

THE POLITICAL ECONOMY OF THE CHINESE BUSINESS CYCLE: THE DANGERS AHEAD

By Miron Mushkat*

China has grown by leaps and bounds since the inception of the reform programme in the late 1970s. However, progress during this period has been uneven, with the country moving abruptly from a state of "boom" to one of "bust" and vice versa. At present, evidence is beginning to emerge that the economic engine has yet again gone into overdrive and that countercyclical measures may have to be introduced in order to cool it down. The purpose of this article is to establish whether the economy is indeed about to spin out of control, and explore the implications of such a development for both the mainland and Hong Kong.

1. Introduction

"Nothing so weakens government as persistent inflation."

John Kenneth Galbraith

The Tiananmen Square incident was widely expected to drive China into a state of ideological paralysis, reduce it to a pariah nation and wreak havoc on its economy. Surprisingly, however, the country has shaken off the effects of that traumatic event with remarkable ease — promptly forging a viable policy consensus, astutely maneuvering itself into a position of international respectability and skilfully reigniting the static economic engine. Today, China is in a decidedly reformist mood; it is engaged in constructive diplomatic exchanges with a large number of countries and its economy is booming.

Needless to say, China continues to face a host of short-term challenges. Below the surface, factionalism and intra-elite conflict remain a pernicious influence, tension between the centre (i.e., Beijing) and the periphery (i.e., the provinces) is simmering (by the late 1980s, the country had become effectively "cellularized" into a

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plethora of semi-autarkic local and regional enclaves), cracks are beginning to show in the social order (as evidenced by a wide array of relevant indicators — from beggary, drug addiction, gambling, graft, prostitution, street crime and vagrancy to an explosion of interest in geomancy, popular religion and witchcraft), and ethnic minorities in Inner Mongolia, Tibet and Xinjiang are growing increasingly assertive (e.g., see Baum, 1992).

The importance of these problems, however, should not be overstated. They can be legitimately regarded as an inevitable by-product of the process of socioeconomic change (i.e. the "germs" of modernization; see Myers, 1985). The critical issue is not whether they exist and on what scale, but whether the leadership has the capacity to respond to them effectively and is willing to take the necessary steps to minimize their disruptive impact. And, as matters stand, it is difficult to avoid the conclusion that the handful of individuals who manipulate the levers of power in Beijing have established the appropriate control mechanisms and are displaying a reasonable degree of cohesion/energy in tackling the difficulties which the regime presently confronts.

This said, there is one area in which the pressures that are building up could prove highly destabilizing in the short term: the economy. Socialist countries are supposed to be less susceptible to cyclical swings than their capitalist counterparts, yet the Chinese experience suggests otherwise. Since the founding of the People's Republic in 1949, China has experienced a very high degree of economic volatility by international standards. This is partly attributable to the reckless policies pursued by Mao Zedong and members of his court (e.g. the Great Leap Forward and the Cultural Revolution), but even the post-1978 (i.e. reform) economy had been distinctly unstable: on three occasions - 1980, 1985 and 1989 - it spun out of control, exhibiting excesses on the inflation and current account fronts (see Figures 1-3).

While China has not suffered unduly as a result of the corrective measures introduced to restore macroeconomic balance — indeed, the country has technically avoided a recession and recoveries have been quick to materialize — the adjustment has been costly in terms of output lost, unemployment caused and confidence eroded. For obvious reasons, government statistics do not fully reflect this fact. The unemployment figure for 1989 is a case in point. According to official sources, it rose by merely 0.6 percent (from 2.0% to 2.6%)

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Figure 1 - Real Gross National Product



Figure 2 - Overall Retail Price Index (Annual Data)

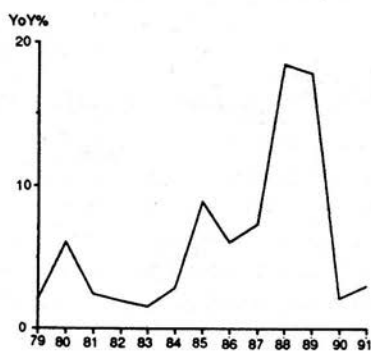
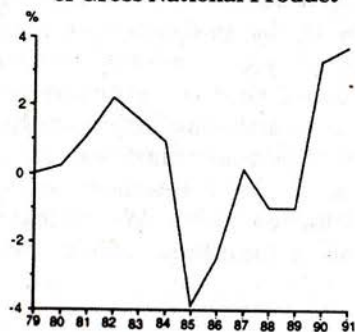


Figure 3 - Current Account Balance as a Percentage of Gross National Product



during that year, which is inconsistent with anecdotal evidence suggesting that millions of workers joined the ranks of the unemployed in the aftermath of the Tiananmen Square incident.

