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S. Hrg. 102-586, Pt. 2

GLOBAL ECONOMIC AND TECHNOLOGICAL CHANGE: FORMER SOVIET UNION AND EASTERN EUROPE, AND CHINA

HEARING

BEFORE THE

SUBCOMMITTEE ON TECHNOLOGY AND NATIONAL SECURITY

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

PART 2

JUNE 8 AND JULY 27, 1992

Printed for the use of the Joint Economic Committee

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CONTENTS

WITNESSES, STATEMENTS, AND SUBMISSIONS FOR THE RECORD

Monday, June 8, 1992

PAGE

Bingaman, Hon. Jeff, Chairman of the Subcommittee on Technological and National Security, Joint Economic Committee: Opening Statement 1

Reports by the Central Intelligence Agency and the Defense Intelligence Agency entitled:

"The New Russian Revolution: The Transition to Markets in the Other Commonwealth States" 3

"Eastern Europe: Struggling to Stay on the Reform Track" 41

McLaughlin, John, Director of the Office of Slavic and Eurasian Analysis, Central Intelligence Agency 93

Prepared statement 100

Horste, Kathleen, Special Assistant for Russia/Eurasia, Defense Intelligence Agency 106

Prepared statement 111

Monday, July 27, 1992

Bingaman, Hon. Jeff, Chairman of the Subcommittee on Technological and National Security, Joint Economic Committee: Opening Statement 129

Petersen, Martin, Deputy Director, Office of East Asian analysis, Central Intelligence Agency 130

Prepared statement 137

Report entitled "The Chinese Economy in 1991 and 1992: Pressure to Visit Reform Mounts 143

ECONOMIES OF THE FORMER SOVIET UNION AND EASTERN EUROPE

MONDAY, JUNE 8, 1992

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TECHNOLOGY AND NATIONAL SECURITY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room SD–628, Dirksen Senate Office Building, Honorable Jeff Bingaman (chairman of the Subcommittee) presiding.

Present: Senator Bingaman.

Also present: Richard F Kaufman, General Counsel.

OPENING STATEMENT OF JEFF BINGAMAN, CHAIRMAN

SENATOR BINGAMAN. The Subcommittee hearing will come to order.

The hearing marks an historical watershed in several respects.

Today, we're receiving the last reports of the Central Intelligence Agency and the Defense Intelligence Agency on the Soviet Union, and their first on Russia and the other republics of the former Soviet Union.

As everyone is aware, the Soviet Union was dissolved as a political entity in December of last year and the republics that made up the USSR reformed themselves as independent, sovereign republics. The reports that we receive today will review economic performance and defense spending and related activities in 1991, which was the last year of the USSR's existence.

The intelligence agencies will also report on what has occurred in the republics thus far in 1992, the first year of their existence since the breakup of the Soviet Union.

As I understand what's been delivered to us now, we have a CIA report on the former Soviet Union. We have a CIA report on Eastern Europe. And we have a CIA report on Moscow's defense spending cuts accelerate. And then we also have a statement by the Defense Intelligence Agency that covers that whole range of issues, as I understand it.

In addition to having this broad range of issues reported on today, this hearing will be done in open public session, which is a circumstance that was not possible during the long period of the Cold War.

The most remarkable thing about the hearing, however, concerns the substance of the inquiry; namely, the shift and transition from socialism

to market systems in the former Soviet Union and the former communist countries of East Europe.

It would be unfortunate if we took for granted the monumental importance of these historic changes.

Russia and the other former socialist countries have decided to shift to market systems and they have taken meaningful steps in that direction.

There are obviously going to be difficulties and mistakes, but the West and the United States, in particular, need to be helpful rather than hypercritical.

It is sometimes the case that we do not understand the value of something until it is lost. It could be a tragedy of global proportions if the West became too impatient in seeking rapid progress in the former communist countries and too demanding in obtaining compliance with conditions attached to economic aid.

Our witnesses this morning are: John McLaughlin, Director of the CIA's Office of Slavic and Eurasian Analysis; John Gannon, Director of the CIA's Office of European Analysis; and Kathleen Horste, the Special Assistant for Russian and Eurasia in the Defense Intelligence Agency.

Each will give an oral statement, following which we'll have some questions.

[Reports presented to the Subcommittee by the Central Intelligence Agency and the Defense Intelligence Agency follow:]

THE NEW RUSSIAN REVOLUTION: THE TRANSITION TO MARKETS IN THE OTHER COMMONWEALTH STATES

A paper presented by the Central Intelligence Agency and the Defense Intelligence Agency to the Joint Economic Committee's Subcommittee on Technology and National Security

(embargoed until 1400 8 June 1992)

Summary

When the Soviet Union met its end in December 1991, more than six decades of central planning had left its former member republics ill prepared for the transition to independent market economies. Recognizing the failure of the old system, however, all of the members of the new Commonwealth of Independent States (CIS) have introduced economic reforms that were at best distant dreams only a year ago.

Reform Efforts

While all of the CIS states have made some progress in reforming their economies, Russia is clearly in the lead. In January 1992, Russia launched a comprehensive program to introduce key elements of a market economy and stabilize fiscal and monetary conditions. To date, Russia has made considerable progress in liberalizing prices, reining in the budget deficit, and cutting government spending on investment and defense. About 80 percent of wholesale prices and percent of retail prices were freed on 2 January, and further price liberalization has followed. The government's claims about reducing the budget deficit during first quarter exaggerate its accomplishment, but even when adjusted to comply with international accounting practices, the budget demonstrated substantial progress toward fiscal restraint. In addition, Russian statements suggest that 1992 defense spending will fall sharply.

More recently, a political backlash against the sacrifices these measures have entailed--most evident at the April meeting of the Russian Congress of People's Deputies--has prompted the government to adjust its program--for example, by relaxing restraints on credit. While the government has continued to move forward with painful measures such as sharp hikes in energy prices, continuing calls for major reductions in taxes, large increases in spending, and massive infusions of credit are increasing the pressure on the leadership to compromise its stabilization program.

Much work remains to be done, moreover, in privatizing state property, opening the domestic economy to the outside world, and developing market-oriented laws and institutions. According to Russian statistics, fewer than 1 percent of retail stores, public dining facilities, and consumer service outlets had been privatized by 1 April this year, and only about 2 percent of agricultural land was in the hands of private farmers. Many of the operators of private businesses are not full owners in the sense that ownership is understood in most Western countries and there are important restrictions on the resale of land. Reorienting trade with the rest of the world will be a lengthy process, even if partial currency convertibility is achieved later this year as planned, and legal and institutional development will take longer still. The financial system, in particular, remains rudimentary; bank deposits, for instance, still cannot be freely converted into cash.

The non-Russian members of the CIS also have made progress toward market economies, but all of them lag considerably behind Russia. All of the other states, for example, have followed Russia's lead in liberalizing wholesale and retail prices, but almost all have left more extensive price controls in place. All of them also have made less progress than Russia in liberalizing foreign trade and in enacting legislation to support the transition to market economies.

Defense Conversion

All of the Commonwealth states--particularly Russia and Ukraine, which contain the vast majority of defense industrial enterprises of the former Soviet Union--are looking to defense conversion as a means of downsizing the massive military industrial base and increasing production of consumer and investment goods. Nevertheless, progress in converting military industry has remained minimal, as defense plants continue to be hampered by difficulties in developing new products and supply chains, problems in marketing new products, and a shortage of funds. As a result of deep cuts in orders for weapons and an inability to compensate with increased civilian work, many defense enterprises are on the brink of financial collapse. These enterprises are hoping for additional financial support from the government during the coming year. Defense industry and government officials are also seeking assistance and private investment from the West and Japan, and many of the new states have stated their intention to use profits from arms sales to fund conversion.

Outlook

Throughout the Commonwealth, the economic transformations that are occurring will be accompanied by social and political turmoil. In the next year or so tensions are bound to increase significantly as unemployment grows and privatization evokes bitter quarrels over social justice. There will be powerful pressures to adopt inflationary policies in an effort to ease the pains of economic transition. In Russia, Yel'tsin has managed so far to stick to the major tenets of his reform program, but his continued ability to do so may well be reduced by political fallout from the sacrifices reform will entail.

Even under the best conditions, the economic outlook for the next year or two will be grim in all of the Commonwealth states. Output will continue to decline, unemployment and inequalities in the distribution of income will rise, and the struggle against inflation will be difficult. In large part, the outcome will depend on the degree of success that the new countries achieve in the following key areas:

- Keeping budget deficits and bank credits low enough to brake inflation while still providing social support for pensioners, low-income families, and workers who lose their jobs.
- Shrinking defense industry and converting its production lines to consumer and investment goods, while mitigating the impact of unemployment on its workers, managers, and scientists.
- Reducing direct government intervention in the economy and simultaneously encouraging the development of a vigorous private sector, especially in trade, agriculture, and other consumer-oriented areas.
- Reviving trade with one another and the outside world, which will require a coordinated approach to price liberation, fiscal and monetary policies, exchange rates, and export and import duties.

Meeting these challenges will depend not only on the policies adopted but also--and especially--on the political skills of the leaders in the CIS states. Economic assistance from other countries can play an important supporting role, although most of the effort for the transition will have to come from the Commonwealth states themselves.

To compound the domestic difficulties of the Commonwealth states, political and economic frictions among these countries will likely continue, spurred by nationalism and--economic hardships that are likely to be even greater in the non-Russian states

than in Russia. The new countries also face enormous challenges in working toward agreements on dividing the military and financial assets inherited from the Soviet Union and resolving potential ethnic and territorial disputes without resorting to major violence.

In Russia and elsewhere in the Commonwealth the process of reform is likely to continue to move forward. Still, as shown by the political furor at Russia's recent Congress of People's Deputies and continuing friction between the government and the legislature, the process will be contentious, it will move in fits and starts, and it will be marked by recurring crises. At best, it will be a decade-long process and the downside risks will be enormous. The range of potential outcomes, moreover, will be wide, and there will remain the possibility of extended political deadlock and instability so serious that it could derail reform in both the economic and political spheres.

From the Collapse of the Union to Russian Shock Therapy

The revolution under way in the former Soviet world reached a critical stage in 1991 with the formal dissolution of the USSR and the fragmentation of its once highly centralized economy. The year was marked by an intensing struggle between the union government, which was trying desperately to regain political and economic control, and the republics, which were increasingly asserting their independence. In one of history's ironies, the attempted coup in August accelerated the two trends its plotters said they were trying to stop--the erosion of central political authority and the deterioration of the economy. Post coup efforts to negotiate a new basis for the union were overtaken in December by the formation of the Commonwealth of Independent States (CIS) by 11 of the 15 former republics. This Commonwealth has no meaningful power of its own, however, and political and economic power has shifted decisively from the defunct center to the individual states. It is these new countries, rather than any central authority, that have taken up the challenge of political and economic recovery.[1]

Although facing a wide range of serious internal problems, Russia, by virtue of its size and abundant natural resources, is the most powerful of the CIS states, and important developments there reverberate throughout the Commonwealth. As a result, when Russia launched its "big bang" of economic reforms in January of this year, the other members of the CIS were inevitably and profoundly affected.

The Fall of the Soviet Economy

The economic picture in 1991 was almost totally bleak for both the union and its member republics. Output fell, prices soared, living standards deteriorated, internal and external trade plummeted, and the mechanism for servicing the foreign debt broke down. While the overall picture is clear, however, reliable details are often lacking as a result of the fragmentation of the statistical system and the impact of the broader changes occurring in the economy on the ability of the authorities to collect comprehensive data. Statistics for the former republics are now of primary interest, but the availability of such statistics is limited, and some of the figures reported by individual states are difficult to reconcile with each other and with those reported for the former union as a whole. Moreover, the traditional bias of Soviet macroeconomic statistics toward an

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[1] This paper focuses on the members of the Commonwealth of Independent States and Georgia, rather than all of the former Soviet republics.

overstatement of growth likely is changing to understatement as a result of the end of the central planning system and the increasing importance of private economic activity (see inset). These problems are of particular concern because we have not developed the same kinds of estimates of economic performance for the former republics that we had for the USSR. As a result, this paper relies more heavily on official macroeconomic statistics issued by national and **Commonwealth authorities than papers for this Committee have in the past. The statistics selected for presentation here can he used to provide a broad understanding of changing economic conditions--figures that we consider less reliable have been passed over--but not to support precise or detailed analysis.**

Changing Problems With Soviet Statistics

Some of the shortcomings of Soviet official statistics are longstanding. Forexample, Soviet macroeconomic statistics have overstated real growth and understated inflation for decades. Moreover, these statistics have not painted an accurate picture ofthe allocation of resources among producers and users of output because of thedistortions of Soviet prices. A general lack of detailed information about the definitionsand estimating methods used by the statistical agencies has compounded these problems.

Other shortcomings have worsened recently. Statistical agencies still collect data,as in the past, from factories and farms that sometimes report more or less output thanthey actually have produced. Most Western economists believe that incentives tooverreport output used to be dominant because managers and workers were rewardedfor meeting and exceeding centrally planned targets. In the last two years, however, these incentives have weakened and finally vanished, while incentives to understate output inorder to avoid taxes and retain goods for unofficial deals, such as barter and black-markettrade, have gained force.

In addition, Soviet statisticians traditionally concentrated on collecting data from largestate-run enterprises and developed minimal experience in collecting data based on sampling small firms. One of the problems with traditional Soviet price indexes, for example, is that they have been based largely on list prices rather than the prices actuallypaid by purchasers. Poor sampling techniques have also resulted in inadequate data on the growing private sector in its wide variety of forms--legal, questionably legal, and clearly illegal.

Declining Output

The economy's downturn last year resulted largely from the disintegration of the bankrupt central planning system--in particular, the breakdown of the traditional distribution system and the disruption of trade among the republics. These problems, in turn, were aggravated by worsening shortages brought on by a combination of rising inflationary pressure--the result of huge budget deficits and a ballooning money supply--and the continuation of extensive price controls.

