1993

The economy in overdrive: Will it crash?

Penelope B. Prime

Georgia State University, pprime@gsu.edu

Recommended Citation

Prime, P. B. (1993). The economy in overdrive: Will it crash? Current History,92(575), 260-264.

The last time the Chinese economy overheated, it catalyzed the protests that led to the 1989 crackdown in Tiananmen. "The question [now] is whether rapid growth and accelerating inflation will lead to another economic crisis—and if so, what the political ramifications will be. . . . Retrenchment could work again, but the reins are not as tight as they once were. [And a] failed clampdown might be as politically dangerous as a successful one. . . ."

The Economy in Overdrive: Will It Crash?

BY PENELOPE B. PRIME

Last fall, delegates to the Chinese Communist party's fourteenth congress proclaimed that China's "planned commodity economy" was now a "socialist market economy." What is the significance of this change in terminology? In practice as well as rhetoric, markets have replaced planning. China still plans, of course, but recent years have seen a significant reduction in the extent to which the government determines the economy's course. Market mechanisms have expanded from consumer goods to include producer goods, raw materials, and even stocks and bonds. The party's removal of the word "planning" from its label for China's economic system signals an ideological acceptance of markets and the likelihood that reforms will continue.

The introduction of the market has, however, created boom and bust cycles. The economy experienced serious inflation and imbalance in 1985, and again in 1988 and 1989. The last bout of overheating contributed to the pro-democracy protests in Beijing's Tiananmen Square in June 1989. Following the bloody suppression of the movement, many thought the government would curtail economic reform. While this did occur, it turned out to be a surprisingly brief effort followed by a strong rebound. Growth was so rapid in 1992 and the first quarter of this year that overheating again appears inevitable. Foreign investment and trade have risen even faster than in the past. The question for 1993 and 1994 is whether rapid growth and accelerating inflation will lead to another economic crisis—and if so, what the political ramifications will be.[1]

PENELOPE B. PRIME *is an associate professor of economics at Kennesaw State College. She is currently an analyst with the China Branch at the Center for International Research at the United States Bureau of the Census.* *The author would like to thank Tina Harbaugh for her assistance with data collection and Jong-Heum Park for his comments on an earlier draft.*

[1]Unless otherwise noted, all figures are from China's annual statistical yearbooks, *Beijing Review,* and the Foreign Broadcast Information Service.

STOCK FRENZY AND SOFT DRINKS

Two developments last year significantly influenced the operation of the Chinese economy and expectations about future growth. These were the rapid extension of securities markets and a flood of foreign investment into the country.

The establishment of securities exchanges enhances the economy's marketization and benefits the economy's reform in several ways. Through stock or bond issues enterprises have the opportunity to raise capital, which may eventually wean them from the state budget. The country's political leaders are eager to revitalize large enterprises through market pressure, but without truly privatizing. (True privatization has been circumvented by limiting the number of shares sold to individuals; most shares are owned by other state enterprises or the government agencies that managed them in the past.) Another benefit of the exchanges stems from the fact the populace now holds large amounts of cash. Purchasing shares absorbs this money, channeling it into production and lowering demand for consumer goods.

There are currently two stock exchanges in China. The one in Shanghai started up in December 1990. The Shenzhen special economic zone (SEZ) in southern China opened the second exchange in July 1991, after experimenting with shareholding systems as early as 1987. Numerous other cities and provinces have been lobbying Beijing for authorization to set up their own stock exchanges—so far without success. There are dozens of other securities markets throughout China, but these handle treasury bonds only; in Shanghai and Shenzhen alone both stocks and bonds are traded.

The two exchanges are small but growing quickly. As of late 1992 the two combined had issued the shares of approximately 30 companies; by early this year the number had jumped to 70. Nearly 4,000 other enterprises in China are internal shareholding companies, in which the corporation in conjunction with employees holds shares. Many of these firms someday hope to go public.