Nor is it just a matter of economic costs. The business cycle tends to give rise to a political cycle which has perhaps even more serious consequences. Specifically, during phases characterized by vigorous expansion ("booms") the radical reformers gains prominence, whereas those marked by fiscal and monetary contraction ("busts") feature a conservative revival. If the peak of the cycle coincides with spontaneous mass protest activity, which is normally the case (e.g. the Democracy Wall movement in the late 1970s/early 1980s, the student protest demonstrations of December 1986 and the democracy movement of April-May 1989), the following correction is in fact likely to involve a systematic purge of the radical reformers and thus significantly depress sentiment towards China and China-related entities such as Hong Kong (see Table 1 and Dittmer, 1991)

		Economic Dimension	Business Cycle	
			Boom	Bust
Political Dimension	Mass	High	Tolerance	Purge reformers
	Activity	Low	Purge conservatives	Chill

The historical pattern may not recur in the future or, if it does, in a less disruptive form than in the past. This assumption was embraced confidently by analysts at similar cyclical junctures during the reform period, yet it never proved to be correct. In the face of mounting evidence that the economy is growing at a rate exceeding its potential and that inflation in the principal cities is running intermittently at double-digit level, the onus is on China-watchers to provide a careful assessment of the short-term risks which the present situation poses. We endeavour to do so, from Hong Kong as well as a mainland perspective, in the following sections.

2. Economic Conditions and Prospects

In taking the pulse of the Chinese economy it is common to focus on manifestations of price instability and signs of deterioration in the trade/current account balance. The former play a particularly important role in the diagnostic process because the mainlanders, at all levels, are thought to have a very low tolerance for inflation. After all, China is a "less developed country" with a per capita annual income of just 1,709 yuan (i.e. approximately US\$321). The consumption and saving rates are about 70 percent and 30 percent respectively. This means that per capita consumption is a mere 1196 yuan. Thus, if prices soar, the impact on basic living conditions can be quite dramatic.

Further, most people in China do not enjoy the freedom to change jobs, which limits their ability to adapt to galloping inflation. Nor can they normally acquire assets which allow individuals in capitalist countries to preserve the real value of their money wealth (e.g. foreign exchange, gold and property). Under such circumstances, policies which breed price instability are considered unacceptable even by ideologically-neutral politicians. For such politicians — and, even more so, members of the conservative faction (indeed, all senior leaders) — inflation also evokes images of the late 1940s, a period which witnessed the collapse of the Nationalist regime against the backdrop of escalating prices and thus provided those active in the Communist movement with ample evidence that a high rate of inflation inevitably leads to chaos (*luan*)/turmoil (*dongluan*).

The historical lesson notwithstanding, the People's Republic has not necessarily been a model of price stability. As one would expect, inflation in the strict sense of the term was not a silent feature of the hermetically-closed and tightly-controlled pre-reform system. It did exist in a "repressed" form, however, and the rigid economic structure fashioned after the Communist revolution is partly responsible for the tendency of prices to spiral upwards in the post-1978 environment. By the same token, if repressed inflation is taken into account, it becomes patently clear that price instability has been a constant threat throughout the reform era.

The dismantling of administrative controls, while highly desirable in principle, has been a source of inflationary pressures in recent years because the deregulation of prices has turned out to be a delicate political balancing act rather than just a straightforward

exercise designed to enhance the efficiency of the system. Thus, although reformers envisaged a downward as well as an upward adjustment of prices, in practice it has proved exceedingly difficult to overcome the resistance of the enterprises and government agencies involved to plans to reduce the prices of overvalued commodities and the adjustment has invariably taken the form of increases in the prices of undervalued goods alone (e.g., see Ishihara, 1990; and Yi, 1990).

The reluctance to lift controls in a decisive fashion has exacerbated the problem. To be more explicit, China has not been willing to shift fully from a government-determined price system to a market-adjusted one and the hybrid which has emerged is scarcely conducive to stability. Enterprises naturally endeavour to boost the portion of their output that is marketable at self-determined prices, often without fulfilling government-imposed production targets. The artificial shortages that are created in the process propel prices to a higher level than would otherwise be the case, signalling market tightness that is not an accurate reflection of the underlying demand-supply conditions. Needless to say, in an environment characterized by scarcity, whether real or apparent, cost increments are easily translated into higher prices (e.g., see Ishihara, 1990).

Incomplete decentralization of economic decision-making is another source of destabilizing influences. The point is that state-owned enterprises in China have been granted greater discretionary powers under the responsibility system (most importantly, they no longer have to turn over all their profits to the state but can retain a portion thereof for distribution to employees or investment in the enterprise) without being exposed to the vagaries of market forces. Consequently, they operate in a semi-autonomous manner yet are not subject to realistic budget constraints (i.e., the state can always be relied upon as a lender of "last" resort and a provider of "soft" loans; hence the frequent references in the media and professional literature to "soft budget constraints").

With the expansion of management rights and in the absence of financial market discipline, employees of state-owned enterprises have been able to press directors to lift substantially wages/salaries and non-pecuniary benefits for workers. Directors, in turn, have been sympathetic to these demands because of the need, in an increasingly fluid environment, to secure the cooperation and political support of the rank and file of the organization. Unsurprisingly,

therefore, the annual rate of increase in total wages has exceeded the annual rate of increase of national income since 1978, and this has led to a sharp rise in consumption demand (e.g., see Yang and Tisdell, 1992, pp. 25-41).

Similar forces are at work in the investment domain. The difficulty here lies in the fact that, due to the partial nature of structural reform, the benefits from and responsibility for investment are asymmetric. Specifically, state-owned enterprises can obtain more (discretionary) profit by undertaking successful capital projects but need not accept responsibility for unproductive investment because they are able to shift the burden onto the government through subsidies, onto the bank through soft loans and onto the consumer by raising prices given supply shortages (so far, the Bankruptcy Law has not been applied to state-owned enterprises, only to collectively-owned ones). The corollary is that investment demand normally exceeds the supply of capital equipment by a wide margin (e.g., see Yang and Tisdell, 1992.)