According to official statistics for the Commonwealth states, real output--adjusted for inflation--fell by 8 percent in industry and 7 percent in agriculture last year. Decreases in the output of energy and industrial materials reflected the depletion of natural resources and the deterioration of old plant and equipment, coupled with a lack of new investment. Oil and coal output were 10 percent below 1990 levels, and production of ferrous metals, fertilizer, plastics, cement, lumber, and paper also went down sharply. The falloff in production of these basic commodities contributed to supply shortfalls throughout the economy. Output of civilian machinery, for example, reportedly declined by 10 percent, partly because of inadequate metal supplies. Moreover, a sharp decline in military orders reduced total machinery output even further.

The grain crop was about 25 percent below the near-record 1990 harvest, largely as a result of severe drought in key growing regions, and milk and meat output fell by 6 to 7 percent, reflecting feed shortages and a four-year decline in livestock herds. Vegetable and potato production rose slightly, however, thanks to an increase in the number of urban garden plots.

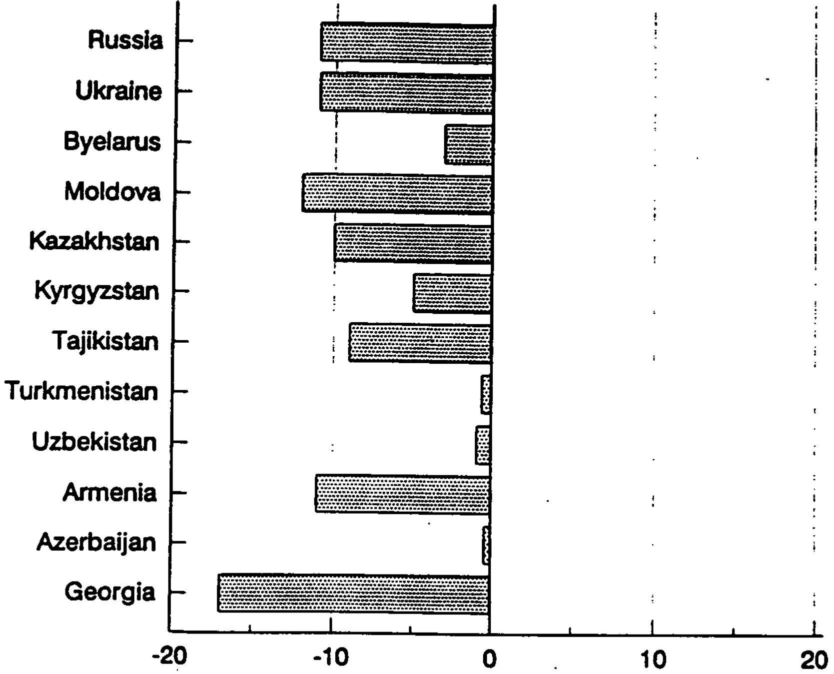
Overall, official statistics indicate that production declined more steeply in Russia, Ukraine, Moldova, Armenia, and Georgia than in Byelarus, Azerbaijan, and the Central Asian states (see figure). The poor results in Russia and Ukraine probably were due in part to their high concentration of extractive industries, which led the economic downturn. The difficulties in Moldova and Armenia reflected ethnic conflicts that blocked supply flows, especially of energy.

Inflationary Spiral

Huge increases in the budget deficit and money supply fueled triple-digit inflation last year. One result of the power struggle between the center and the republics was a prolonged battle over budget responsibilities that left budgets at all levels of government in disarray. Partly because of this confusion of authority, the total deficit of union, republic, and local budgets, plus off-budget pension and stabilization funds, probably reached about 20 percent of GDP in 1991. The money supply ballooned in response to this enormous deficit plus a rapid expansion of bank credit.

Wholesale prices were raised by decree on 1 January 1991, retail price hikes followed on 2 April, and many price controls were removed. By yearend, roughly half of industrial output and a large share of construction work reportedly were sold at free wholesale prices, and half of retail sales were at prices that had been decontrolled at least partially.

Although it is difficult to estimate the resulting price increases with precision, inflation clearly soared. Official price indexes for the Commonwealth states indicate that retail prices in 1991 increased by 80-90 percent, on average, over 1990 levels and wholesale prices for industrial output rose by 130-140 percent. The yearend results were even more striking. Retail prices had registered a 140 percent increase as compared with December 1990, and industrial wholesale prices had risen by 230 percent. Inflation in retail prices did not vary much among the republics, but rates of increase in industrial wholesale prices diverged considerably, partly because of differences in the mix of output.



[a] Official statistics.

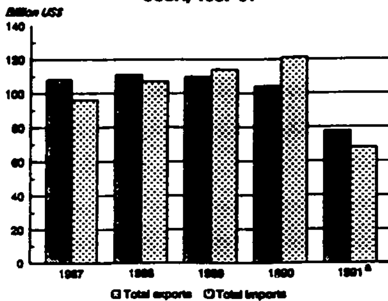
Breakdown of Interstate Trade

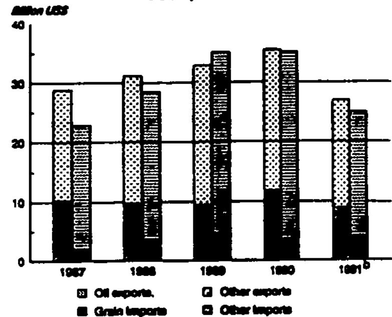
Domestic economic troubles were compounded by sharp drops in trade among the former Soviet republics. During the past two years, this trade has increasingly fallen victim to inflation, shortages, and the perceptions of most of the former republics that the complex Soviet system of economic interdependence left them at a disadvantage. In addition, authorities at various levels of government have restricted exports with the intent of retaining goods for consumers and factories under their jurisdiction but with the result of worsening the disruption of trade flows. Official statistics for the CIS indicate that the volume of interstate deliveries of consumer goods during the first nine months of 1991 was about 50 percent lower than in the same period of 1990. Interstate deliveries of many producer goods also fell sharply: coal by about 30 percent; trucks, buses, passenger cars and tractors by about 40 percent; and metal-cutting machine tools by about 50 percent.

Foreign Economic Relations in Turmoil

Trade with the outside world also plummeted. According to official statistics, the total value of exports by the Commonwealth states to countries outside the former Soviet Union was about 30 percent smaller in 1991 than in 1990, and the value of imports from these countries was down by about 40 percent. Falling output reduced exports of oil, coal, and timber, and a combination of declining export revenues and rising requirements for servicing the hard currency debt forced painful cuts in imports. Domestic production of food, clothing, and chemicals reportedly was hit hard by shortfalls in supplies of imported materials and equipment, and even imports for the consumer market fell.

Trade with Eastern Europe plunged after being transferred to a hard currency basis and world market prices in January 1991. By comparison, the decline in trade with traditional hard currency partners was milder, and the former USSR registered a surplus of roughly $2 billion last year in this trade (see figure).





Trade fell throughout the CIS at rates that varied greatly among the member states. The decline in exports to countries outside the former Soviet Union was mildest in Russia, at about 30 percent, and sharpest in Ukraine, at about 50 percent; decreases in other Commonwealth states ranged between 35 and 45 percent. Armenia's imports from these countries went down by only about 20 percent, while reductions in the rest of the Commonwealth ranged from about 35 percent in Uzbekistan to about 50 percent in Moldova.

Our estimates indicate that the debt of the former USSR to its traditional hard currency creditors reached about $60 billion at the end of 1991. Although this is not an overwhelming debt relative to export capabilities, the ability of the central government to collect export earnings deteriorated rapidly in the wake of the failed August coup. The result was an acute shortage of hard currency that forced the successor states late last year to negotiate a deferral of repayments of principal on most official and commercial debts. In late November eight republics--Russia, Armenia, Byelarus, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan and Turkmenistan--agreed to assume "joint and several" responsibility for the debt incurred by the USSR and to implement economic reforms under the direction of the International Monetary Fund. In return, the G-7 countries agreed to defer repayment of the principal on most official debts for one year and promised to maintain financing for imports.[2] In December the same republics reached an agreement with commercial creditors to defer repayments of principal on most commercial debts, and Ukraine and Georgia signed the G-7 agreement in March and May 1992, respectively.

Consumer Hardships

Of the many consumer miseries last year, one of the most serious was a worsening of the availability of food as a result of falling production, reduced imports, depleted inventories and reserves, and the deterioration of the central distribution system. The general decline in farm output was so great that even regions that normally produce more food than they consume needed imports from abroad. Also, while imports of grain and meat increased, imports of other basic foods decreased, often sharply. Humanitarian aid provided some relief for vulnerable regions and social groups but probably amounted to less than 1 percent of total food imports. Inventories of food at factories and in the traditional distribution system fell to rock-bottom levels, and even state reserves were tapped. At the same time, the population's ability to draw on household hoards helped limit the decline in food consumption. The deterioration of interstate trade left regions that depend on outside supplies in even more difficult circumstances--especially in the Caucasus and Central Asia, where food consumption per capita is lower than in the rest of the former Soviet republics.

According to official statistics, real personal incomes, on average, were relatively stable last year--that is, money incomes increased at about the same annual rate as consumer prices in all states except Armenia, Georgia, and Moldova. Administered price hikes outstripped gains in income during the second quarter, but incomes caught up by rising rapidly during the third and fourth quarters. Within these averages, however, large numbers of pensioners and government workers were faced with low money incomes and steep increases in food prices that left them worse off, while much smaller

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[2] The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

numbers of entrepreneurs and private-sector workers took advantage of opportunities to earn very high incomes and became better off.

Moreover, shortages continued to worsen as a result of the sharp increase in average incomes and the many price controls that remained in place. Official statistics on the gap between nominal personal incomes and expenditures suggest that regional shortages were most severe in the Caucasus, where ethnic and political unrest disrupted the flow of goods, and in Kazakhstan and Central Asia (except Kyrgyzstan), where retail price controls were tighter than in Russia. Some of the resulting strains, however, were undoubtedly relieved by the underground economy, which is more vigorous in these areas than in the Slavic states, according to official statistics, Western research, and a large body of anecdotal information.

Investment and Defense Industries in Disarray

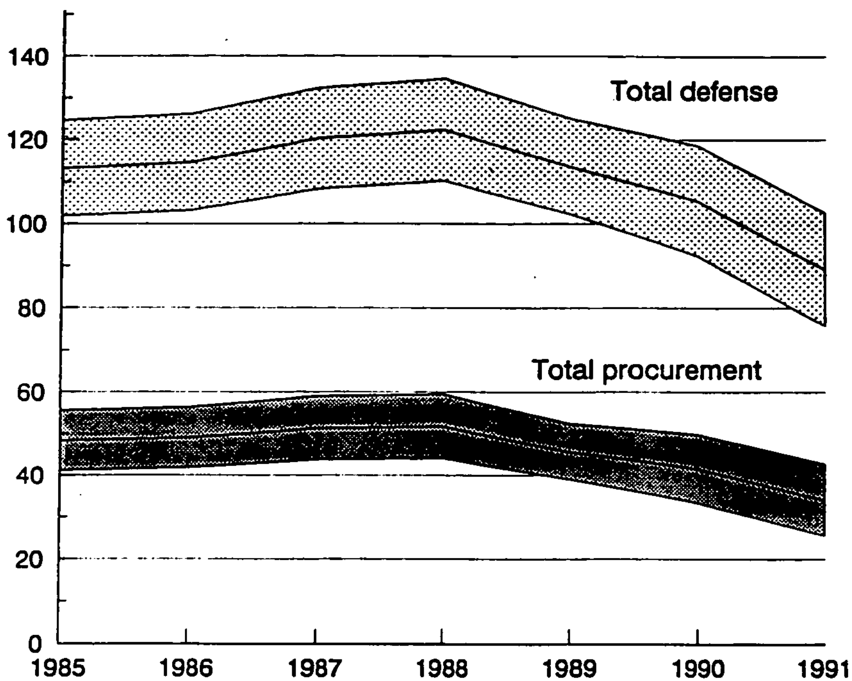
Industries producing goods for investment and defense lost the privileged economic position they had held since the 1930s. The centralized bureaucracies that had funded these industries and given them priority access to supplies were largely dismantled, and the republic authorities that began to take over were under intense pressure to slash spending.

The official statistics published so far contain little information about real changes in investment last year, except that Russian investment decreased by 11 percent. It is clear, however, that the construction industry was in disarray and the backlog of unfinished construction mushroomed.

Our estimates of Soviet defense spending-which reflect greater uncertainty than usual, due to changes in Soviet policy directions disarray in the military, and disruptions in industry--indicate an overall decline of 10 to 25 percent, with a best estimate of a reduction of about 15 percent. We estimate that military procurement of weapons dropped by roughly 20 percent in 1991 to a level about one-third below its high point in 1988 (see figure). By 1991 tank and artillery procurement outlays had fallen by some 60 percent from 1988 levels, while outlays for tactical aircraft and space fell by nearly 50 percent. Procurement to support the naval and strategic offensive missions was hit by cuts of over 20 percent in 1991 after being relatively protected in 1989-90.

Estimated Soviet Defense Spending, 1985-91

Billions of contant 1982 rubles



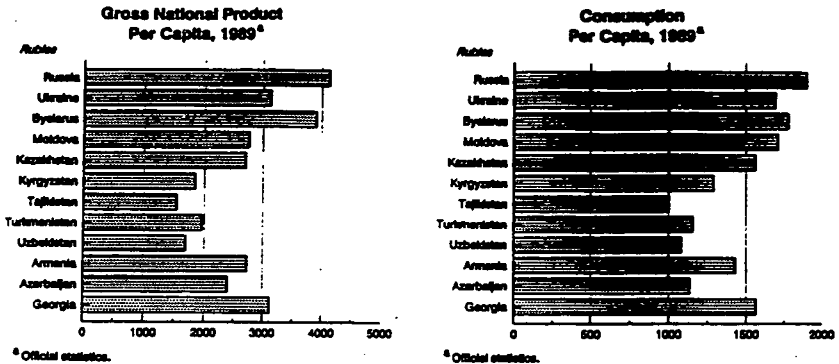
We believe that cuts in procurement during 1989-1990 were largely planned--primarily the result of unilateral reductions announced in December 1988 by then President Gorbachev. In 1991, however, scheduled procurement cuts were compounded, particularly in the latter half of the year, by supply disruptions, further cuts in weapons orders, the failure of the republics to contribute as planned to the central budget, and the loss of authority of the central defense industrial ministries in the wake of the failed coup.

