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CHINA: MID-COURSE CORRECTIONS

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China continues fitfully to implement a great economic reform program and to replace ideologues with technocrats as its political and economic managers. Chinese policy has so many momentary tides and waves on its surfact that its overall tendencies can be judged only from a deep historical perspective.

The Chinese revolution since 1949 passed through numerous cycles of technocracy and ideological fanaticism. In the early period, Chinese politics was dominated by guerrilla revolutionaries whose economic priorities were redistribution and destruction of the power bases of the old order. Their constructive efforts were based on the typical thrid world illusion that a modern economy can be constructed overnight, that this can best be done in isolation from the advanced countries, and that political will is more important than organization and expertise. These were the dominant themes despite intervals of technocratic calculation (1953-57 and 1962-65). This era culminated in the Cultural Revolution, 1966-76, which was more destructive of the country's economy and morale than the Iranian revolution has been, and ended only with the death of Mao Zedong.

After Mao's death, his wife made an abortive effort to revive the violent fanaticism of the Cultural Revolution and was defeated instantly by Hua Guofeng, who advocated more moderate politics but sought to retain a totally bureaucratized economy and to pursue further great leap into heavy industrialization; his economic plan was symbolized by the Baoshan steel mill, still the greatest white elephant of the Chinese economy. Within two years, Hua was overthrown and a leadership managed by Deng Xiaoping began implementing a program based on market incentives, technical expertise, modern technocratic organization, and economic decentralization. All of these tendencies are just that: tendencies, not absolutes. China is, and will remain, primarily a socialist economy with centralized control. But the tendencies affect a vital margin, most notably in the foreign sector.

Throughout all the periods of alternating fanaticism and technocracy, there have been four constants which are particularly noteworthy for foreign banks. First, China has been extremely conservative in managing its foreign debt. To China's leaders, foreign debt was the principal tool by which foreigners had destroyed China's sovereignty a century ago; in both Taipei and Beijing, avoiding excessive financial dependence on foreigners has remained an obsession. This obsession has been moderated at the margin, but has not disappeared. Second, China's experience of hyperinflation earlier in this century was even more searing than Germany's, and today China's leaders have fresher memories of hyperinflation than Germany's. Therefore, they manage the domestic budget very conservatively, and overreact to the first signs of inflation. Third, through every phase of every cycle, the leadership has put domestic economic and political stability firmly ahead of foreign adventures unless they saw an immediate physicaal danger to China itself; hence there was no Chinese intervention in Vietnam, and the military budget has always been kept under control. Fourth, under emperors, warlords, Kuomintang, communist ideologues, and communist technocrats, China has always understood the importance of Hong Kong to its economic well-being and has refrained from any serious threat to Hong Kong's stability. These constants provide a baseline from which to assess more volatile aspects of Chinese economic and financial management.

There is also a political baseline from which to judge current changes. The old revolutionaries have mostly died. The Cultural Revolution so devastated every major group of Chinese society -- farmers, workers, intellectuals, government officials, Communist Party apparatchiks, economic managers -- that it created an enduring, near-universal revulsion. Even the revolutionary students of the Cultural Revolution era now revile it; because they lost their chance to acquire education and skills, they are now called, and call themselves, the "Lost Generation." Thus, while every aspect of the current reforms is controversial, there is no support for a return to wild radicalism.

Politically, Deng Xiaoping's reforms have instituted a period of reconciliation and healing. Business organizations, government bureaucracies, and the Communist Party are rejuvenating themselves. People have more space for private lives, and interests are more often consulted. Mutual efforts to achieve economic growth have replaced the ideology of class struggle and permanent revolution. To be sure, there are purges, millions of Party members are unhappy, and new economic opportunities have created social inequality to a degree that already rankles, but these are stresses and strains rather than social warfare.

Economically, Deng has initiated a revolution. Agriculture has been shifted from collectives to share tenant socialism; the key economic unit is the family, rather than the commune or brigade, but the family must meet a state quota before entering the free market with the remainder. Light industry has been given far greater priority, and key industries within it have exploded in production and productivity. Incentives have been introduced, state controls have been relaxed at the margin, profits are insisted upon, and some prices have been decontrolled. Scientists are being wooed rather than denounced, and technocratic managers are replacing party hacks at the leadership of enterprises.

The changes in agriculture produced such dramatic benefits that the new system is politically irreversible. Farm incomes rose over 94 percent in one three year period; the farmers would fight a war before allowing the state to return to collectives.

Reforms are fairly far advanced in many parts of light industry, but the record varies enormously by industry and by region; one has to label the achievement spotty so far. In heavy industry, the reforms haven't even seriously begun.