The impact of demand expansion, whether it originates from the consumption or investment side, on price stability depends on the elasticity of supply. If demand expansion causes supply to increase rapidly because, for instance, resources have been unemployed, it may not result in inflation. Demand expansion, on the other hand, will result in inflation if resources are not in elastic supply. Yet, it is possible for demand-pull inflation to occur under the planned/semi-reformed system even though resources are underemployed. This is the case in China and the explanation for the phenomenon is to be found in the institutional realm.

For one thing, under the semi-reformed system, restrictions still exist on factor mobility (e.g. movement of labour), and tight controls in certain areas of economic activity (e.g. supply of basic raw materials) hamper the operation of the market mechanism. This results, *inter alia*, in illegal practices such as "official profiteering" whereby cadres purchase supplies of a commodity at quota prices (which they are allowed to do) and resell (illegally) at market prices (Yang and Tisdell, 1992). The fact that state-owned enterprises have become "employee-dominated" and remain insulated from the full impact of market forces also has a detrimental effect on the adjustment of the supply-side of the economy to demand pressures.

As indicated earlier, since state-owned enterprises can retain a share of their profits under the semi-reformed system, it is advantageous to them to inflate their costs so as to reduce the apparent profit. The underlying logic is patently clear: All of potential profit diverted into payment of higher wages and salaries is retained by the employees of the firm, but if it is declared as such and paid as a bonus to employees out of retained profits or used by the firm for other purposes, a proportion will have to be paid to the state thus leaving the enterprise with a smaller pool of discretionary funds. While the strategy is appealing from the perspective of the beneficiaries, there are limits beyond which it cannot be pursued. When these limits are reached, workers and managers often find it in their interest to inflate costs in other ways (e.g., by tolerating absenteeism, slackness at work and providing non-financial inducements). Needless to say, such behavioural responses detract from the efficiency of the supply-side of the economy (e.g., see Yang and Tisdell, 1992).

So far no reference has been made to the monetary dimension of the problem. The reason lies in the fact that changes in the money stock in China are the product of endogenous rather than exogenous influences. Put another way, price instability is primarily an institutional/structural phenomenon and monetary variables merely reflect pressures which originate elsewhere in the system (e.g., see De Wulf and Goldsborough, 1986; Feltenstein and Farhadian, 1987; Chow, 1987; Portes and Santorum, 1987; Jao, 1990; and Peebles, 1991).

We have already explained that state-owned enterprises operate under a soft-budget constraint and thus enjoy virtually free access to credit. In the absence of market-derived incentives to boost efficiency, their managers are also not motivated to pursue sound financial strategies. The upshot is that incurring substantial losses is the norm in this sector and the government is compelled to foot the bill. Attempts by state-owned enterprises to retain as large a portion of earnings as possible (i.e., minimize transfer to the government) compound the problem in that they result in an erosion of the public revenue base. Because prices are not market-clearing, the budget has to absorb a vast amount of price subsidy to boot.

A chronic fiscal deficit is the inevitable outcome of these institutional flaws and structural imbalances. While the People's Bank of China is no longer merely a cashier of the Ministry of

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Finance (or, from a broader perspective, State Council), having nominally been transformed into a Central Bank in 1984, the deficit is routinely and largely financed by advances from that institution. The Ministry of Finance has yet to acknowledge that such advances constitute a debt which needs to be repaid. Another method of financing the fiscal deficit is through a mechanism referred to by Chinese economists as "fiscal issue" (*caizheng faxing*), or what is known in capitalist countries as "running the printing-press". Both bank and central bank accommodation add fuel to the inflationary fire, but it should be emphasized again that these activities are a passive response to stimuli which emanate from domains other than the monetary sector (see Figure 4 and Jao, 1990).

Institutional flaws and structural imbalances are a semi-permanent feature of the system in that they cannot be corrected in an expeditious manner. The Soviet experience amply demonstrates that the costs of radical economic surgery are prohibitively high and that piecemeal engineering of the Beijing variety is a more sensible strategy for a socialist country pursuing Western-style reforms. The intractability of the problem notwithstanding, China does not suffer from chronic price instability, nor is the current account invariably in the red. Institutional flaws and structural imbalances exert a pernicious influence when the economy is expanding at a rate exceeding its potential but do not present insurmountable difficulties at other junctures.

The corollary is that the real growth of gross national product, relative to the appropriate norm, should be the starting point in the assessment of pressures within the economic system. Although data whose reliability can be ascertained with a reasonable degree of confidence are available only on an annual basis, and with a lag, a fairly strong statistical relationship exists between changes in industrial production and GNP (see Figure 5). Consequently, it is possible to draw the necessary inferences by following this indirect route (industrial production statistics are published on a monthly basis and in a timely fashion). The results are not entirely accurate yet they are sufficiently close to target to prove useful in this general context.