Progress in converting the thousands of defense plants and roughly 1,500 military research and development facilities on the territory of the former USSR was minimal. After rising slightly in 1989 and 1990, civil production by the defense industrial sector almost certainly fell in 1991. Individual enterprises continued to be stymied by difficulty in adapting to new products and establishing new supply chains, a lack of skills in dealing with developing markets, and the unavailability of financial support for costly retooling. Three years of declining defense orders, combined with the inability to offset these declines with gains in civil production, pushed many defense plants to the verge of insolvency, and some were forced to let workers go because of the lack of funds.

Legacies of the Old System

When the Soviet Union met its end in December 1991, more than six decades of central planning had left the former member republics ill prepared for the transition to independent market economies. Workers and managers were generally well educated by international standards but lacked experience in market-oriented business practices. The inherent deficiencies of the centrally planned system, combined with years of neglect of consumer preferences and the monopolization of large shares of production and distribution, had encouraged widespread inefficiency and poor quality. Obsolescent, energy-guzzling, polluting technologies dominated much of industry and agriculture.

Despite the promises of generations of Soviet leaders that socialism would equalize levels of economic development across republics, large differences in income and wealth persisted. In fact, regional inequalities widened during Gorbachev's tenure, and, thanks to glasnost, became increasingly apparent to the population. Soviet official statistics indicate that, aside from the Baltic republics, Russia and Byelarus had the highest levels of output and consumption per capita by 1989, with Ukraine and Moldova lagging slightly behind. Kazakhstan, Armenia, and Georgia followed at lower levels of development, while Azerbaijan and the Central Asian republics came in last (see figure).



Status of Economic Reform Programs

Recognizing the failure of the old, centrally planned system, Russia has taken decisive steps since January toward a market economy. As a result of Russia's influence over their economies and, their own convictions of the need for reform, the other Commonwealth states have moved in the same direction. All have made some progress, but the governments of several of these countries have indicated their reluctance to continue to pursue reforms as rapidly as Russia.

Russia

Russia's comprehensive program to introduce key elements of a market economy and stabilize fiscal and monetary conditions consists of several major components:

- Liberalizing prices, in order to let them help balance supply and demand by signaling where production should increase or decrease.
- Slashing the budget deficit and tightening credit, to limit inflation in the wake of price liberalization.
- Shifting some government spending from investment and defense to social needs, especially safety nets for the low-income and unemployed population.
- Privatizing state property and expanding opportunities to set up new private businesses, in order to promote competition among producers and thereby improve incentives to reduce costs and increase output.
- Lowering barriers to foreign trade and investment, to help reorient the domestic economy toward world markets, prices, and technologies.
- Enacting the legislation and building the institutions needed to foster the development of a market economy.

Russia already has made considerable progress in liberalizing prices, reining in the budget deficit, and cutting government spending on investment and defense. But a backlashagainst the sacrifices these measures have entailed--most evident at the April session of the Congress of People's Deputies--has led the government to make adjustments to its program, notably by relaxing restraints on credit. Although the government has continued with painful measures such as the sharp hikes in energy prices in May, it is facing increasing pressure to reduce taxes, increase spending, and loosen credit to a degree that couldundermine its stabilization program.

Much work remains to be done, moreover, in privatizing state property, opening the domestic economy to the outside world, and developing market-oriented laws and institutions. The financial system is particularly ill suited to the needs of a market economy; bank deposits, for instance, still cannot be converted freely into cash.

Prices. Wholesale prices covering about 80 percent of the value of output and retail prices applying to about 90 percent of the value of sales were freed on 2 January. At the same time, state-set prices--primarily for energy and basic consumer necessities--were raised sharply, generally to 3 to 5 times their previous levels. Since January, controls have been removed from another 5 percent of retail prices, and, despite the opposition of many legislators, energy-using industries, and other CIS states, energy prices have been raised again in the first of several stages intended to reach world price levels in 1993.

Prices shot up following their liberalization in January and continued to climb, albeit at slower rates, in February and March. According to Russian statistics, wholesale prices of industrial output leaped in January to 500 percent of their December 1991 level and reached roughly 900 percent of that level in March. Retail prices rose somewhat less rapidly, to 350 percent of their December level in January and 620 percent in March. Shortages have eased substantially as a result, although most of the adjustments so far appear to reflect reductions in demand rather than additions to supply.

Fiscal and Monetary Policy. Russia adopted a first-quarter budget that was nearly balanced, and in late April the government reported an actual deficit of only 1.5 percent of GDP. This report reflected a definition of the deficit that was clearly designed to put the best possible light on the government's record. Nonetheless, even when adjusted to conform to international standards, the first-quarter budget gave evidence of substantial progress toward fiscal restraint. The key to success was that the government managed to hold down spending, although partly by merely postponing some planned outlays until the second quarter. Collection of the new, 28-percent tax on value added started slowly in January but improved steadily in February and March.

In addition, the Central Bank of Russia and the government cooperated during the first quarter to tighten monetary policy. Ceilings on interest rates charged by commercial banks were removed in January, and the central bank raised the interest rate at which it lends to commercial banks to 20 percent on 1 January, 50 percent on 1 April, and 80 percent in late May. Reserves that commercial banks must maintain with the central bank were raised in two steps to levels by 1 April of 15 percent for deposits with terms of less than one year and 20 percent for longer-term deposits.

Although lending by the central bank and commercial banks increased modestly during the first quarter, debts that enterprises owed each other mounted rapidly. As a

result, the government is confronted with the difficult task of easing credit sufficiently to prevent bankruptcies on a massive scale but not so greatly as to fuel inflation or undermine efforts to require enterprises to respond to market conditions. During the April meeting of the Congress of People's Deputies, calls for a bailout of state-owned firms and for major reductions in taxes grew particularly intense. In the postcongress period these calls have grown louder and more insistent, subjecting the government to increasing pressure to act in ways that could undermine its stabilization program.

Social Safety Net. The government has eliminated wage controls except to set the minimum wage and pay rates for workers employed by the government itself and by budget-funded organizations such as schools, clinics, and hospitals. Increases in the minimum wage, pensions, and family benefits have compensated for only part of the consumer inflation that occurred during the first quarter of 1992.

Job placement and retraining programs are in place-although their effectiveness is untested so far--and unemployment benefits are being paid. In March the government announced its intention to impose tighter limits on unemployment benefits in order to reduce budgetary outlays and encourage workers who are laid off to find new jobs quickly.

Privatization. President Yel'tsin obtained preliminary legislative approval in December 1991 for an ambitious program for the rapid privatization of small enterprises involved in the production and distribution of consumer goods and services. In 1992 the government intends to sell off 50 to 70 percent of state enterprises engaged in retail and wholesale trade, the food processing and light manufacturing industries, the provision of personal services, construction and the construction materials industry, and motor transportation and vehicle repair. Most of these enterprises are to be either sold at auctions or converted to joint stock companies with shares offered for sale. In either case, workers at privatized enterprises will be given special concessions--a 30-percent discount from the asking price if the enterprise is auctioned, or 25 percent of the shares free and another 10 percent at cut rates if the enterprise is converted to a joint stock company (see inset).

Privatization in Nizhniy Novgorod: A Modest Success

Since late March 1992, weekly privatization auctions have been held in Nizhniy Novgorod (formerly Gor'kiy), and Russian officials have been touting them as an example of how small state firms can be transferred quicKly to private hands. The number of enterprises actually privatized is still relatively small, but the process of privatization in Nizhniy Novgorod is working well in comparison with other parts of Russia.

Nizhniy Novgorod is Russia's third largest city, with a population of 1.4 million. Located about 250 miles east of Moscow, it is home to some of Russia's key defense plants. The driving force behind the auctions in the city is Boris Nemtsov, the 32-year-old governor of the region, who last January invited the International Finance Corporation--a World Bank affiliate-to draft a blueprint for the city to sell off its 2000 retail shops and restaurants within six months. The blueprint was ready in only six weeks.

Although fewer than 5 percent of the targeted firms have been privatized since the auctions began, so far the process has worked with only a few minor hitches, exceeding the expectations of both the Western technical advisers and Russian privatization officials. For example:

- Most properties have drawn 4 or 5 bidders and have sold for 20 to 30 times the starting price set by the government.
- Almost half of the enterprises have been sold to employees.
- Over half of the buyers have been able to secure financing to purchase their properties: one labor union reportedly received a 2-million ruble loan.

There are several reasons privatization has gone better in Nizhniy Novgorod than elsewhere in Russia. Probably most important is the political solidarity between Nemtsov and the mayor of Nizhniy Novgorod--both leaders who were elected by wide margins. Moreover, the city boasts a substantial pool of entrepreneurs who are actively supporting and participating in the auctions. Nemtsov also reportedly worked out a deal with Russian federal officials to streamline privatization procedures. To speed the transfer of state firms to private hands, the local government decided to sell everything by auction, thus avoiding the complicated and time consuming process involved in the creation of joint stock companies and eliminating large amounts of paper work. Sensitive to concerns that "outsiders could buy up the city," local officials have not allowed foreign investors or buyers from other CIS states to participate in the auctions.

In a separate presidential decree issued in December 1991, Yel'tsin instructed all solvent state and collective farms to decide by 1 March whether to reorganize under new forms of ownership and to carry out any reorganizations by the end of 1992. The decree provides for various alternative forms of organization, including an association of private or "peasant" farms, a joint stock company, or a workers' collective with shares owned by the members.

Although sales of state property have picked up since January, progress in privatization remains very limited so far. According to Russian statistics, fewer than 1 percent of retail stores, public dining facilities, and consumer service outlets had been privatized by 1 April this year, and only about 2 percent of agricultural land was in the hands of private farmers. Moreover, many of the operators of private businesses are not full owners in the sense that ownership is understood in most Western countries, and there are important restrictions on the resale of land. In addition, entrepreneurs are widely resented by the public and often linked, in popular opinion, with corruption or criminal activity.

Privatization of large enterprises is not scheduled to begin in earnest until 1993, at the earliest. Their privatization will involve a lengthy process, starting with the conversion of such enterprises into joint stock companies owned by the state and proceeding later to the sale and distribution of shares to other owners (see inset).

Privatization of the Kama River Truck Plant:

A Study in Problems

In June 1990 the Kama River Truck Plant, one of the world's largest producers of trucks, was chosen to be a model for the privatization of giant Soviet industrial firms. Over the past two years, however, privatization has proceeded at a crawl at Kama River and the plant's experience has previewed the problems Russia is likely to face in privatizing.

Kama River, which was founded in the early 1970s, was selected over other candidates for early privatization primarily because it was thought to enjoy unusually favorable market conditions, with Soviet and East European firms clamoring to purchase the approximately 120,000 trucks it produced each year. Like other giant Soviet firms, however, the plant was paying insufficient attention to production costs and had little incentive to modernize. By making it a joint stock company, Soviet reformers hoped to bring about badly needed management changes, streamline its operations, and, by selling stock, raise money for retooling.

With state officials and the plant's own managers in charge of the privatization process, however, the sale of stock has proceeded slowly and in a manner designed to minimize the role of outsiders. Over half of the shares reportedly have not been offered for sale; they currently are held by various levels of government with the Russian government holding the most. Share sales have been closely controlled by the plant management, which has sold 30 percent of the authorized stock to 1,200 suppliers and major customers. The remaining stock has been sold to Kama's 170,000 workers and retirees at a preferential price. Virtually none of the shares have been offered or resold on Russia's nascent stock exchanges.

As might be expected in light of this record, privatization has not brought about an overhaul of Kama River's management, and little has been done to restrain production costs or modernize plant and equipment. The state-appointed enterprise director, who has run the plant since 1987, is still in charge, and workers report that they have no fear of being fired and that their work ethic is unchanged.

Russian authorities nonetheless have apparently drawn some useful lessons from the types of problems experienced at Kama River. Under Yel'tsin's recently approved privatization program, the government may hold a controlling share of stock in an enterprise for only three years and even then may exercise only 20 percent of the shareholders' votes. Also, Russian officials have indicated that the shares of stock given gratis to enterprise workers will not include voting rights--a provision designed to prevent the work force from blocking moves to cut costs and restructure.

Foreign Trade. Since January 1992 the Russian government has set exchange rates at much more realistic levels than in the past. In addition, individuals and enterprises are now allowed to buy hard currency from commercial banks and on interbank markets, respectively. Although very little hard currency has been available for sale on these new markets, the value of the ruble has strengthened markedly in the last two months (see figure).

Moreover, Russia has reduced the number of goods for which export quotas and licenses are required, abolished import quotas, and limited the number of goods for which import licenses are required. The government also has declared its intention to remove all remaining export quotas except those on fuels and items restricted for security reasons and to introduce a more competitive system for issuing export licenses. The goods that will remain subject to restrictions, however, are major earners of hard currency.

Legislation and Institutions. Russia has made important progress in building the legislation and institutions needed to facilitate the development of a market economy, but much work lies ahead. Key laws were passed in 1990 and 1991 on property rights, land reform, demonopolization, privatization, the tax and banking systems, unemployment, and foreign investment. Many of these laws have flaws, however--some of them serious--and some important laws--for example, on bankruptcy--have not yet been enacted. Moreover, commercial and contract law are only beginning to develop, and the government and courts will need to work out effective procedures for enforcing the new laws that are enacted (see inset).