The stock exchanges issue two types of shares: "A" shares, issued only to citizens, companies, or institutions

China's Foreign Trade and Investment
(billions US $)

	1986	1987	1988	1989	1990	1991	1992	1993
Foreign Investment								
Contracted	11.74	12.14	16.00	11.48	12.09	19.58	68.50	NA
Utilized	7.26	8.45	10.23	10.06	10.29	11.55	18.80	NA
International Trade								
Exports	30.94	39.43	47.51	52.53	62.09	71.91	84.99	37.15
Imports	42.90	43.21	55.26	59.14	53.34	63.79	80.60	40.69
Trade Balance	-11.96	-3.78	-7.75	-6.60	8.75	8.12	4.40	-3.54

Note: The figures for 1993 are for the first six months.

in China, and "B" shares, issued only to foreigners. The B shares are denominated in yuan but must be paid for with United States or Hong Kong dollars. Since they are a risky investment, foreign interest has primarily been expressed through trading in shares in Hong Kong companies that do business with China. Foreign houses have set up numerous mutual funds for foreign investors, including Paine Webber's Greater China Fund, James Capel & Company's China Fund, and the Jardine Fleming China Region Fund. Last year the New York Stock Exchange listed its first Chinese company, China Brilliance Automotive Corporation, and plans to list a number of mainland corporations on the Hong Kong exchange are in the works.

Stocks have caught the interest of the people of China as well. New issues have attracted large crowds. Disappointed citizens rioted last fall in Shenzhen when the forms that must be used to apply to purchase shares ran out. Many people bring substantial savings to invest if they are among the lucky ones granted a chance to buy. Because of the intense demand for shares, prices have been inflated and at times have fluctuated wildly, and a second market flourishes on the steps of the official exchange. Investing has helped reduce the demand for consumer goods, easing the pressure on these prices. If people think hyperinflation is just around the corner, they may pull money out of investments and savings accounts and go on a buying spree. Since savings totaled the equivalent of $200 billion at the end of last year, such a spree would surely fuel inflation.

Along with the securities market, capital has also been generated through foreign investment. Businesses from around the world continue to see China as potentially, if not currently, a profitable venture. In 1992 alone new foreign investment totaled almost $19 billion—a phenomenal 63 percent increase over new foreign investment the previous year—and this figure does not include contracts worth billions of dollars signed that year.

The inflow appears to be more than just a rebound from the slowing of investment following the repression of the democracy movement in 1989. Several new considerations in the minds of investors may be fueling it. Although the yuan technically is still not convertible, foreign currency exchange centers, or swap markets, are common in major Chinese cities and seem to be functioning well. In early June all controls on the value of the yuan were lifted in these markets. Use of foreign exchange within China has also gained marginal acceptance. In Fujian province, for example, the Taiwan dollar is widely used, as is Hong Kong currency in Guangdong. This year, for the first time, China plans to offer a bond denominated in United States dollars; leaders obviously believe people hold enough dollars that such an issue will attract investors.

Prospects for foreign sales in China's domestic market have also brightened. Incomes and savings are beginning to reach levels that allow citizens to satisfy a taste for quality and variety by buying goods from abroad. Restrictions on foreign companies and joint venture sales in the domestic market are easing. One can find soft drinks such as Pepsi-Cola not only in the cities but also in the far corners of southwestern Yunnan province and other remote areas. More important, foreign products are increasingly sold in Chinese shops (brought to the shelves by Chinese distribution networks) and not just in hotels and restaurants catering to visitors to the country. The domestic demand for computers, machinery, and other inputs into production continues to grow as Chinese enterprises increasingly make more of their own investment decisions. Production for China's domestic market rather than for export to third-country markets may be attracting companies that had been watching China from afar. Some foreign companies producing goods in China have actually exported less than they expected because of their ability to sell domestically.

Another driving force behind the surge in foreign investment has been the rising cost of manufacturing in Hong Kong and Taiwan. For Hong Kong, which will become part of China in 1997, the decision to move production makes sense. For Taiwan, investment in the mainland is more of an issue politically. The Taiwanese government has been leery of having too much of its citizens' and corporations' funds invested in China, but has not stopped the flow of capital. In a significant development, nongovernmental

Selected Economic Indicators

	1986	1987	1988	1989	1990	1991	1992	1993
Gross National Product (annual growth)	8.1	10.9	11.3	4.4	4.1	7.7	12.8	15.0
Currency in circulation (annual growth)	23.3	19.4	46.7	9.8	12.8	20.2	36.4	45.0
Domestic Budget (billion yuan)	-7.1	-8.0	-7.9	-9.2	-14.0	-21.1	-23.7	NA
Cost of Living (annual growth)	7.0	8.8	20.7	16.3	1.3	5.1	6.4	10.3
General Retail Price Index (annual growth)	6.0	7.3	18.5	17.8	2.1	2.9	5.4	16.0
Investment in Fixed Assets (billion yuan)								
State firms	197.9	229.8	276.3	253.5	291.9	355.8	510.6	58.8
Collectives	39.2	54.7	71.2	57.0	52.9	62.9	123.3	NA
Total Retail Sales (annual growth)	15.0	17.6	27.8	8.9	2.4	13.4	15.7	27.0