Figure 4 - Model of the Inflationary Process

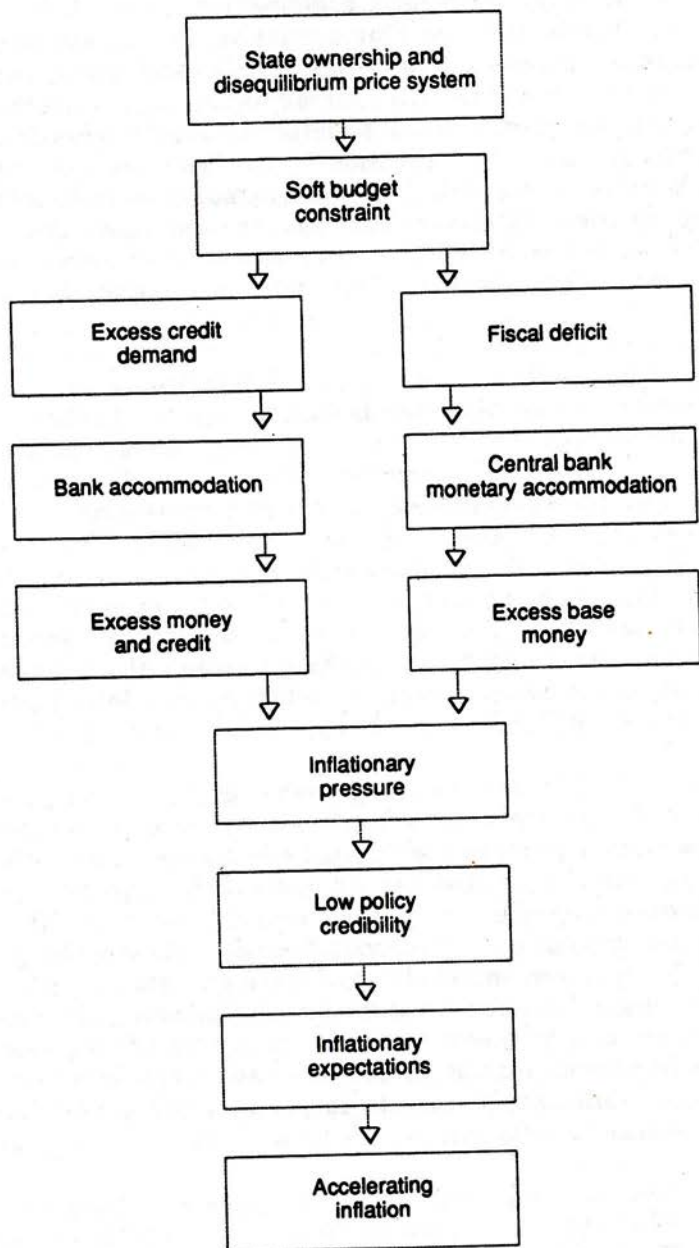
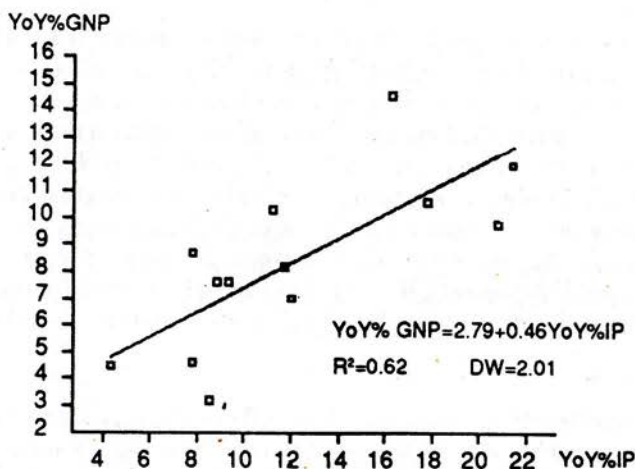


Figure 5 - GNP Growth as a Function of Industrial Production Growth (IP) (Real)



In the past twelve months, industrial production has expanded at an average rate of 18.5 percent, with the monthly numbers moving to a progressively higher level. If it is posited that they are stabilizing around 22.0, the implication would be that GNP is rising at a rate of 12.9 percent. In annual terms, this is a figure which, since the inception of the reform programme, was exceeded only in 1984 and 1985 and well above the 8.0-9.0 percent that we deem to be desirable from a supply-side perspective. Such vibrant performance, while a reflection of fundamental strength, has previously unleashed substantial inflationary pressures and has provoked adverse reactions in the policy domain, upsetting the socio-political equilibrium in the process.

The robustness of the economy is partly attributable to the buoyancy of exports. An apparently undervalued currency had driven them to lofty levels (see Figure 6), boosting the net foreign assets of the monetary system (see Figure 7). It would be inaccurate, however, to ascribe the jump in liquidity to external factors alone. Domestic credit, mostly channelled to transactors other than the central government, has risen sharply to accommodate demand stimulated or sustained by the type of institutional/structural forces discussed

earlier (see Figure 8). The upshot is that the money supply has ballooned to the point that it threatens price stability (see Figures 9 and 10).

It might be argued that the threat is theoretical rather than real. Thus far, the rate of inflation for the country as a whole has remained at the low end of the cyclical range and the spike in prices in the principal cities witnessed in 1992 increasingly seems like a temporary phenomenon (see Figure 11). Indeed, as matters stand, China, whose economy is displaying greater vigour than that of any other Asian country, is experiencing one of the lowest inflation rates in the region. Compared with Hong Kong, in particular, the mainland appears to be a paragon of price stability and analysts are confidently predicting that galloping inflation is a thing of the past.