Russia's Criminal Code and the Move to a Market Economy

The Russian legislature has revised its criminal code to remove restrictions on economic activities that were illegal under Soviet law but are legitimate and even officially encouraged in countries with free market systems. Nonetheless, restrictions remain in the penal code which, if not eliminated, will continue to stifle the development of the private sector.

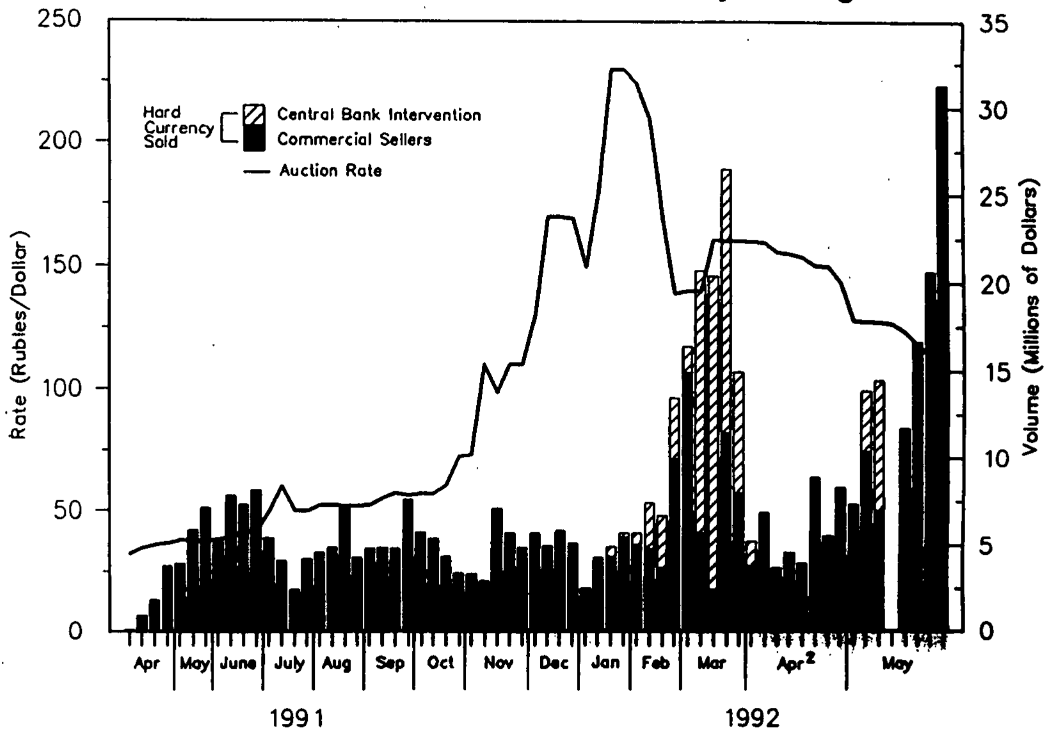
According to Russian government data, there are 127,000 Russians in prison for profiteering, speculation and other economic activities, many of which would not be illegal in the West. Russian human rights activists claim the number imprisoned for economic crimes is closer to 300,000.

Under Yel'tsin, reformers have pushed hard to overhaul the economic criminal statutes in an effort to create a legal system that will encourage legitimate market-oriented business practices. In December, after contentious debate, the Russian Supreme Soviet adopted amendments to the republic's criminal code, which:

- Legalized private entrepreneurship and activity as commercial middlemen, both of which were explicitly prohibited until then.
- Reduced the ability of the police to arrest citizens for vagrancy, begging, or other "parasitical ways of life"--often code words for working outside the state sector.
- Abolished special residency permits, a step which freed entrepreneurs to set up businesses where they chose and allowed workers to relocate without government permission.

Despite these improvements, the economic criminal code continues to include prohibitions that may well discourage would-be entrepreneurs. While middleman activity is now legal, for example, "profiteering," which is defined as the buying and reselling of goods for the purpose of making a profit, is still a crime and carries a prison sentence of up to seven years. Similarly, while Russian citizens may now trade in securities, they may not "speculate"--an ambiguous term open to interpretation by local officials--in these financial instruments without risk of receiving a jail term of up to 15 years.

Trading on the Moscow Interbank Currency Exchange [1]



[1] The Gosbank Currency Exchange prior to December 1991.

[2] Auctions increased from once to twice weekly.

Unclassified

New, market-oriented institutions such as commodity exchanges, privately owned banks, and information networks have sprung up rapidly during the past two years. The financial system remains rudimentary, however, particularly in the barriers that remain in place on the conversion of bank deposits into cash. In addition, managers and entrepreneurs need training in all aspects of doing business under market conditions--including accounting, marketing, organization, and personnel management.

Non-Russian States

The non-Russian members of the CIS have all declared their intentions to move toward market economies. Some of these states have made notable progress in particular areas, but overall they all lag far behind Russia. All of the other states, for example, have followed Russia's lead in liberalizing wholesale and retail prices, but, out of concern over popular protests, almost all have left more extensive price controls in place. All of them also have made less progress than Russia in liberalizing foreign trade and in enacting legislation to support the transition to market economies.

Ukraine and Byelarus. The efforts of Ukraine and Byelarus to move toward market economies are similar in many respects. Both states liberalized prices in January, although Ukraine subsequently reimposed some controls, and both appear to be heading toward large budget deficits this year. Economizing measures may have to include cutbacks on consumer subsidies and other forms of social support to population groups that can get along without such assistance. In addition, Ukraine and Byelarus both lag behind Russia in liberalizing foreign trade and in passing legislation needed for the development of a market economy. Ukraine is ahead of Byelarus in adopting laws on privatization, but both states recently enacted liberal foreign investment laws.

Kazakhstan and Central Asia. Kazakhstan and Kyrgyzstan have made considerably more progress toward market economies than Tajikistan, Turkmenistan, and Uzbekistan. All of the states in this region liberalized prices in January--following Russia's lead--but all of them have selectively reimposed price controls or rolled back administered price hiked. Without the budget transfers that the Soviet central government provided through last year, all of these states are struggling to reduce their budget deficits, and some are trying to patch holes in their social safety nets at the same time. Privatization has gotten off to a faster start in Kazakhstan and Kyrgyzstan than in the rest of the region, but, as in Russia, there are important restrictions on ownership rights and grounds for concern that the old elite will dominate and corrupt the privatization process. Uzbekistan has made some progress in privatizing agricultural land, but Tajikistan and Turkmenistan lag far behind. Kazakhstan lags only slightly behind Russia in adopting the legislation needed for a market-oriented economy, but all four Central Asian states have a good deal more work to do on this front.

Moldova and Caucasus. Progress on economic reforms has been delayed by armed conflicts in Moldova, Armenia, Azerbaijan, and Georgia. Prices were liberalized in January in all these states except Georgia, where action was delayed until March. Throughout the Caucasus, the costs of war have made budgetary problems even more severe than in the rest of the Commonwealth, and in Armenia the legislature has not yet passed laws on the budget and banking systems. With the notable exception of a program in Armenia that succeeded in transferring 80 percent of agricultural land to private farmers last year, the privatization of state property is just getting under way in

Moldova and the Caucasus. To date, Moldova and Georgia have made more progress than Armenia and Azerbaijan in establishing the legislative base for a market economy.

The Challenges Ahead

The economic outlook for the next year or two is grim for all of Commonwealth states as a result of the problems inherited from the failed command system and the rigors of the transition to a new, market-oriented one. The economic transition on which these countries have embarked will be accompanied by major social and political changes, including rising tensions resulting from the sacrifices reform will entail. Workers laid off by industries that cannot survive without government support and traditional interest groups, such as the military-industrial complex and the labor unions, stand the most to lose and are already becoming increasingly critical of reform.

As a result of tensions like these, governments pursuing economic reforms will run considerable political risks. In addition, nationalism of various stripes will gain momentum, and tensions between relatively well-to-do countries and very poor ones will increase.

Under the best of circumstances, the next few years will witness turmoil and recurring crises, and, even if conditions improve thereafter, the task of building a new economic system will require many years.

Short-Term Prospects

For the next year or two, Russia will face a continuing struggle to halt the decline in living standards and keep a lid on social unrest. The other Commonwealth states--all of them poorer than Russia--will have to confront even tougher economic and social problems. In Russia and elsewhere, the ability of the authorities to cope with these problems will depend largely on developments in the following key areas:

- The degree of fiscal and monetary restraint maintained by the governments of Russia and the other large countries that share the same currency.
- The encouragement given to the development of the private sector, especially in trade, agriculture, and other consumer-oriented areas.
- The extent of progress in reviving trade among the former Soviet republics and with the rest of the world.

Economic assistance from other countries can supplement the efforts of the Commonwealth states themselves, especially by supporting a revival of foreign trade and providing urgently needed technical assistance.

Fiscal and Monetary Restraint. The Russian government recognizes that it must strictly limit the budget deficit and the extension of bank credit if it hopes to brake inflation. But government spending is the main source of support available for pensioners, low-income families, and the people who are expected to lose their jobs as state enterprises cut back production of goods for which demand has plummeted. In addition, budget outlays and bank loans are needed to help maintain some financial support for output and employment in the investment and defense industries as they reorient their production to meet the needs of a market economy.

Much of the debate at the April session of the Russian Congress of People's Deputies concerned these issues, which will remain controversial because of their close connection with the extent of government support for individuals and enterprises left worse off by the economic transition. In response to the legislature's concerns about growing

economic hardship, the government has agreed to increase the amount of bank credit available for investment, agriculture, and industry--especially the energy sector-and to continue to provide loans for conversion of the defense industry to civilian production.

The non-Russian Commonwealth members all appear to be having greater difficulty than Russia in balancing their budgets. Resources are especially limited in the Central Asian states and Azerbaijan, where budget subsidies from the Soviet central government have ended abruptly and living standards are much lower than in Russia. As in Russia, the challenge in all of these states will be to provide needed relief from transition pains without letting inflation spiral so rapidly that prices cannot provide the signals required for the development of markets.

Development of thePrivate Sector. Throughout the Commonwealth-and especially outside Russia--governments need to reduce their direct intervention in the economy and simultaneously encourage the development of market-oriented trade and supply networks to take over the functions of the old central allocation system. These governments also need to facilitate the development of banks and other financial institutions and minimize restrictions on the production of consumer goods and services.

The Russian privatization program launched this year is sensible in its concentration of initial efforts on trade, small-scale production of consumer goods and services, and agriculture. A presidential decree in late January helped the process along by removing many restrictions on the purchase and resale of goods and bringing a sharp increase in street trading. The privatization of small businesses got off to a slow start in January and has been moving ahead haltingly since then. The formation of private farms is proceeding at a faster pace, and state and collective farms have begun to reorganize under new forms of ownership, including associations of peasant farms.

Most of the non-Russian states lag behind Russia in privatizing state assets, but Armenia is far ahead in transferring agricultural land to private farmers. Moreover, the large underground economies in Kazakhstan, Central Asia, and particularly the Caucasus could provide a basis for rapid development of the private sector in those regions.

Revival of Trade. Trade among the Commonwealth states has been hit hard by the collapse of the union and the central planning system. This trade is also suffering from the proliferation of quantitative controls on exports and the continuing intervention of governments in interstate trade--practices that are interfering with the development of direct transactions between buyers and sellers. Solutions to these problems will require coordination among the new states on price liberalization, fiscal and monetary policies, exchange rates, export and import duties, and movement toward world prices. In addition, improvements in the mechanism for making payments across state borders would help, and arrangements need to be made for countries that are determined to introduce national currencies to do so in an orderly manner.

The non-Russian states are likely to suffer more damage than Russia from the disruption of trade among the former republics. All have smaller, less diversified economies--some with particularly narrow specialties--and almost all are considerably more dependent on trade, often in energy and food. Moreover, all but Azerbaijan and Turkmenistan will lose from the move toward world market prices because their export earnings will not rise nearly enough to cover the increases in their import bills.

In their trade with the rest of the world, Russia and the other Commonwealth states are striving to revive imports in order to boost domestic supplies, step up exports to pay for these imports, and work out arrangements for repaying the foreign debt left behind by the Soviet Union. Because all of the successor states are having difficulty collecting hard currency, they probably will seek to negotiate some postponement of interest payments on the debt-in addition to the deferral of repayments of principal that was worked out in late 1991.

Foreign Economic Assistance. Most of the effort for the economic transition in the Commonwealth states will have to come from the new states themselves, but assistance from other countries will play an important supporting role. The $24 billion package of assistance to Russia announced by the G-7 countries in April 1992 includes trade-related credits worth $11 billion, to come mostly from the pool of credits pledged earlier but not yet disbursed. This package also provides for the deferral of $2.5 billion worth of payments on medium- and long-term Soviet debt and for new loans worth $4.5 billion from the International Monetary Fund (IMF), World Bank, and other multilateral lending agencies. Finally, the G-7 package includes a $6 billion fund to help stabilize the exchange rate of the ruble vis-a-vis hard currencies.

The G-7 package of credits, loans, and debt deferral, which will be disbursed only if Russia meets IMF conditions, will most likely cover Russia's basic needs for hard currency imports and payments on its share of the former union's debt this year--provided that the package is supplemented by other deferrals of debt service payments promised earlier. In addition to this aid for Russia, the other Commonwealth states undoubtedly will require large-scale financial assistance as well.

The ruble stabilization fund is intended to help Russia expand exports and imports by limiting the financial risks incurred by potential trade partners when exchange rates fluctuate. If Russia achieves its goal of making the ruble convertible later this year--at least for export and import transactions--the government will then be obliged to pay hard currency to anyone wishing to sell rubles at the prevailing rate. The stabilization fund is designed to increase international confidence in Russia's ability to make such payments and, if necessary, to supplement Russian hard currency reserves. It is difficult to estimate a reasonable exchange rate, however, because existing markets for rubles are so limited that they provide only rudimentary indications of supply and demand. To defend an exchange rate once it is fixed, moreover, Russia will have to limit its domestic inflation to rates similar to those the countries to whose currencies the ruble is pegged.

