of trade in the past has raised questions as to its adherence to the non-discrimination principles of GATT.

As has been pointed out, some aspects of the trading arrangements in China are quite complex, with a number of different participants.

The interactions of these different institutions provide opportunities for the granting and for the concealment of subsidies that can support discriminatory treatment. Table 4 presents data on the magnitude of the losses of the FTCs from 1986 to 1987. To put these losses into perspective, the values of China's total exports in corresponding years are added in a final line.

It can be seen that, although the losses of the FTCs declined from 1986 to 1991, they remained, in that year, at about 5 per cent of the total value of exports. Since the losses were, most likely, concentrated in certain types of trade, rather than being spread evenly across all trading categories, the losses were, most likely, a larger fraction of trade of particular types. It should also be pointed out that the table does not include any losses of the FTCs of the provincial governments that might have been borne by those governments.
Table 4

<table>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Losses</td>
<td>24.96</td>
<td>28.21</td>
<td>26.85</td>
<td>33.64</td>
<td>22.44</td>
<td>17.61</td>
</tr>
<tr>
<td>Total Losses of SOEs within budget</td>
<td>41.71</td>
<td>48.17</td>
<td>52.06</td>
<td>74.96</td>
<td>93.26</td>
<td>93.11</td>
</tr>
<tr>
<td>Total Exports</td>
<td>108.58</td>
<td>147.18</td>
<td>176.95</td>
<td>195.25</td>
<td>293.06</td>
<td>375.04</td>
</tr>
</tbody>
</table>

Table 4 proves nothing with respect to government support of exports by China, since some, unknown portion of the losses may have arisen in the subsidization of imports. The table does suggest, however, the difficulties that arise for outsiders in coming to a judgment as to the extent to which the central and provincial Chinese governments still do play a direct role in trade.

Economic reform and political reform

It is natural to look for generalizations from the Chinese experience on the relation between economic and political reforms. In particular, compared to the former Soviet Union, it is tempting to say that the Chinese policy demonstrates the success of giving priority to economic reform (perestroika) over

30 This table is taken directly from World Bank (1994a), p. 26.
openness and political reform (glasnost'). The temptation has not been resisted by many commentators.

The history of the reforms in China, the former Soviet Union and Eastern Europe provides us with only a small sample of possibilities, however. Thus, the art of the political historian, rather than the techniques of the econometrician, is required to produce generalizations. Since the experiences with economic reform have been so dissimilar, it is plausible that they are due to differences in the societies, their economies and the political conditions which prevailed at the outset of the reform programs. There are important dissimilarities in all of these aspects, of course, but the differences in the conditions when the reforms first started seem especially important.

In particular, the political and economic events in China just before the reforms primed the country for the subsequent economic changes. The Cultural Revolution had thoroughly disrupted ordinary life in both urban areas and the countryside and even led to small scale civil war in some cities. There had been extensive disruptions in the government bureaucracies and in the professional classes, as well in the political leadership groups. As the Cultural Revolution faded, many, if not most, of the displaced persons returned to their previous, or similar, positions. It seems a reasonable presumption, nonetheless, that there was a residue of resentment among all classes against a
system that had treated them badly. This would have created an openness to reforms that promised not only economic improvements but a reduction in the pervasiveness of government supervision and an expansion of the scope for personal activity. Moreover, the reinstated bureaucrats and political leadership did not have entrenched positions and privileges to defend against new ideas.

However, the personalization in the Gang of Four of the excesses of the Cultural Revolution helped to maintain the image and authority of the Communist Party. In addition, since the source of the reforms was the new leadership of the Communist Party, accepting and supporting the reforms did not require rejection of the political system. Thus, the Party and the government retained legitimacy, in the sense that its announcements had credibility. In addition, the turmoil at the center of government in Beijing must certainly have strengthened the provincial leaders and bureaucracies. Much of the original 'decentralization of economic power' was not a replacement of government by market control, but rather a transfer of power from the central government to the provincial governments, creating opportunities for local officials to strike out and make their reputations on their own initiatives.

Yet skepticism about the proposed reforms would have been natural, given the history of repeated tacks and turns and changes in direction and consequent disruptions. However, there was a substantial and immediate payoff to the reforms that were
initially made in the agricultural sector. The increase in productivity increased agricultural incomes and improved the quantity and variety of foodstuffs available in the cities. So, unlike previous reforms, this one seemed really to work.

This story offers some strong contrasts with the former Soviet Union and Eastern European countries. While their economies were virtually stagnant prior to the reforms, they were not in disarray and confusion. Thus, there were still established positions and privileges at all levels to defend against the threats of new policies. Moreover, the new policies were announced by governments that had admitted any number of political, personal and economic crimes in the past.

Finally, the reforms in the former Soviet Union and Eastern Europe did not pay off quickly in significant economic improvements. Rather, the populace were asked to engage in another act of faith: that, with sacrifice and forebearance, their lives would continually improve. With differences in content, that, of course, was the promise of the Bolshevik Revolution. It was a promise that had not been fulfilled and the same old gang was asking it of them again. It is slight wonder that it could not generate general support.

This reasoning about the still early experiences with economic reform of the former Soviet Union, Eastern Europe and China argues that they are not differentiated by the contrast
between the consequences of the timing of glasnost' and perestroika. Rather the different experiences reflect the histories, mainly recent, with which the different countries entered on their new economic adventures.

Conclusions

It is striking that, as a transition economy, China has managed its international trade and payments as an effective adjunct to its development policy and without persistent problems. Though there have been difficulties, they have not been persistent, and have not become major obstacles to its economic growth. To achieve this, China has moved away from the completely planned and managed international trade and payments policy with which it entered its reform period in 1978 and which it maintained for several years afterward. Increasing freedom has been given to exporters and importers. A dual price system for foreign exchange was created to facilitate trade without imposing all the costs of a full devaluation. Subsequently the exchange rates were unified.

Yet, it would be mistaken, as noted above, to consider Chinese foreign trade and payments now as completely market determined. There still is a substantial amount of planning and control, but, without more information than is available to outsiders, it is impossible to evaluate its relative importance.

The obstacles to the transformation of China's international economic relations have been formidable. The
attitude of irrelevance with which international trade must have been regarded by many enterprises had to be supplanted with trade incentives. The independent attitudes and ventures of provincial leaders had to be tamed. The multiple temptations of international markets had to be both resisted and exploited.

None of this has been done perfectly, to be sure. There are enough imperfections and holes in the policies to have sunk the ship, except for one thing. The expansion of the domestic economy and of exports has been so strong as to overcome any defects without major crises. For this some credit must be given to the foreign trade and exchange rate policymakers and policy executers, who have managed to steer an unwieldy, if fast moving ship. To some extent also the successes of the economic reforms are reactions to the economic and political failures of the Cultural Revolution. The political excesses and economic turmoil of that period the prepared the ground for economic reforms. The injection of some degree of market economics then quickly produced substantial improvements by reducing the profound inefficiencies that had previously prevailed in foreign trade practices and production. The initial successes have been a strong validation of subsequent policies.
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