A number of reasons have been offered in an attempt to explain systematically the anomaly presented by the combination of explosive growth/expanding liquidity and relatively stable prices. Nature's benevolence, or a string of bumper harvests, is the factor featuring most prominently in accounts of this intriguing phenomenon. In a country like China, it is claimed, the behavior of the food component of the cost-of-living index is a more relevant consideration in assessing the potential for an inflationary flare-up than the level of economic activity/changes in the money supply. Yet, to the extent that the indices relied upon for this purpose do not reflect accurately the shifts in consumer spending on the mainland, the assertion is not entirely valid. Further, nature can turn malevolent and it is imprudent to base one's prognosis exclusively on trends in prices of a highly volatile item which is not even included in the core rate of inflation.

Marked improvements on the supply side are cited as another element in the equation likely to prevent an upward spiral in prices. Specifically, the balance of power between state-owned enterprises and privately-operated business entities (including collective vehicles) is said to have swung in favour of the latter. The former generated merely 55 percent of industrial output in 1990 — versus 65 percent in 1985 — and no longer exert the strong influence on micro and macro performance that they did at similar cyclical junctures in the past. The conclusion to which this line of reasoning leads is that there is now sufficient flexibility on the supply side of the economy to ensure smooth adjustment to fluctuations in demand, regardless of their amplitude.

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Figure 6 - Nominal Merchandise Exports and Imports

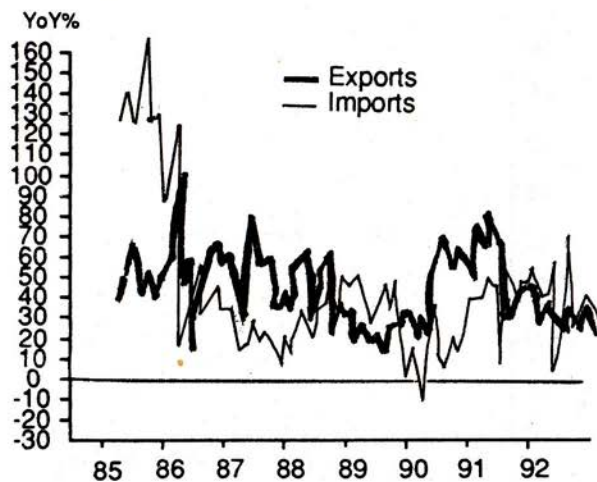


Figure 7 - Net Foreign Assets of the Monetary System

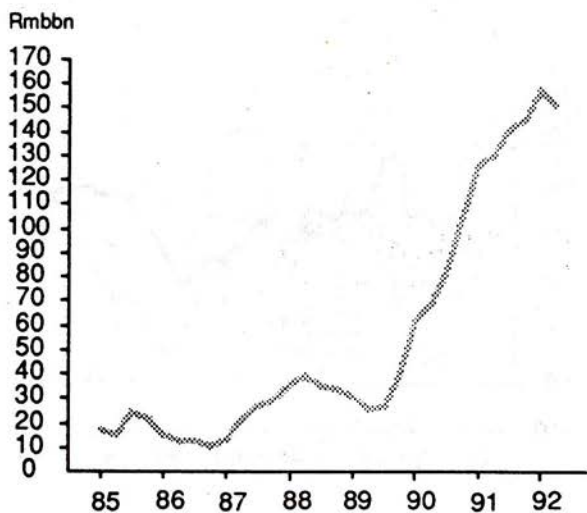


Figure 8 - Domestic Credit

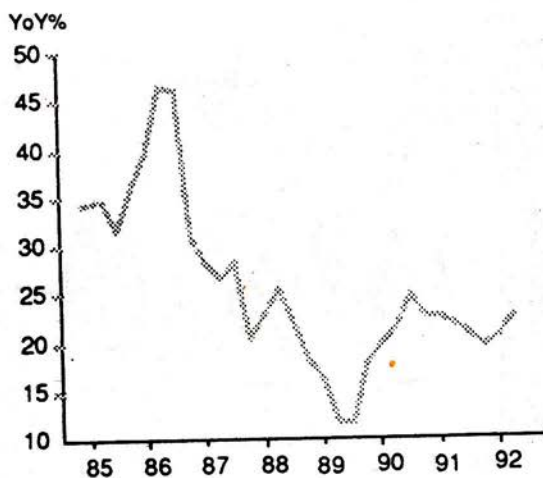


Figure 9 - Currency in Circulation (C), Narrow Money (M1) and Broad Money (M2)