Medium-Term Goals

If their short-term stabilization efforts are successful over the next year or two, Russia and the other Commonwealth states will be able to turn more attention to rebuilding their economies on the basis of markets, competition, and private ownership. The top priorities will include the continued development of market-oriented legal institutions, financial organizations, and a vigorous, diversified private sector. Another major task will be to reorient investment, production, and employment toward the needs of domestic consumers and the export market. Retraining and job placement services for workers laid off by declining industries will be an important part of this effort, and so will be the repair of environmental damage.

Defense Conversion

As a result of the breakup of the Soviet Union, the newly independent states are planning for their own national security requirements military forces (see inset), and defense industrial needs. The concept of a conversion program spanning all of the former republics is dead. Instead, each new state has claimed control of the defense enterprises on its territory, and each has asserted the right and intention to proceed with conversion as it sees fit (see inset on Russian law on defense conversion as an example of one approach). To date, however, none has implemented a fully coherent program, although all of the states are struggling with this problem and all are seeking Western and Japanese assistance.

Jurisdictional Changes and Defense Budgets for 1992

In December 1991 the former Soviet Defense Ministry, General Staff, and Armed Forces were transferred to CIS control and became common assets of the 11 CIS member states. CIS military officials lobbied hard, with mixed success, for the establishment of a unitary CIS armed force composed of all former Soviet military forces and equipment-both strategic nuclear and general purpose-in each CIS member state. In the nuclear realm, the CIS defense structure provides strong centralized control of nuclear weapons and several CIS states have pledged resources for the strategic forces. In the conventional arena, the CIS seems to have evolved into a loose, voluntary collective security arrangement involving only a few of the former Soviet republics, basically Russia and Central Asia.

Virtually every CIS state is now in the process of building a national army based on at least a portion of the former Soviet military units and equipment located on its territory. Ukraine and Russia are the furthest along in terms of the establishment of national armies, while the other states are taking a slower approach, in part due to fiscal constraints. The Central Asian states claim that they will provide the funds necessary to build their conventional forces, but many will face severe economic constraints and few will soon find the funds necessary to reach their force goals.

According to Russian statements, the draft 1992 CIS military budget is probably about one-half the size of the 1991 official Soviet budget in real terms. According to CIS agreements in December 1991 and February 1992, the Russian defense budget was to make up about 60 percent of the total 1992 CIS defense budget, while the non-Russian states were to contribute the remaining 40 percent. Press reports, however, indicate that the contributions of the non-Russian states have fallen far short of the originally agreed amounts. Russia probably will not make up all of the shortfall because of its own fiscal problems. Therefore, the actual CIS defense budget this year may be even less than the target and little more than Russia's defense budget--only about one-third of the 1991 Soviet defense budget in real terms.

Russian on Defense Conversion

In March 1992 President Yel'tsin signed a Russian defense conversion law that authorizes individual enterprises to devise their own conversion plans and makes participation in a state plan voluntary. The primary focus of conversion is to be the production of high-technology goods for export, with the production of goods for the domestic economy ranking as a secondary concern. The law stipulates that financing for conversion should come mainly from arms export earnings-although exports of sensitive equipment and weapons will require government licenses--and tax concessions, including accelerated depreciation of assets. Funds may also be raised by privatization and foreign investment, and enterprises are allowed to pool their capital.

The conversion law emphasizes the importance of maintaining military capabilities and mandates the development of weapons production requirements to serve as a basis for deciding which capabilities will be retained by the military and which ones converted to civilian uses. This law allows the military to use funds from the defense budget to keep "essential" plants operating, but because of the sharp cuts in procurement, most defense industrial enterprises will not receive this protection. In an effort to avoid unrest, the law permits a two-year extension of benefits for selected workers and grants priority development assistance to localities where more than 20 percent of the work force is laid off as a result of conversion.

Looking for Foreign Assistance. Government officials and enterprise managers desperately continue to seek both aid from foreign governments and international institutions, such as the World Bank, and investment by private corporations in joint ventures. Regional and city governments, concerned about the impact of defense industrial downsizing, have increasingly become players in conversion, reaching out to Western businesses and governments for aid. Defense industrialists also have begun to expand efforts to seek foreign aid and investment on their own, often creating new organizations in the process. Some organizations, such as the Center for Conversion in the Foreign Policy Association, are nongovernmental groups at the CIS level. Other groups, such as Uralkonversiya, were started by regional governments, and still others--the Military Industrial Exchange, the Military-Industrial Investment Company, Radioavionika, and Ural-Kosmos--were founded by defense industrial managers and bureaucrats trying to take advantage of their positions in the old system to prepare lucrative positions in the new one.

Looking to Export Arms. Although the governments of most of the CIS states are taking steps to control unauthorized exports, most still view hard currency arms and military technology exports as an important means of keeping workers employed and limiting the social fallout from military funding cuts (see inset). Governments are now creating new mechanisms to manage and promote foreign arms and weapons technology sales, and private channels for military sales--ranging from legal companies to gray- and black-market entrepreneurs--are also appearing. To entice buyers, governments, production enterprises, and research organizations are now marketing some of the best weapons and military technologies of the former Soviet Union, including advanced fighter aircraft and air defense missile systems. Large amounts of new and older weapons systems from military stocks are also available.

Russian President Yel'tsin has repeatedly advocated expanding conventional weapons exports. In October 1991, for example, he stated that Russia should continue to compete in the international arms market because such activities were "sufficiently profitable" financially. According to Russian television, moreover, he recently issued a decree authorizing the sale of 1,600 aircraft from Russia's current inventory. First Deputy Premier Gaydar this year has also supported arms exports as a way to minimize the costs of procurement cutbacks. Ukrainian Conversion Minister Antonov has stated publicly that Ukraine will export weapons to help finance conversion, although as late as March 1992, in response to international concerns about proliferation, he claimed that Ukraine had not yet sold "a cent's worth" of weapons.

It will be some time before comprehensive export controls can be reasserted with great effectiveness. According to the Russian press, CIS Marshal Shaposhnikov recently bemoaned the illegal transfer of hundreds of firearms, artillery pieces, and armored vehicles to criminals in the Caucasus and Moldova. The CIS states, however, probably would be somewhat responsive to direct Western pressures to control exports of weapons or military technologies and will have to balance their need to earn hard currency against the possible damage to their potentially far more lucrative relations with the West.

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Proliferation of Special Weapons and Sensitive Materials

We have not detected significant transfers of sensitive materials or expertise from the former Soviet Union, but the dissolution of central authority and the economic turmoil there have increased the potential for proliferation.

- The thousands of nuclear warheads deployed or in storage in Russia, Ukraine, Kazakhstan, and Byelarus appear secure for now, although declining military morale and discipline since the breakup of the USSR could threaten traditional controls.
- CIS countries that have supported ballistic missile production facilities could spread sensitive technology by marketing space launch vehicles and components based on ballistic missile technology.
- Chemical and biological warfare materials are difficult to detect and easy to transfer; most of these proliferation threats have been centralized in Russia.
- Thousands of former Soviet scientists and engineers--mostly Russians--probably have sensitive weapons information and are subject to increasinglydismal living and working conditions; some may consider marketing their expertise abroad.

At least some CIS states appear willing to accommodate pressures from the military-industrial establishment to market sensitive materials and equipment, despite reassurances to the West that they will be sensitive to proliferation concerns. CIS countries, for example, are marketing advanced conventional weaponry such as the SA-10, the Commonwealth's most advanced strategic surface-to-air missile system. The Russian government also has refused to cancel Glavkosmos' plan to transfer cryogenic rocket motor technology to India.

Current controls on the proliferation of sensitive materials, equipment, and expertise are tenuous, as CIS countries have only recently begun to consider legislation to replace what controls existed under the former USSR. Russia probably inherited most of the Soviet export control apparatus and seems to be moving more rapidly than the other CIS states to establish export control institutions, although most CIS states appear sensitive to Western proliferation concerns. President Yel'tsin has issued decrees to establish export controls over sensitive materials and conventional arms. These decrees call for criminal and administrative penalties to be set for violations and require lists of controlled technology to be drawn up by October 1992.

Several republics--including Russia and Ukraine--claim to be maintaining other Soviet controls, such as denying emigration for 5 to 10 years to scientists with sensitive information. Most of the pervasive coercion and control systems of the past have broken down, however. The Communist Party organizations that were the watchdogs at every level of Soviet society have been disbanded, and the KGB has lost much of the authority and institutional power to monitor Soviet society.

Smuggling and black-market sales of sensitive materials probably represent the most serious near-term threat, although CIS officials have so far reported illegal activity only among less sensitive military items.

In any event, the Soviet Union's successor states will probably emerge as alternative suppliers of at least some advanced conventional weapons systems and related technology, components, and services. The danger posed by these exports, however, will depend largely on the circumstances of the individual sales--for example, how many weapons are purchased and whether the buyer can operate a system to its full potential.

Hard Times Ahead

The economic and political situation in all of the Commonwealth states will be extremely difficult and uncertain for at least the next year or two. Under the best conditions, output will continue to decline and unemployment will rise. As painful as these changes may be, however, they will reflect long overdue reductions in subsidies for inefficient industries, unproductive investment, and military spending, rather than economic depression in the usual sense of the term.

Governments throughout the Commonwealth are trying to strike a precarious balance between keeping budget outlays and bank credit tight enough to brake inflation while still providing social support for the low-income population and preventing massive layoffs in the investment and defense industries. Even if such efforts are reasonably successful, unemployment will be higher next year than it is now, social tensions will rise, and governments will face serious political challenges.

Moreover, political and economic frictions among the Commonwealth states will likely continue, partly because the non-Russian states are likely to suffer even greater hardships than Russia. One of the greatest challenges for these countries will be to divide the military and financial assets inherited from the Soviet Union and to resolve potential ethnic and territorial disputes without resorting to major violence.

In Russia and elsewhere in the Commonwealth the process of reform is likely to continue to move forward. Still, as shown by the political furor at Russia's recent Congress of People's Deputies and continuing friction between the government and the legislature, the process will be contentious, it will move in fits and starts, and it will be marked by recurring crises. At best, it will be a decade-long process and the downside risks will be enormous. The range of potential outcomes, moreover, will be wide, and there will remain the possibility of extended political deadlock and instability so serious that it could derail reform in both the economic and political spheres.

MOSCOW'S DEFENSE SPENDING CUTS ACCELERATE

Key Judgments

New policy directions, disarray in the military, and disruptions in industry all combine to impart great uncertainty in our estimates of Soviet defense spending in 1991. Taking all of the uncertainties into account, our estimate is that the 1991 decline in overall defense spending was between 10 and 25 percent, with a best estimate of 15 percent. This brings total cuts since 1988 to more than 25 percent and leaves spending at levels last seen in the early 1970s. As a result, the legacy of military-economic capacity left by the USSR for the successor states primarily Russia--is much smaller than several years ago, and eroding rapidly.

Estimated procurement outlays--accounting for about 40 percent of total defense spending--dropped about 20 percent in 1991, and were one-third lower than at their high point in 1988 (see figure 1). Since 1988 there has been a sharp rise in the annual number of weapon production programs terminated or cut substantially.

Ground procurement was down 40 percent and theater air procurement was down almost half from 1988. Procurement for general purpose naval forces dropped roughly 30 percent in the same period. Procurement spending for the strategic offensive mission fell by one-third over the past three years. Estimated procurement spending for space programs declined by one-half since 1988. Strategic defensive forces continue to be the least affected mission area. We estimate spending for these forces declined less than 10 percent since 1988.

Our estimates for military research, development, testing, and evaluation (RDT&E) are much less precise, but finding for military R&D probably fell about 25 percent last year and was roughly one-third below peak levels. The number of men in uniform has declined by about 1 million since 1988, cutting personnel expenditures by about 20 percent. A somewhat smaller decline in spending for operations and maintenance was partially offset by the costs of relocating units and eliminating weapons.

The decline in defense spending accelerated in 1991--particularly in the latter part of the year--and is even more dramatic in 1992. High inflation and deficit-induced cuts are plaguing the defense budgets of all the new states as they attempt to reshape former Soviet forces into theIr own national armies and guard units. Russia and Ukraine are contending for control of the preponderance of former Soviet forces, but the expenses that accompany the assets they acquire will present a formidable financial challenge.

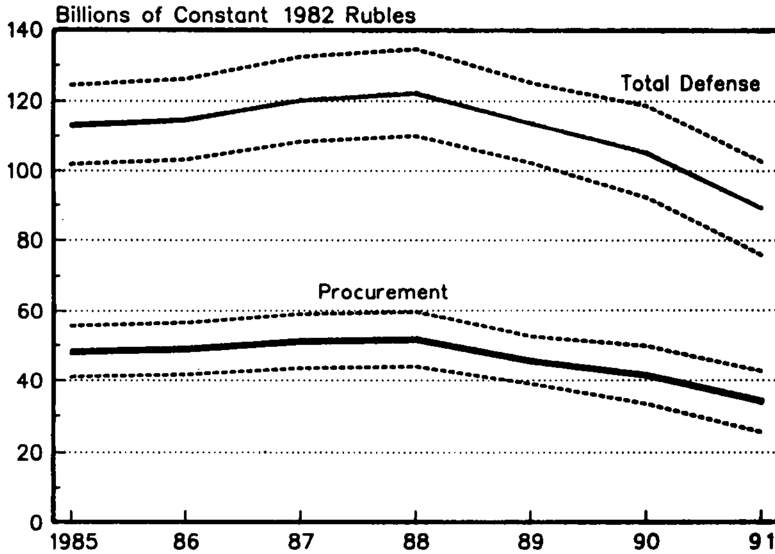
A draft defense budget for the Commonwealth of Independent States was submitted to the Russian cabinet in early March. With acknowledged inflation in weapons running at almost 600 percent, the 384-billion-ruble total appears to represent about a 50-percent cut in real terms from the 1991 Soviet defense budget. TASS claims that the budget calls for a 70-percent cut in procurement in real terms, compared with the 1991 Soviet budget. Most major weapons programs would have to be canceled to achieve such a huge cut in procurement in a single year.