The greatest revolution has been in the foreign economy. China has reached abroad for technology and capital. It has opened virtually the whole coastline to foreign investment and created special economic zones where capitalist standards prevail. Thousands of students have gone abroad for foreign education, even at the cost of becoming tainted with capitalist ideas. There is now almost universal admiration in Beijing for Taiwan's economic achievements.

These reforms have of course stimulated opposition. Some parts of the military are unhappy at the way the military budget has been held down. The radicals who are being purged from the Communist Party, and the middle level apparatchiks who have lost their leadership of the economy, are greatly distressed. Many thoughtful Chinese are worried about the spread of ineqality and the upending of China's social pyramid: the old hierarchy was cadres-military -workers-farmers, and the new one is farmers-workers-cadres-military. The cadres are told that they can become teachers -- one of the most deprived groups in contemporary China -- if the reforms generate enough income to fund the new positions. But the opposition lacks direction and unity. No group has proposed an attractive alternative to Deng's program; one scholar has compared the dilemmas of Deng's opponents to that of the Mondale Democrats. And the opposition is torn and divided. The military resents its low priority, but most soldiers are from farm families, and those families are benefitting beyond their wildest dreams from Deng's reforms. The Party cadres are unhappy, but their children are fast learning how to use their superior education and political access to earn their fortunes.

The results of this opposition have been two. First, from within the Party has come what the Chinese call "red eye symptoms," jealousy, criticism, and footdragging. Second, there is a current campaign against abuses of the reforms and collateral damage done by the reforms. This is directed against overinvestment, inflation, corruption, and a fear of loss of central control and of ideological degradation.

Most of the increase in corruption is a problem of transition, but is very severe during the transition. So long as the state completely controls every aspect of economic life, corruption can be controlled to some degree and the residual can be largely hidden from view. When the economic arena controlled by the market is initially expanded, the founding and operation of most businesses remains dependent on government and Party decisions. Thus, huge opportunities open for impoverished government officials to extract favors in return for supportive decisions and for entrepreneurs to offer bribes or exploit personal connections. China's problem in this respect is identical to Indonesia's. If the reforms proceed, eventually competition among firms will severely curtail the favors that firms can provide and still survive financially, but that point remains far in the future. Meanwhile, the dramatically improved standards of living of farmers and of many new entrpreneurs whets the appetites of those who engage in the kind of corruption predominant in a purely socialist economy: diversion of state resources for private benefit.

China's most severe structural economic problem concerns pricing. So long as prices are controlled by the state, market forces in other areas cannot ensure rational economic outcomes: Those firms which have the luck or political power to obtain low prices for their inputs and high prices for their outputs will succeed even at low efficiency, whereas less fortunate firms will fail even if they are highly efficient. In recent months, it has been particularly common for firms to find that their raw material costs have risen to market levels but the the prices of their products are still controlled; in consequence many face bankruptcy. At the same time, sudden introduction of market prices risks unacceptable inflation, commodity shortages, and even severe welfare problems (if the prices of essential commodities rise faster than wages).

China has handled the resulting dilemma through a dual strategy of gradualism: prices of some goods are decontrolled before the prices of others, and prices of many goods are controlled on the quota which the firm must provide to the state but decontrolled on the surplus remaining after the quota has been satisfied. Such gradualism is sensible, but creates huge incentives to profit from remaining disparities between market-priced goods and non-market goods, and between state quota prices and market prices for the same goods.

In addition, opportunities created by expansion of the market-oriented sector develop faster than market discipline or entrepreneurs' skills in analyzing potential markets. Hence an explosion of entrepreneurial energies has created many inappropriate investments; these can cause inflation, waste of scarce resources, and social problems. Hence there has been a general tightening of administrative and financial controls.

Finally, there has been a campaign by Deng and his colleagues to preeempt opponents who accuse them of abandoning socialism. From the leadership has come an outpouring of speeches saying that China will never abandon socialism. This has brought with it a new campaign against social and moral indiscipline.

Overall, this correction program is multifaceted and important. But so far it shows no sign of reversing the momentum of reform. It is a mid-course correction. It has been carried out so far in the manner of a parent disciplining an unruly adolescent rather than dispossessing him. It is difficult to know how far the correction program will go; China watchers have so little solid information that they are usually very confident about such things and frequently wrong. But nothing in the current correction program suggests an abandonment of the basic reforms, particularly in agriculture and light industry, and above all nothing even remotely suggests fundamental alteration of the economic and political baseline discussed above.

For the foreseeable future, the problems in doing business with China will continue to be red tape, identifying the appropriate customers, and ambiguity caused by a vague legal system and untrained Chinese personnel. Political and credit risk will be far less important.