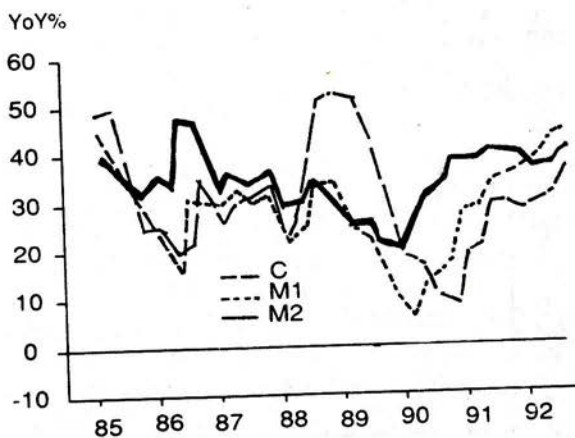


Figure 10 - Deviation of Liquidity Ratio (M2/GNP) from Trend

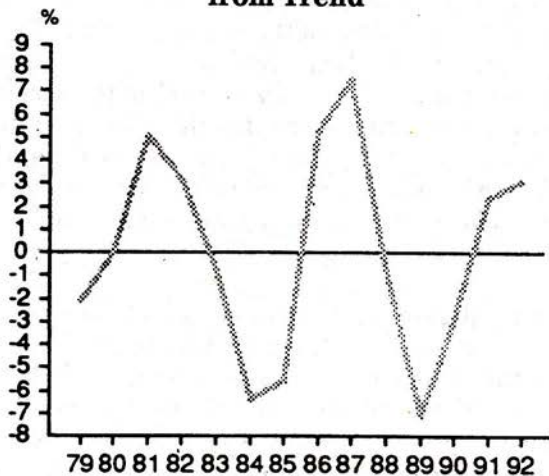
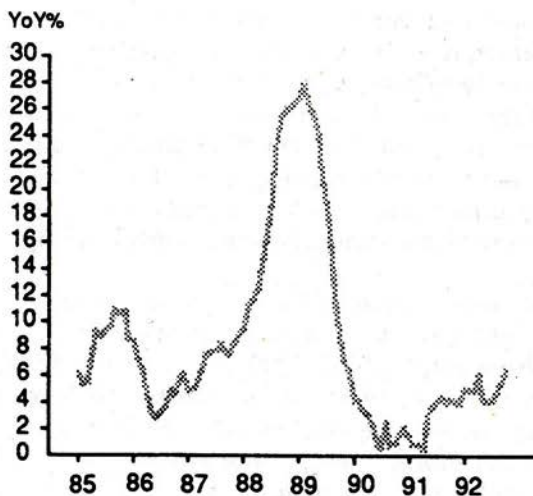


Figure 11 - Overall Retail Price Index (Monthly Data)



The swing, however, has not been decisive enough to justify such a conclusion. State-owned enterprises still account for around 50 percent of industrial output and remain, at least in the quantitative sense of the term, the mainstay of the urban economy. Thus, although the country is growing by leaps and bounds, the manufacturing sector (this is even more apparent in the case of the service industry, except for those peripheral segments which have been effectively privatized) continues to suffer from serious rigidities. The infrastructure is also grossly inadequate — or at least not capable of supporting a boom on the present scale — and bottlenecks in this critical area are an obvious source of inflationary pressures.

The caution displayed by the consumer is the third factor which is thought to have kept prices on a comparatively even keel in recent months. Indeed, household spending has not been as robust as one would expect under the circumstances. To the extent that private consumption expenditure is dependent on income (gross national product, at the aggregate level), as our statistical model suggests (see Figure 12), real retail sales should have been climbing at a rate of 19 percent or so (given that GNP is approximately 13 percent above the level observed a year earlier). Yet, unlike in the past, they have not surged in response to the leap in gross national product (see Figure 13).

Households are believed to be satiated with consumer goods, following the buying spree of the late 1980s, an assumption which we do not find entirely convincing. They are diversifying into financial assets and property to boot, a point which is difficult to dispute but whose significance should not be overstated. (The diversification has by no means assumed the form of a stampede and appreciating portfolios - or even the mere possession of such assets - could of course produce a heightened sense of material well-being/"wealth effect" and sooner or later stimulate household spending on durables).

The uncertainty induced by enterprise reform, particularly the increase in unemployment and the growing realization that the system of lifetime employment is beginning to unravel, may have contributed to the reluctance of consumers to loosen the purse strings more aggressively. Again, however, one is reluctant to embrace uncritically this seemingly compelling explanation for the relevant statistics do not inspire much confidence. (For instance, is unemployment higher at present than it was following the Tiananmen Square incident, as the data indicate?) Also, there is a conceptual

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difficulty inherent in reconciling the notion of widespread concerns about job insecurity with the reality of a buoyant economy. (Surely existing unemployment must be primarily of the frictional — as distinct from cyclical or structural — variety?)

Academic as it may sound (by Chinese standards), households are possibly behaving in accordance with Milton Friedman's at least partially valid permanent-income hypothesis. That is, having witnessed three sharp cycles in the past fifteen years, they are cautiously regarding the latest burst of economic activity as a temporary phenomenon, soon to be followed by the now fully predictable slowdown. If this is the case, the gains in income associated with it are viewed as transitory, rather than permanent,

Figure 12 - Retail Sales (RS) Growth as a Function of GNP Growth (Real)