Even this budget is probably overoptimistic, however, because it calls for substantial financing from non-Russian CIS members. For example, Byelarus's contribution was set at 30 billion rubles, but First Deputy Prime Minister Myasnikovich subsequently stated that his country planned to spend only 8 billion rubles on defense in

1992. In fact, we expect that Ukraine and most other CIS members will join Byelarus in allocating much less for defense than envisioned in the draft budget. Most of what they do allocate probably will be spent directly on their own military personnel. This means that the CIS will probably receive only token contributions for R&D and procurement, leaving Russia to pick up the bill. As a result, spending on arms in 1992 could be cut by more than 85 percent.

Figure 1

Estimated Soviet Spending for Defense Activities, 1985–91[a]



[a] These estimates are designed to capture real resource flows to defense programs. They do not measure military, defense industrial, or R&D capabilities. See DI Reference Aid SOV 87–10069 (Unclassified), November 1987, A Guide to Monetary Measures of Soviet Defense Activities.

Defense Spending Cuts Accelerate

Even before the failed coup last August, economic disruptions, republic assertiveness, and turmoil in the military had fundamentally undercut implementation of the USSR's original 1991 defense program. In the aftermath of the coup, power shifted decisively to the republics, destroying the former union.

This paper documents our estimate of defense spending during this turbulent time. The disintegration of the USSR, together with worsening economic disruptions, makes the uncertainty surrounding our estimates unusually large this year (see box). Our estimates indicate that, after sizable cuts in both 1989 and 1990, cuts in real defense spending in the former Soviet Union accelerated in 1991. We estimate that, during this period, total spending declined by more than 25 percent after reaching its peak in 1988, and fell about 15 percent in 1991 alone. Reductions occurred in all major resource categories and mission areas and caused spending to fall to levels last seen in the early 19705 (see figure 2).

Increased Uncertainty in Estimating Defense Spending

New policy directions, disarray in the military, and disruptions in industry all combine to impart greater uncertainty in estimates of 1991 defense spending. We continue to rely on our direct-costing building-block methodology supplemented by analysis of announced cuts in the official defense budget. As in past years, we have the most confidence in our estimate of the procurement of major systems such as surface combatants and aircraft. We continue to have the least confidence in our estimates of spending on RDT&E. Taking all of the uncertainties into account, our estimate is that the 1991 decline in overall defense spending was from 10 to 25 percent, with a best estimate of 15 percent.

Procurement Spirals Downward

Estimated 1991 procurement outlays--accounting for about 40 percent of the total--are approximately one-third lower than at their high point in 1988 (see figure 1). Outlays dropped sharply in 1991--by about 20 percent, more than double the decline in each of the two previous years.

Reductions occurred in procurement for all types of general purpose weapons--land, naval, and air--and for strategic offensive weapons, and were both broader and deeper than in 1990. Procurement for strategic defensive forces, however, slowed only slightly (see figure 3). We believe that, during 1988-90, cuts in procurement were largely planned-- primarily the result of unilateral cuts announced in January 1989 by then President Gorbachev. In 1991, however, scheduled declines were compounded, particularly in the latter half of the year, by falling weapons orders, supply disruptions, and resubordination of defense industry facilities--from all-union Soviet defense-industrial ministries to individual Commonwealth states--in the wake of the failed coup.

Figure 2

Estimated Soviet Spending for Defense Activities, 1970–91

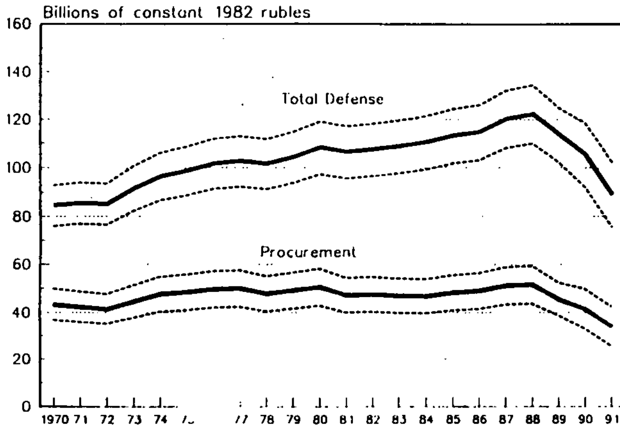
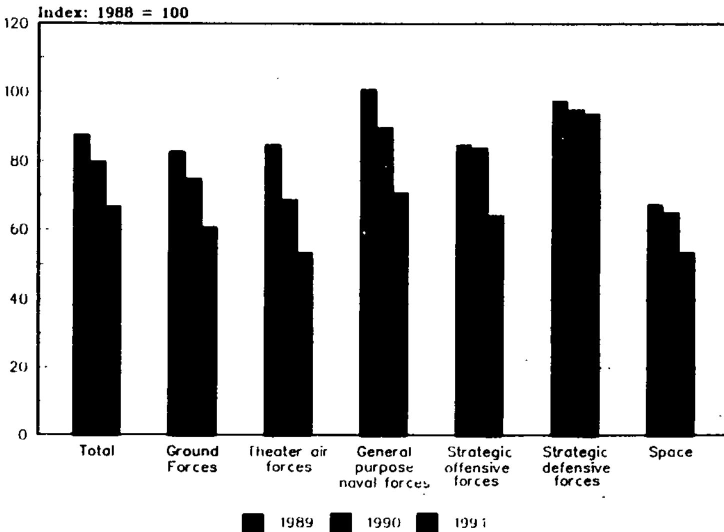


Figure 3

Estimated Soviet Spending for Military Procurement as a Share of 1988 Procurement Spending



Our spending estimates are built on detailed analyses of Soviet weapons production, and the spending trends mirror trends in the Soviet weapons production base. On average over the past two decades, the USSR maintained an estimated 400 to 500 military systems in production. We estimate that since 1988 there has been a sharp increase in the number of programs terminated or cut substantially (see figure 4). On the other hand, some high-priority weapons production programs continued in 1991 at close to 1990 rates.

Ground Forces. Ground forces procurement continued to take heavy cuts, with estimated outlays down by about 40 percent from 1988 levels. Alter absorbing large cuts--about 25 percent--during 1989-90, procurement expenditures for ground forces were cut again in 1991--by about 20 percent in real terms. The number of tanks procured dropped by 45 percent in 1991. The number of light armored vehicles procured fell by about 40 percent in 1991, and the number of artillery pieces by more than 45 percent.

Theater Air Forces. Estimated outlays for theater air procurement have fallen by about one-half since 1988, including a decline of around 20 percent last year.

Naval Forces. The general purpose Navy also took heavy cuts. Estimated procurement for general purpose naval forces has dropped roughly 30 percent since 1988, including a decline of about 20 percent last year. Delivery of major combatants and submarines fell sharply.

Strategic Offensive Forces. We estimate that procurement spending for the strategic offensive mission fell by approximately one-third over the past three years, including a decline of about 25 percent in 1991.

Strategic Defensive Forces. Strategic defense force modernization continued at a relatively steady pace last year--estimated spending for procurement has declined less than 10 percent since 1988.

Space. Estimated procurement spending for space programs has declined by about one-half since 1988, including a drop of around 20 percent in 1991. The number of space launches--and space launch vehicles procured--has declined by more than one-third since 1988 and is now the lowest in 25 years.

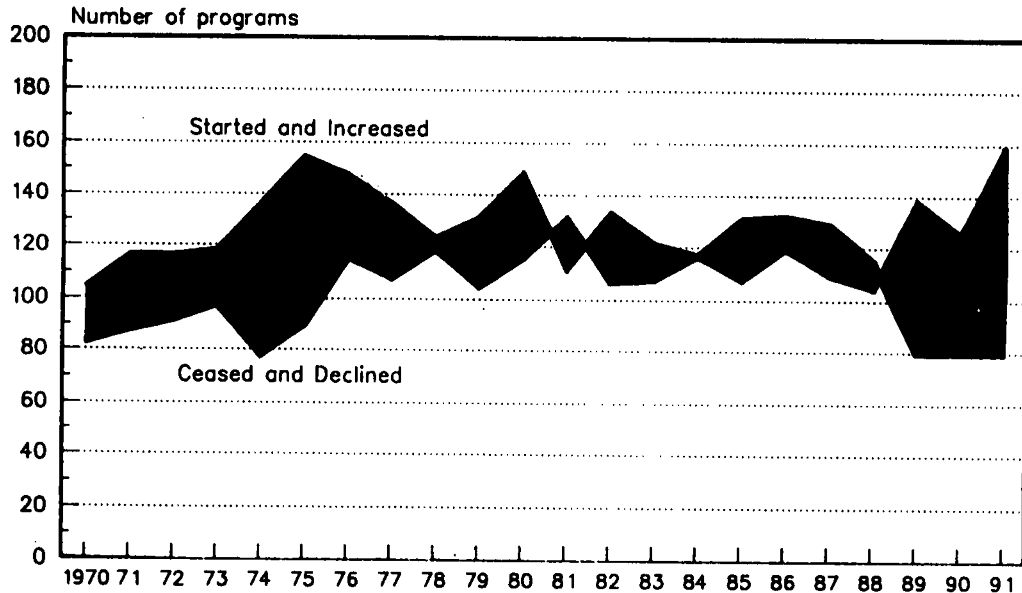
Other Spending Categories

Personnel. Since 1988, personnel expenditures have dropped about 20 percent, and the number of military personnel has declined by about 1 million. Accelerating draft shortfalls throughout the former Soviet Union, reduced callup goals, tighter medical standards, and the early release of conscripts are rapidly reducing overall military strength.

Operations and Maintenance (O&M). A decline in spending for operations and maintenance--about 10 percent since 1988--reflects a reduction in the number of exercises and in overall operating tempos, which has been partially offset by the costs of relocating units and eliminating weapons. A continuing downturn in space activity, as well as a smaller force operating with lower equipment levels, also contributed to the reduction.

Figure 4

Estimated Soviet Weapon Production Program Activity, 1970-91[a]



[a] The green areas show the years for which the number of weapon program starts and substantial increases-- physical production increases of more than 10 percent-- exceeded the number of program cessations and substantial declines. The red areas show the years for which the reverse relationship prevails. Because of the difficulties of pinpointing the precise year some programs begin or end, we have more confidence in the general trends depicted than in the data for any given year.

Research, Development, Testing, and Evaluation. We are least certain of our estimates of RDT&E because most of these activities are not directly observable. Although the most visible R&D activities generally continued last year, anecdotal evidence indicated that financial support was withdrawn by varying degrees at R&D facilities. The preponderance of anecdotal evidence showed that some work on a large number of individual programs continued last year. Official Soviet statements, assessments of a broad sample of R&D programs, and reporting from many sources suggest, however, that RDT&E expenditures, after falling by about 10 percent in 1990, were cut far more--by approximately 25 percent--in 1991.

Outlook

The downward spiral in defense spending is accelerating dramatically this year. Before the announcement of the Commonwealth's formation, the contradictory pressures of inflation and the budget deficit, complicated by the republics' demands for cuts, resulted in a planned defense budget for 1992 that was up in nominal terms but down in real terms. In January 1992, the Russian legislature approved a first-quarter defense budget that cut overall procurement spending on the order of 85 percent and R&D spending about 65 percent.

A draft 1992 CIS defense budget was submitted to the Russian cabinet in early March. With acknowledged inflation in weapons running at almost 600 percent, the 384- billion-ruble total appears to represent about a 50-percent cut in real terms from the 1991 Soviet defense budget. TASS claims that the budget calls for a 70-percent cut in procurement in real terms, compared with the 1991 Soviet budget. Most major weapons programs would have to be canceled to achieve such a huge cut in procurement in a single year.

Even this budget is probably overoptimistic, however, because it calls for substantial financing from non-Russian CIS members. For example, Byelarus's contribution was set at 30 billion rubles, but First Deputy Prime Minister Myasnikovich subsequently stated this his country planned to spend only 8 billion rubles on defense in 1992. In fact, we expect that Ukraine and most other CIS members will join Byelarus in allocating much less for defense than envisioned in the draft budget. Most of what they do allocate probably will be spent directly on their own military personnel. This means that the CIS will probably receive only token contributions for R&D and procurement, leaving Russia to pick up the bill. As a result, spending on arms in 1992 could be cut by more than 85 percent.

Eastern Europe: Struggling To Stay On The Reform Track

A paper submitted to the Subcommittee on Technology and
National Security of the Joint Economic Comittee,
Congress of the United States

(Embargoed until 1400 8 June 1992)

Summary

Eastern Europe has made progress on reform in the past year. No country has yet achieved a market economy, and reforms have not yet lifted these economies out of recession. But gains have been made on a wide range of issues since mid-1991: the private sector has become larger, there are fewer price controls, currencies are more convertible, property rights are stronger, and most governments are more strongly committed than ever to reform.

Poland, where political stalemate has stunted progress for the past year, is the key exception. Support for shock therapy waned in 1991 as parties calling for antirecessionary policies won a majority of the seats in the October parliamentary elections. The government formed in January 1992 has struggled unsuccessfully to cobble together support for its economic program from the fractured 29-party legislature.

The rest of Eastern Europe has fared better:

- Hungary's steady progress toward a market economy has made it the clear favorite of Western investors.
- Czechoslovakia launched its economic reform program one year later than Warsaw and
- Budapest, but Prague is now instituting reforms at a more rapid pace than its neighbors.
- Bulgaria's new government has accelerated economic reforms, culminating in the passage in April of the long-delayed privatization law.
- Romania has advanced substantially in the past year under reformist Prime Minister Stolojan, but the government's penchant to intervene casts doubt on Bucharest's ability to stay the course.