Note: The figures for 1993 are for the first quarter, except for the cost of living, which is for January. GNP and retail sales figures are for the first five months of 1993. The figures for 1992 and first quarter 1993 GNP were reported as gross domestic product.

groups from Taiwan and China met for the first time this spring in Singapore to discuss increasing exchanges and communications across the straits.

Over the decade, foreign investment provided China with raw materials through imports, transferred new technology, and earned foreign exchange through exports. While these benefits will continue, something new appears to be happening as well. The latest wave of investment seems to cover a broader area geographically, reaching inland regions as well as the traditional coastal zones. As a result, foreign companies want to use China's raw materials, energy sources, and infrastructure more than they did in the past, which increases the already high demand for them. These companies also have the financial resources to offer higher prices for the inputs they need. So while foreign investment is supplying additional capital, it is also contributing to rapid growth and the resultant overheating of the economy.

A REPEAT PERFORMANCE?

With expected annual growth rates for real gross national product well over 10 percent, will 1993 and 1994 see a repeat of the creeping inflation of 1987 followed by the hyperinflation of 1988 that caused leaders to force the economy into retrenchment? There are indeed many similarities between trends during the earlier period and those unfolding in the Chinese economy now.

Growth, inflation, and the money supply were all high by 1988. After respectable growth of 8 percent in real GNP in 1986, the figure jumped to 11 percent in both 1987 and 1988. Inflation, as measured by China's official cost of living index, was 7 percent in 1986 and 9 percent in 1987, and skyrocketed to 21 percent in 1988. Currency in circulation increased 19 percent in 1987 and jumped to 48 percent the next year. Finally, rapid income growth raised imports and depressed exports, resulting in trade deficits throughout the late 1980s.

In 1992 and early 1993, a similar pattern developed, but with even higher growth. Real GNP increased 13 percent in 1992 and at an annual rate of 15 percent during the first five months of this year; this compares with 8 percent in 1991 and only 4 percent in 1990. The cost of living went up 5 percent in 1991; last year this index advanced only 1 percentage point, but in January 1993 it rose at an annual rate of 10 percent. The urban cost of living index reportedly was up almost 20 percent by May 1993 compared with a year earlier. Other reports on inflation for early 1993 put it as high as 25 percent above the level the previous year. Cash in circulation increased 36 percent in 1992, compared with 20 percent in 1991, but jumped to a 45 percent annualized rate in the first quarter of 1993. After posting trade surpluses for three years, beginning with the last quarter of 1992 China once again registered trade deficits. The deficit for the first six months of 1993 was over $3 billion, more than doubling in May and June alone.[2]

These trends have raised concerns both at home and abroad. In May interest rates in China were raised for the first time in a year in an attempt to attract savings and discourage loans; the small hike, however, had little apparent effect. Plans to tighten credit discussed by Chinese leaders last fall seem to have fallen by the wayside. The 1993 Plan for National Economic and Social Development discussed, in general terms, maintaining the economy's balance and reform of the banking system. But concern over the potential problems associated with overheating is more muted than in the past.

[2]Figures on cash in circulation are from "Banking on Zhu," *The Economist,* July 3, 1993, p. 33; trade deficit statistics are from "China's Trade Deficit Doubled in 2 Months," *The New York Times,* July 6, 1993, p. C8.

Many economists in China argue that major differences between the current picture and the situation in the late 1980s mean drastic action may not be necessary this time.[3] One difference cited is that inflation in the 1990s is due primarily to price adjustments and increases in costs, rather than the severe imbalances between demand and supply that occurred in the previous decade. Demand is high, but more for investment goods than consumer goods. The supply of consumer goods, they argue, has kept up with demand. Further, peoples' incomes rose faster than inflation during 1992, in contrast to 1987 and 1988. Finally, the optimistic analysts acknowledge the money supply is increasing rapidly—too rapidly—but say that at least it is going into productive, long-term investment rather than subsidizing unproductive enterprises.