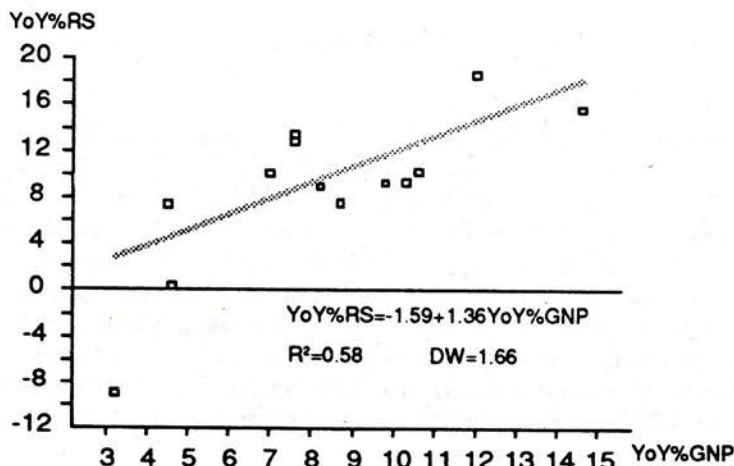
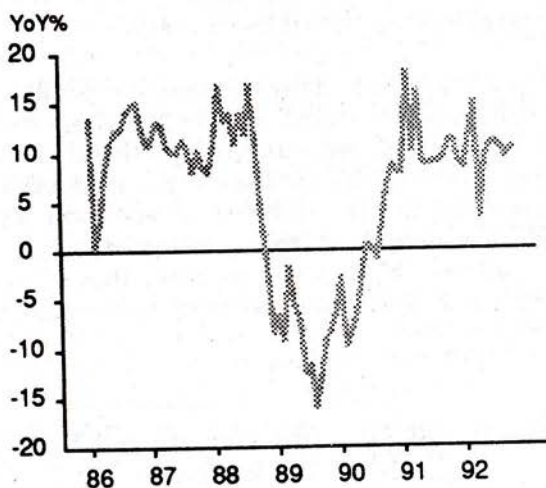


Figure 13 - Real Retail Sales



in nature and hence the unwillingness to take greater-than-usual risks.

Another theoretical construct which may shed light on the current pattern of consumer expenditure is that of "adaptive expectations". The point is that household expectations, which adapt slowly to changes in the environment, still probably reflect the severe cyclical correction experienced in 1989 and therefore constrain spending. This said, the longer the economy continues to display signs of extraordinary vitality, the more likely are gains in income/changes in the environment to be considered as "permanent"/incorporated into expectations. The upshot, it is reasonable to assume, will be a pick-up in consumer demand and a faster rise in prices.

Whatever the explanation for the restraint exhibited by households, it is correct to describe the present boom as being primarily "investment led" (it should be noted in this context that the heavy inflows of foreign capital have also contributed to the rapid expansion of the money supply; see Figure 14). The absence

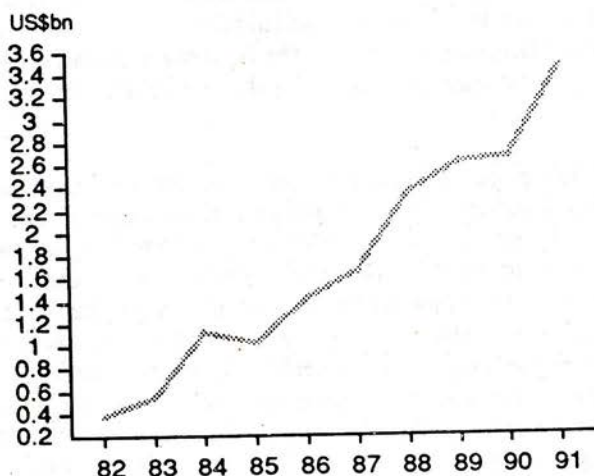
of the consumer from the scene of action has prompted analysts to conclude that inventories have been accumulating at an uncomfortable rate — thus, on the positive side, helping to contain inflationary pressures. The snag is that no reliable data are available to support such a conclusion. It is true that industrial production has outpaced retail sales but this could be due to the healthy demand for investment goods rather than manufacturers' policy of churning out unwanted consumer products.

The brisk pace of industrial activity implies that inflation at the plant level (China does not publish a producer price index and one has to rely on anecdotal evidence) has reared its head again. Assertions that modest increases in unit labour costs — thanks to moderation on the wage front and gains in productivity — have operated as a countervailing force in this respect cannot be substantiated directly or indirectly. Given the paucity and poor quality of the statistics, there is a degree of risk in offering judgment tilted decisively in a certain direction but — in view of the robustness of the economy, expansion of liquidity and strains in the industrial domain — it is legitimate to argue that inflation at the consumer level has remained subdued only by virtue of the bumper harvests seen recently and because of official tinkering with the price mechanism.

No negative connotations are attached to the term "tinkering" here. It merely reflects the fact that the post-1989 reform effort has been largely confined to the structure and performance of enterprises and that the price system has not been overhauled and transformed into a more effective barometer of pressures in the economic domain. Consequently, it does not emit signals which are entirely accurate and one should not rely on it exclusively in assessing the potential for an inflationary flare-up. A deterioration in the foreign trade/current account picture (indeed, see Figure 15) is a useful indication in this respect and other, less conventional, forms of data manipulation can be resorted to in order to improve the quality of the diagnosis (e.g. see Peebles, 1991; Hsu, 1989; and Clutterbuck, 1991).

A relatively simple, yet quite powerful, methodological device which can be employed for that purpose is a technique developed to measure "repressed" inflation in China. It is based on the well-known equation of exchange ($MV=PT$, where M is the currency in circulation, P is the general price level, T is the volume of retail sales and PT , by implication, is the value of retail sales). Proceeding

Figure 14 - Foreign Direct Investment



on the assumption that the velocity V is approximately constant, one can utilize the equation to obtain estimates of repressed inflation in the country. The results for the past two years are shown in Table 2 and they demonstrate that "total" inflation during that period has been rather high. (For further discussion of this technique and its variants see Ishihara (1990), Jao (1990), Peebles (1991), Chen and Hou (1986), Feltenstein and Ha (1991).