Privatization. Efforts to shed state ownership and control of production continue to make progress. Although advances often seem slow and uneven, the rise of the private sector since 1990 has been dramatic. The private sector now accounts for half of production in Poland and nearly as much in Hungary. Entrepreneurs have also made important progress in Bulgaria and Romania in the past year. Entrepreneurs have opened or bought businesses by the hundreds of thousands to meet the demand--pent up for decades--for consumer goods and services. An important effect of the explosion of private sector activity is its role in the spread of market forces through the economy.

The transfer of large state-owned manufacturing firms to private ownership has moved much more slowly. Underlying the slowdown is the fear of steeper recession and, in particular, higher unemployment. Czechoslovakia stands the best chance of rapid mass privatization on the strength of its voucher program; Bulgaria and Romania now have laws on the books, but implementation will be slow.

<u>The Economy in 1991: Mixed Results</u>

Despite progress with reform, the region suffered with another year of severe recession as GNP fell an average of 13 percent in 1991. Czechoslovakia and Bulgaria recorded the sharpest declines, while the downturns in Poland and Hungary were more moderate. Expansion of the private sector was not enough to overcome the plunge in output of state-owned factories in Eastern Europe. Most countries cut inflation, but unemployment soared with the slump in manufacturing. From virtually no unemployment

in 1990, jobless rates in most countries jumped to 10 percent or more by the end of 1991, and rates in some one-company towns have topped 20 percent.

Although economic reforms contributed to the recession, the collapse of Eastern Europe's trade with the former Soviet Union was the most important factor in last year's decline. The shift at the beginning of 1991 to hard currency settlement of Soviet-East European trade coincided with Moscow's credit crunch. Eastern Europe, which was still heavily reliant on sales to the former USSR, saw its exports drop by more than half.

Increased trade with the West helped soften some of the blow from reduced trade with the former Soviet Union. Strong export performances by Hungary and Czechoslovakia boosted their international reserves and credit standings. Bulgaria and Romania, however, were bogged down in financial difficulties that reduced trade sharply.

Outlook

The next year will be pivotal for Eastern Europe's transition. Several economic trends and forces now at work should help the process, but the risk of a setback is high in some countries. Political factors--government leadership, stability, and popular attitudes--will be the primary determinants of the outcome.

The outlook is for another tough economic year in Eastern Europe, although the slide will not be as steep as in 1991. Indeed, after several years of recession, GNP should bottom out in at least some countries--most likely those in the northern tier--within the next year. The factors and events that made 1991 such a difficult year--particularly the plunge in exports to the former Soviet Union--probably will not worsen or recur, and some positive trends will continue:

- the brisk growth of the private sector;
- a rise in foreign investment; and
- gains in trade with the West.

Moreover, economic reform programs will probably begin to pay more dividends. Legislation put in place in 1990-1991 has set the stage for reforms to take root. Economic actors now have had at least a year--more than two years in Poland--to adjust to new rules of economic behavior.

The region, however, still will face economic problems in the next year. Industrial output will continue to fall sharply, particularly if mass privatization of state industries takes hold. Unemployment is the greatest concern; rates are likely to continue to climb after a large jump in 1991, and the safety net will be stretched by budget problems. Nearly all of the countries could experience double-digit rates of joblessness before the end of the year. The battle against inflation will once again be tough in all but Hungary and Czechoslovakia.

Even those countries that emerge from the recession will see only a spotty and anemic recovery:

- The inefficient state sector will hinder growth and productivity.
- After rapid growth in the service and retail sectors, the rise of the private sector will stall if entrepreneurs fail to make inroads in manufacturing.
- Dependence on Russia for energy supplies leaves the region vulnerable to shortages that would disrupt industrial output.
- Hard currency constraints will hold down imports needed for restructuring and supplying the population.

- Continued violence from the breakup of Yugoslavia and uncertainty about the new CIS will possibly make foreign investors and lenders cautious about Eastern Europe.

In the Longer Run

Continued progress with reforms will test the social fabric and political stability of the East European countries. The emphasis of reform programs will shift increasingly from passage of legislation to implementation of difficult measures such as privatization of state industries and restructuring of inefficient firms.

Political leaders will face the challenge of convincing populations that have already endured heavy sacrifices to hold out longer. No country has yet borne the full impact of restructuring, and all will have to get over a large unemployment hump as inefficient plants are finally shut down. Poland and Romania are now in the shakiest positions. Warsaw will have to resolve its current political problems to move forward, and Romania will have to show more consistency in its reforms and policies. The other countries stand a better chance of advancing, but they may encounter problems similar to Poland's once their reforms reach a later phase.

The most successful leaders will be those who can draw enough popular support to push reform measures through legislatures and who can persuade the population that near-term sacrifices are required to achieve the goal of long-term prosperity. Moreover, external pressure--from the IMF, the World Bank, and Western governments--will also be key to keeping reforms on track. Those countries able to stay the course will begin to see more payoff in the next few years. By the mid-1990s, most if not all of the East European countries will:

- register economic growth;
- sell off a large share of state industry so that private sector output eclipses that of the state;
- be more closely integrated with the EC; benefit from steady increases in foreign investment.

Eastern Europe: Struggling To Stay on the Reform Track

Introduction

Eastern Europe's shift from a command economy to a market system began under difficult conditions. The East Europeans had no models to follow; decades of Communist rule had left their economies distorted, uncompetitive, and in decline; inexperience with democracy has complicated the building of political consensus to make tough economic decisions; and the collapse of Soviet dominance has introduced new instability into the region and disrupted these countries' longstanding trade ties with the USSR.

The process of economic transition, which started at the beginning of 1990 with Poland's "Big Bang" and has since been duplicated in varying degrees in Hungary, Czechoslovakia, Bulgaria, and Romania, has yielded valuable lessons. The transformation has turned out to be a longer and more complex process than the East Europeans expected at the outset. East Europeans have learned that laws can be passed in a year or two to eliminate central controls and create the conditions for a market economy, but much more time is needed to change the attitudes of workers and managers accustomed to the inefficiency and lack of incentives inherent in centrally planned economies. Moreover, refitting antiquated factories and rebuilding a crumbling infrastructure require vast resources that often are not be available.

On the positive side, the East Europeans have shown a surprising degree of support for economic reforms and tolerance of austerity during the transition. This support has waned somewhat in the past year, but the stability of the past two years in the face of inflation, recession, and high unemployment is testimony to the determination of East European leaders and populations to stay the reform course. Another encouraging sign is the rapidity with which entrepreneurs have seized opportunities to own businesses, indicating that entrepreneurial impulses were dormant--or channeled into black market activities--but not extinguished under Communism.

The experience of Eastern Europe will provide important guidance to Russia and the other former Soviet republics that have embraced sweeping economic reforms this year. Indeed, former Polish Deputy Premier Balcerowicz, the architect of Poland's Big Bang, visited Moscow in December 1991 to advise Soviet economists and leaders on reforms. There are major differences between the East European countries and the former USSR that limit the applicability of Eastern Europe's experience--the size of Russia and its economy are unmatched in Eastern Europe, for example--but several CIS republics are following roughly the same pattern in implementing reforms. The lifting of price controls launched real reforms in all the East European countries as well as in the former Soviet republics, and the general acceptance in Russia of higher prices with a minimum of unrest parallels the East European experience.

The West has a large and growing stake in the transformation under way in Eastern Europe. West European neighbors, nervous about political turmoil and immigration from Eastern Europe, are eager for the East Europeans to succeed for both political and economic reasons. The European Community has laid the groundwork for close economic ties through association agreements signed with Poland, Hungary, and Czechoslovakia and under negotiation with Bulgaria and Romania. These call for greatly expanded trade access and closer political cooperation in the next few years and hold

out the possibility of eventual membership in the EC--if reform programs are completed. But the West Europeans are also reluctant to open up some markets where Eastern Europe is potentially most competitive and have grown increasingly resistant to coughing up more cash on grounds of equity in burdensharing.

International financial institutions--the IMF, the World Bank, and the European Bank for Reconstruction and Development--have committed billions of dollars of assistance to the region. The IMF, in particular, has taken a major role in encouraging economic policies to guide East European countries through the transition. Western governments have also contributed large sums of financial and other aid to Eastern Europe, and private Western firms are becoming important investors in the region.

Recent Developments and Outlook: Regional Overview

The past year has seen continued, but generally slow progress in East European reforms amid a deepening, regionwide recession. Government commitment to tough stabilization policies--monetary and fiscal measures to control inflation and external payments deficits--has grown more tenuous under mounting pressure in several countries to reflate their economies to end recession. Restructuring has only just begun in several countries; sharp cuts in domestic investment have placed the major burden for modernization on foreign financing from the World Bank and private investors.

Survey of Reforms

Reform efforts have made headway in the past year. (See Annex for details on the status of economic reform programs in each country.) Political stalemate has stunted progress in Poland since mid-1991, but all the other countries have approved and implemented important measures. Nearly all elements of reform programs have advanced since mid-1991: the private sector is larger, price controls are more limited, currencies are more convertible, property rights are stronger, and governments--with the possible exception of Poland's--are more strongly committed to reform.

The rate of progress, however, has been less dramatic than during the first year of reform, particularly for leaders such as Poland and Hungary. New legislation has slowed as has the implementation of some earlier laws. In part, the slower pace is inevitable as reform measures become more complex and painful to implement. The lifting of price controls and elimination of central planning that launched the programs have proved much easier than the massive privatization that is key to further progress.

Also underlying the slowdown is the fear of steeper recession and, in particular, higher unemployment. In the past year, East European reformers have increasingly hesitated on the brink of tough measures that would worsen the economic situation in the short term. Leaders' concerns reflect a decline in popular support for radical reforms. For example, Poland's October election saw the party of former Prime Minister Bielecki, who pressed ahead with Warsaw's pathbreaking reform program, garner barely enough votes to gain representation in parliament.

The States of Transformation

The economic transition under way in Eastern Europe is moving along three separate but related paths: economic reform, stabilization policies, and restructuring.

Economic reform refers to changing the environment and rules that govern economic behavior. Reforms are the new laws that replace the central economic plan with market mechanisms to guide the economy. East European countries have eliminated or sharply reduced government control over the economy while introducing or legalizing the introduction of market incentives. Examples are measures that free prices from government control, abolish the state monopoly of foreign trade, establish and protect private property rights, permit currency convertibility, and transfer ownership of property from state to private hands.

Stabilization policies are fine-tuning measures used to regulate the economies. The goal is usually to strike a balance between keeping inflation in check and achieving economic growth. Holding down inflation has been the primary concern in the early stages of Eastern Europe's reforms; price stability is generally considered necessary for the generation of market forces, and governments have been anxious to curb price increases after the initial jump once controls were lifted. The key tools for stabilization are monetary policy--interest and exchange rates, money supply, and other banking regulations--and fiscal policy. These tools had little meaning under Communism, but economic reforms have made these the key levels of economic policy. The International Monetary Fund conditions members' access to Fund credits on success in meeting performance criteria based on targets tied to stabilization policies.

Restructuring is the final and most difficult stage in economic transformation. To achieve real prosperity and to become internationally competitive, the East European countries must undertake a massive physical rebuilding of their infrastructure--transportation facilities, communications networks, and public facilities--and industrial plant. Outmoded machinery geared to production for the undemanding Soviet and East European markets needs to be replaced with modern and efficient equipment and technology. Reforms and stabilization need to be largely in place for restructuring to make much progress. For the most part, the East European countries are only at the early stages of restructuring. Credits from the World Bank and foreign investment are key sources for the tens of billion of dollars to be spent on restructuring.

Privatization

Efforts to shed state ownership and control of production continue to make progress as the share of private economic activity grows throughout the region. Advances often seem slow and uneven, and the pace of privatization has been the chief frustration of East European reformers, but the rise of the private sector since 1990 has been nonetheless dramatic. The private sector now accounts for half of GDP in Poland and nearly as much in Hungary. The shares are still low in the other countries, where the private sector' is just beginning to take off.

Entrepreneurship Flourishes... Small privately-owned businesses have surged throughout the region. Entrepreneurs have opened or bought businesses by the hundreds of thousands to meet the demand--pent up for decades--for consumer goods and services. The response has been enthusiastic in all of the countries, including those without a history of commercial capitalism. Private employment offers higher incomes and better prospects than continued reliance on lossmaking state firms. A less visible but nonetheless important spinoff of the explosion of private sector activity is its role in the spread of market forces through the economy.

Private sector growth has been limited, however, mostly to retail shops and services. The growth in the past two years was facilitated by the large gaps in these industries. As these gaps are filled, the private sector will need to make major inroads in more difficult areas--manufacturing and large-scale enterprises. The greater capital needs and more complex management of such ventures are likely to be a major constraint on further expansion of grassroots entrepreneurship in the region. At least for the near term, underdeveloped banking systems probably will not be able to meet the credit needs of expanding East European businesses.

...While State-Owned Dinosaurs Hang On. Eastern Europe has had less success in transferring the ownership of large state enterprises to private hands. Despite the passage of privatization legislation, rhetorical support from governments, and the creation of privatization ministries, large-scale privatization programs have been disappointing. Schedules have slipped, unworkable programs have been replaced by new ones, and large sums are still spent to subsidize the state sector. Large state-owned companies still dominate the manufacturing sector, although Hungary has made steady progress and Czechoslovakia is on the verge of a large selloff of state enterprises. In the rest of the region, privatization programs have floundered because of legislative delays, claims of pre-Communist owners, lack of foreign investor interest, and worries about unemployment as firms adjust to pressures for greater efficiency.

Preparation for privatization has proven complex and time-consuming. Companies are often split into smaller units or converted to joint stock companies before privatization. Managers, often with the help of Western investment bankers, generally draft privatization plans that need to be approved by industrial ministries, privatization ministries, and other government officials. These plans present a detailed evaluation of a firm's assets and liabilities, project business prospects and investment needs, and specify options for privatization. In many cases, only a cursory review of these plans by overworked staffs is possible.

A more fundamental obstacle is the low value of many state-owned companies. Inefficient factories that produce low-quality goods have not found buyers at any price.