These economists correctly contend that the economy has developed and been reformed in the four years since Tiananmen, but all arguments that minimize the potential need for retrenchment can be disputed. While price reform has pushed prices up, property speculation has meant higher rents and a higher price index. Demand may not be as imbalanced as in 1988, but the enormous amount of savings held by individuals could at any time be withdrawn, quickly creating serious imbalance. With the high inflation in the first quarter, savings accounts were earning negative rates of interest; in fact, in March total individual deposits fell for the first time since 1988.

The optimists also argue that incomes have kept ahead of inflation in today's economy, unlike during the latter 1980s. But this was while annual inflation was under 10 percent. If inflation continues to escalate toward 20 percent and beyond, real income growth will no longer be sustainable. As real incomes fall, people may be even more sensitive to negative interest rates, and put their money into consumer durables rather than saving it. This of course would push inflation even higher.

Finally, while productivity has improved in China, there are still many failing state-owned enterprises that formerly relied on subsidies through the state budget. Although the subsidies have reportedly been cut back, essentially unprofitable state enterprises continue to be subsidized through a new channel. When they need money, they are virtually guaranteed bank credit, with little or no questioning of how the funds will be used. In addition, more money has become available through foreign sources, securities issues, and underground credit channels. Some of these funds are no doubt going into profitable ventures, but whether these are necessarily the more productive projects, as the optimists argue, is difficult to determine because many prices are still distorted.

But along with the positive—albeit weak—factors that contribute to the optimism of some in China, other indications strongly suggest the economy is overheating. Last year China registered a budget deficit of more than 90 billion yuan, the highest in the history of the People's Republic. Approximately 67 billion yuan was covered by domestic bonds and foreign loans, but over 23 billion yuan was left to be covered by printing new money. It is thus not surprising that China's measure of currency in circulation has increased. The recent pattern has been for currency in circulation to decline in the first quarter of a new year and then grow relatively quickly in the last quarter. This happened even in 1988. But this year the pattern has been broken. The July 3 *Economist* reported that currency actually increased 45 percent in the first quarter of 1993. If the money supply cannot be controlled at the beginning of the year, there is little hope that currency growth this year will be less than in 1992. Nonetheless, banks, especially in rural areas, reportedly were short of cash by midyear. Inflation had already increased substantially as well, even by the conservative, annualized measure used by China's official statistical agencies. If currency expands throughout the year as usual, inflation can be expected to accelerate quickly.

Poor agricultural performance can also contribute to potential overheating. Last year was not a stellar one for two key crops, grain and cotton. Grain production inched up less than 2 percent over 1991, and the cotton harvest was down 20 percent. In contrast, the flourishing industrial and service sectors in rural China registered 37 percent gains in output value over 1991. These nonagricultural sectors in the countryside compete with urban areas for farm products, contributing to rising prices and shortages.

Cash-poor rural banks have had difficulty paying for crops, exposing a critical weakness in the system. Under the reformed system established in the early 1980s, households contract with the state to deliver a certain amount of a crop that the state purchases at a set price. (A household can keep or sell at market prices anything produced beyond the contracted amount.) The government uses the rural banking system to make these purchases. According to Hong Kong newspapers, peasant protests occurred late last year and early this year when the government offered promissory notes instead of cash for the winter harvest. The summer crop will be brought in amid reports that banks are even more strapped for cash than they were earlier. Under these circumstances, government officials are likely to allow increased credit, which would push inflation higher.

Construction and investment in fixed assets also indicate that the economy is growing too rapidly. Last year the construction industry grew 18 percent in terms of the value of business it did. Completed projects rose 38 percent over 1991, and investment in projects under construction increased 49 percent. In the first quarter of this year investment took off. The State Statistical Bureau in Beijing reported that investment in fixed assets in state-owned enterprises rose 71 percent, and investment in local enterprises 81 percent. According to the economic plan, the total

[3]See, for example, Gong Yong, "1988 nian yanzhong tonghuo pengzhang de lishi" [The history of serious inflation in 1988], *Jiage yuekan* [Price monthly], March 1993, pp. 8–9.

investment growth target is not to exceed 30 percent this year. Local leaders across the country have also established industrial development zones. Citing incomplete official statistics, the May 30 *China Focus* reported that as of last September there were 1,951 economic development zones in China. Not all have been successful at attracting investment, and leaders in the central government are considering closing many of them.