Needless to say, there is nothing to prevent planners in Beijing from tinkering with prices in the future and maintaining open inflation at a palatable level. In the long run, however, this is not a viable strategy in that in an environment which is to a considerable extent shaped by market forces the underlying pressures are likely to manifest themselves on one front or another. The foreign trade/current account channel is the most obvious alternative route through which they could flow to the surface and it is just a matter of time before this occurs and assumes critical dimensions. The pattern of price movements in the urban areas also suggests that the policy of controlling inflation through administrative means (i.e. tinkering) has its limits in the present circumstances and that symptoms of

economic overheating could show dramatically in the cost-of-living indices.

The question arises whether, given the decentralization of economic decision-making and easy access to foreign capital, the monetary authorities are in a position to engineer a meaningful slowdown. The answer is that a deceleration in the pace of economic activity will materialize in any event owing to the proliferation of supply-side bottlenecks and that the People's Bank of China/State Council still enjoys a reasonable (albeit diminishing) room for manoeuvre in pursuing stabilization objectives. A combination of fiscal, monetary and regulatory (i.e. bureaucratic) measures could help purge excesses from the system. Indeed, because the current boom has its origins primarily in the realm of investment, restoring a modicum of balance through corrective strategies could in some respects pose less of a challenge than at similar junctures in the past.

There have been indications, since the 14th Party Congress, that the powers that be in Beijing realize that the economy needs to shift into lower gear. Yet, in China problem recognition does not necessarily trigger a prompt response. Timely intervention could bring about a "soft landing" and, if initiated by leaders dedicated to reform (i.e., executive vice premier Zhu Rongji and his advisers), prevent a temporary erosion of their position. On the other hand, procrastination might result in a "hard landing" and a tilt in the balance of power in favour of conservative members of the political elite; the tilt would probably be short-lived but it could complicate the transition from the era of Deng Xiaoping and its policy oscillations to one hopefully characterized by comparatively smooth socioeconomic progress and relative political tranquility.

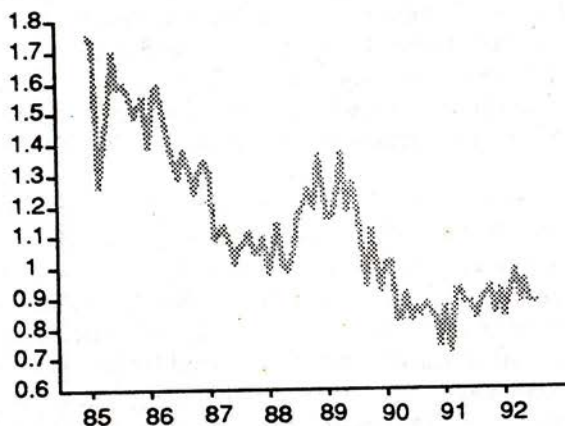
3. Implications for Hong Kong

Hong Kong's economy, not long ago detached to all intents and purposes from China, has grown increasingly dependent on the mainland. Clearly, should the latter undergo a cyclical adjustment, the resurgent capitalist enclave would not be able to escape the consequences. The potential damage, however, is not easy to assess because it is a function of the form that the adjustment takes. A soft landing, while not without costs, might not cause undue difficulties. By contrast, a hard landing would in all likelihood

have considerable economic ramifications and, perhaps more importantly, might depress political sentiment.

In whatever form the adjustment comes, the domestically-oriented sector of the Chinese economy will be more adversely

Figure 15 - Import/Export Ratio (Seasonally Adjusted)



affected than the externally-oriented one (although investment plans in the latter area may have to be scaled down). Hong Kong's manufacturing base in the southern part of Guangdong province should continue operating at a level reflecting conditions on the demand side and supply-side constraints, provided the adjustment does not coincide with a 1989-style disillusionment with China and reluctance to deal with it commercially. Exports from Hong Kong to the mainland for final use there (i.e. retained imports) will consequently bear the brunt of the adjustment and the impact on other flows (domestic consumption/investment as well as foreign trade) need not be severe. Nonetheless, it would be surprising if investment in the territory, and possibly even consumption, did not lose some momentum.

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Ideally, the lull in a number of industries which have performed vibrantly should be exploited to alleviate the problems posed by infrastructural bottlenecks in China, including the southern provinces. The electricity generation network and transport system are obvious targets in this respect and opportunities could present themselves in both areas for Hong Kong investors. On balance, however, the coming correction will bring more pain than pleasure and it is desirable to prepare psychologically for the change in economic climate on the mainland. All one can say at this stage is that the change will almost certainly take place in the near future, be either mild or fairly disruptive, manifest itself more palpably in some sectors than others and, judging from previous experience, turn out to be a temporary (albeit recurring) phenomenon.

Table 2 - Inflation — Open, Repressed and Total (YoY%)

Period	Open Inflation	Repressed Inflation	Total Inflation
1Q91	1.1	1.5	2.6
2Q91	2.5	4.4	6.9
3Q91	4.2	8.4	12.6
4Q91	4.1	7.9	12.0
1Q92	5.0	8.8	13.8
2Q92	4.8	15.2	20.0

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