To sum up, there are many signs that China will experience an even bigger boom in 1993 than in 1992, with more rapid growth in real GNP than in the late 1980s. At the same time, by the first quarter of this year inflation was already the highest it had been since the crisis in 1989, with many overt and latent pressures for still further increases.

FINE-TUNE OR STEP ON THE BRAKES?

The attitude of many officials and academics in China appears to be that markets have been established, and that these can be adjusted through indirect means such as interest rates and tax rates. In other words, "fine tuning" the economy is now an option, whereas in 1988 it was not. Without the tools to adjust demand and supply, severe credit and import quotas were necessary to bring the economy back under control. Lacking credit or inputs, many enterprises had to stop production, halt construction projects, or even close. All this also brought the inflation rate down to 2 percent in 1990.

Many foreign analysts argue that China in fact still does not have the ability to fine tune. Some new institutions appropriate for a market economy are in place, but they exercise insufficient power over key variables, these voices say. For example, the May increase in the interest rate did little to attract savings or decrease the demand for loans. The central bank has in principle the authority to control the amount of loans local banks issue. In practice, however, it is in the interest of local banks to heed local party leaders who want to keep their enterprises running. Further, the numerous nonbank financial institutions that have been set up by the government are not even under the jurisdiction of the central bank.

If the newly reformed system is not yet strong enough to fine tune the economy, does Beijing still have the choice of applying the brakes? In the past, leaders simply ordered a halt on credit in certain sectors or enterprises, and inflation would immediately slow; painful as such a step can be, it has worked. Retrenchment could do the trick again, but the reins are not as tight as they once were. A failed clampdown might be as politically dangerous as a successful one, pointing up the weakness of the central government.

Another political consideration has colored debate on this issue. Paramount leader Deng Xiaoping's strong endorsement of reform early last year has been interpreted to mean that rapid growth should not be criticized. In the past, Chinese leaders used inflation as the bellwether of policy. If inflation became too high, reformers and conservatives generally agreed that growth and imports or other variables had to be sacrificed. The working assumption through mid-1993—at least by some at the top level—has been growth at any cost. Some localities, including Guangdong province in southern China, also prefer to accept inflation as a cost of growth.

Accepting inflation is a new development. Such a strategy might be feasible if prices rise at some reasonable, albeit high, rate. If, however, they begin to increase at an annual pace of 50 percent or more, China will face a much altered future. Inflation at this level would sap or even reverse the strengths the country has been able to exploit throughout most of the reform of the economy. Savings have been high and rising, but severe inflation would cause people to spend instead. Real income for everyone but a few elites would fail to keep up with price hikes. Capital flows could easily turn into net outflows. Finally, the corruption that is endemic in China and is already destabilizing would multiply in the face of expected sustained high inflation.

The peculiar nature of inflation in China poses yet another dilemma. When inflation begins to rise in the country, it tends to accelerate quickly. While adjusting to high inflation would be a challenge, dealing with high but accelerating inflation would be even more difficult. Part of the problem has been an inability to adjust the money supply in increments—an inability that has yet to be overcome.

Some attempt on the part of central officials to slow the economy seems inevitable. In late June, deputy prime minister Zhu Rongji was appointed temporary head of the central bank. His public statements clearly indicated a concern with China's financial situation, and a Hong Kong paper reported a new austerity program targeting imports and credit was being readied. Whether it will work is another question. Since some leaders are against pulling back, any such policy will already have one strike against it.

The course of China's economic transition could be altered by what happens in the next few years. The truly conservative leaders who favor a major shift in China's path will have to act soon. The longer Deng lives, the less political legitimacy they have. Further, if they use the failure of reform as their rationale, they will need to offer alternatives that work, and coming up with these will be difficult. However, most of the devoted socialists may already have bought into the benefits of economic reform available to them from their seats of power. In this case, marketization is likely to go forward, eventually gaining an ability to influence business cycles through interest rates, exchange rates, and the money supply. But even in this optimistic scenario, progress could be derailed if one of the boom-bust cycles is too extreme. The pressure from unpaid farmers and state workers could be too great even for Deng. ■