Moreover, East European officials have been wary of selling at low prices--especially to foreign investors--because of sensitivity to charges of selling out too cheaply. In the meantime, the value of state-owned firms has declined as the recession has deepened. Losses in the past year have resulted in the buildup of large debts that new owners are loath to take on.

The East Europeans have generally chosen to disperse ownership of industry widely through programs to give away or sell at a nominal cost shares in companies being privatized. Czechoslovakia's voucher privatization, which distributes shares to all citizens over 18 years old who pay the equivalent of $35 for a voucher booklet, is the most advanced program in the region. Bulgarian and Romanian laws follow similar approaches but are in much earlier stages. Plans pending in Poland for the past year also call for a wide dispersion of ownership; Hungary is the exception, using a variety of methods to sell companies at roughly market value.

The programs to distribute shares widely have received the most attention, but many other privatization options are also available. Foreign investors can buy plants outright, as can managers and workers. In the absence of a mass privatization program, Poland has relied heavily on "liquidations," the selling of assets of bankrupt firms or the sale and lease of assets of going concerns.

A key requirement for privatization is the creation of a range of internal financial markets and institutions to foster the smooth working of a market economy. Capital markets are needed to value the shares of companies that go private or are about to be sold, to impose pressure on management for profitability, and to give firms the ability to raise capital. Poland, Hungary, and Bulgaria have established stock markets, but shares of only a few companies trade on these exchanges. Despite its ambitious privatization program, Czechoslovakia will not establish a stock market until 1993 at the earliest. Only then will Czech and Slovak citizens (the Czech lands and Slovakia will each have a stock market) be able to easily trade their shares.

Price Decontrol

Price liberalization is the reform that is most nearly complete. Most price controls have been eliminated in Eastern Europe. Bulgaria and Romania made major strides in 1991, while Poland, Hungary, and Czechoslovakia have steadily reduced the lists of sensitive goods exempt from the initial wave of decontrol. Price increases have occasionally spurred strikes and demonstrations, as in Romania in September 1991 and Poland in March 1992.

The East European economies, however, retain many price restraints that inhibit competition and efficiency.

- The continued dominance of state-owned industry and the monopoly power of huge enterprises distort prices.
- Several countries have imposed import quotas and tariffs that hinder foreign competition.
- Wage indexation and taxes on "excessive" wages serve to distort prices.
- Romania lags the rest of the region in the extent of decontrol and in its ability to make changes stick.

Currency Convertibility

All countries in the region have achieved at least partial convertibility of their currencies. Exchange rates have become an important tool of stabilization policies, and currency black markets have virtually ceased to exist in most of the countries. Foreign firms are able to repatriate profits, citizens can hold bank accounts in foreign currency, and most restrictions have been lifted on import payments and other current account transactions. A key factor in the progress of Hungary and Czechoslovakia toward convertibility has been the cushion offered by substantial growth in the level of international reserves during the past year. These reserves provide flexibility in exchange rate management. These countries also made important inroads against inflation in the past year. Romania, with dual exchange rates and high inflation, is the chief exception to the pattern of liberalization, and some controls on capital outflows remain in all other countries as well.

Financial liberalization

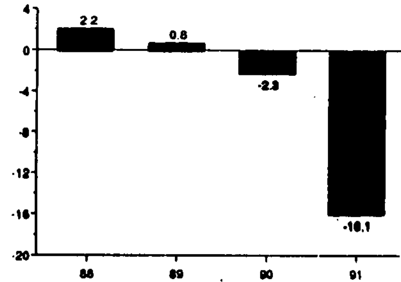
Money was relegated to a secondary role in the centrally planned economies. Government directives rather than prices dictated the production and distribution of goods and services, so that East European currencies not only were inconvertible internationally but also had only limited convertibility internally. Several reforms in the category of financial liberalization--currency convertibility, banking reform, privatization, and price liberalization--will help to establish a major role for money, and, in turn, be more effective as the role of money increases.

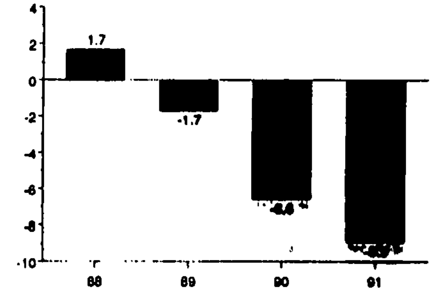
In short, the sooner money can become a powerful force in the economies, the more effective reform measures can be in the real or goods sector of the economy. Apparently strong bankruptcy legislation in several countries, for example, has been undermined by the free flow of credit to firms that would otherwise have gone under. Moreover, the power of stabilization policies to control inflation hinges on a major role for money.

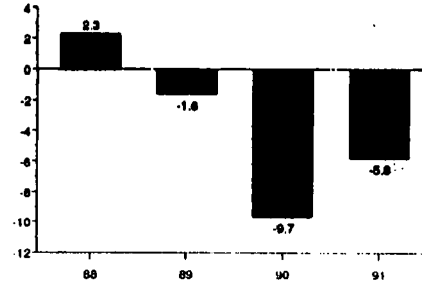
Banking Reform

East European countries took overdue steps in the past year to reform their banking systems. Most countries have made major progress in restructuring their financial systems by splitting commercial banks off from the central bank and have made some progress with plans to privatize banking. The growth of internal debt in the East European economies, which has become a very serious problem on a number of fronts, has weakened banks and hindered the development of strong financial systems. Lossmaking state-owned firms have been kept afloat by borrowing from state-owned banks as well as from other enterprises through nonpayment for supplies. Banks in most countries are saddled with several billion dollars of such debt, which has weakened the lenders and constrained their ability to direct capital to potentially successful new ventures. A few governments have taken steps to write off these debts or to take them over but have not been as aggressive as necessary because of the budgetary impact. The problem only grows worse with time, however, as the losses of state-owned firms mount.

Real Growth in East European GNP
(Percent Annual Change)







Real Growth in East European GNP
(Percent Annual Change)
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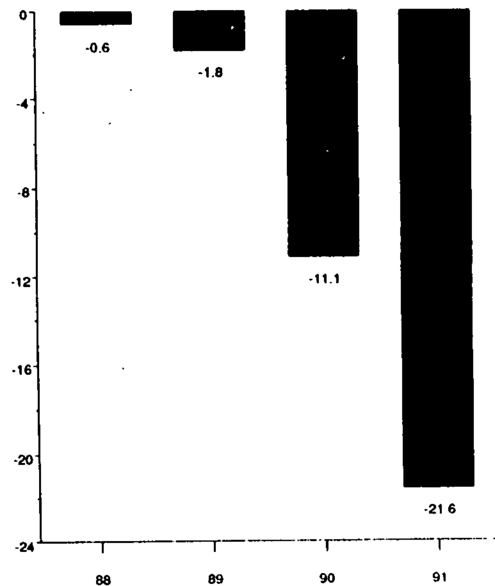
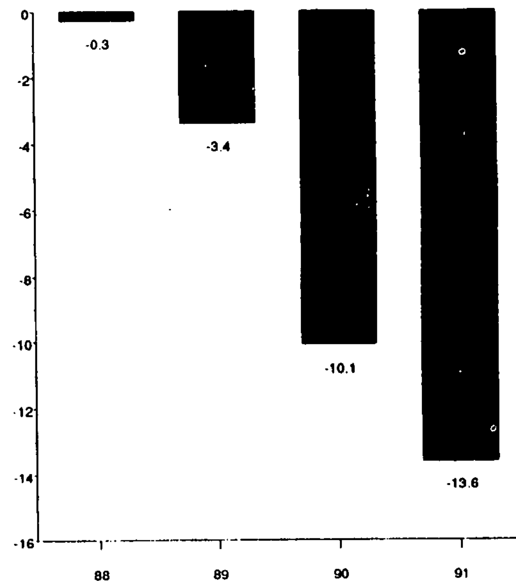




Economic Performance in 1991

Severe recession continued to grip Eastern Europe in 1991. GDP fell substantially in all of the countries and averaged 13 percent less across the region. Czechoslovakia and Bulgaria suffered the sharpest declines, while the downturns in Poland and Hungary were more moderate. Expansion of the private sector in Eastern Europe was not nearly enough to overcome the plunge in output of state-owned factories.

The fall in output in 1991 is often attributed to the impact of reforms, but several other factors also worked to depress output. The present recession started in the late 1980s, well before reforms were implemented. Moreover, a key cause of the slump in 1991 was the collapse of Eastern Europe's exports to the USSR. The shift to hard currency trade between the USSR and its former CEMA partners at the beginning of the year coincided with severe Soviet hard currency shortages. Eastern Europe, which was still heavily reliant on sales to the USSR, saw its exports there drop by more than half. The associated loss in production accounted for a substantial portion of reduced income in most countries. Moreover, the economies of Bulgaria and Romania were also hurt by problems in trade with the West, where two-way trade plunged because of financial problems.

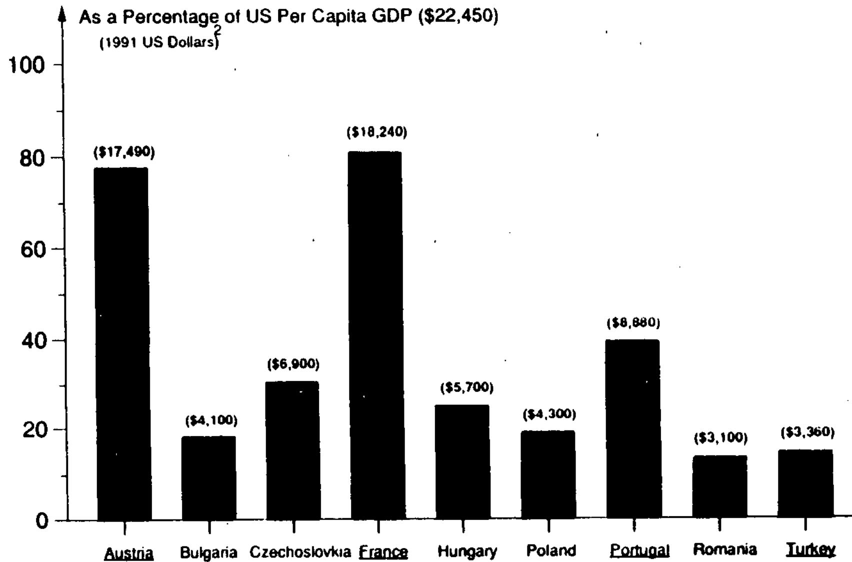
Economic reforms have also contributed to the recession. Although most of the industrial dinosaurs of the Communist era continue to operate, many have seen sharply curtailed output and employment. Stabilization policies designed to curb inflation unleashed by price decontrol has depressed domestic demand and investment.

Official statistics nonetheless almost certainly overstate the severity of the recession. The underlying data are drawn heavily from reports by state-owned industries hurt most by all of the changes in the past two years. Official statistics have been slow to capture much of the flourishing private sector that was the most dynamic factor in the region in 1990-1991. The data also do not fully reflect the improved mix of output in the economies: product ion is now better targeted to meet real consumer demands than was the case under central planning. Finally, amid the recession, pockets of economic boom are found in most countries. Capitals, in particular, exhibit thriving entrepreneurship, a boom in construction and renovation, low unemployment, and sudden prosperity that belie the depressing statistics.

Unemployment has soared with the slump in manufacturing. From virtually no unemployment in 1990, jobless rates in most countries jumped to 10 percent or more by the end of 1991. Rates in some areas, particularly one-company towns, have topped 20 percent. Relatively generous relief programs have helped cushion the impact, and many workers occupy jobs not recorded by official statistics.

Inflation remained a problem in 1991. Prices rose by one-third to two-thirds in the northern tier and at triple-digit rates in Bulgaria and Romania as the continued lifting of price controls led to jumps in all of the countries. In most cases, these resulted in one-time increases and inflation cooled quickly in response to tight monetary policies. Growing budget deficits, caused by declining tax revenues from slumping state industries and rising social payments to the unemployed, put at risk stabilization efforts in several countries.

Eastern Europe: Estimates of Per Capita GDP in 1991[1]



1) Confidence in these estimates is greatest for the West European countries and least for Bulgaria, Czechoslovakia and Romania. Estimates for Hungary and Poland are probably more reliable than that for Yugoslavia. Given the level of confidence in East European per capita GDP estimates, these figures are rounded to the nearest 100 dollars; the West European per Capita GDP figures are rounded to the nearest 10 dollars.

2) Based on international tastes (and prices) as expressed by purchasing power parity exchange rates published by the OECD in Purchasing Power Parities and Real Expenditures - 1985 (Paris; 1987) and the UN/European Comparison Programme in International Comparison of Gross Domestic Product in Europe - 1985 (N.Y.; 1988) U.S. GDP and population--based on the 1990 Census was taken from the February 1992 issue of the Economic Report of the President.

Eastern Europe: Hard Currency Trade

(million US $)

	1990	1991
Bulgaria		
Exports	4212	3737
Imports	5465	3781
Balance	-1252	-44
Czechoslovakia		
Exports	5994	8600
Imports	6780	9150
Balance	-785	-550
Hungary		
Exports	6408	9500
Imports	6070	9300
Balance	+338	+200
Poland		
Exports	9783	12760
Imports	7031	12709
Balance	+2752	+51
Romania		
Exports	3467	3520
Imports	5132	4750
Balance	-1665	-1230

1. Sources: IMF Payments Data, except 1991 figures for Hungary, Poland, and Romania.

Foreign trade and finance presented divergent results across the region. Bulgaria and Romania suffered from a severe credit squeeze that depressed both exports and imports. Both countries were forced to rely on meager export earnings to pay for vital imports. Shortages of imports spread through their economies. Poland, Hungary, and Czechoslovakia, on the other hand, registered strong exports to the West. Poland made no progress toward debt relief with bank creditors, but Hungary and Czechoslovakia enjoyed strong credit ratings and managed to build large cushions of international reserves.

Eastern Europe: International Financial Reserves, Yearend

(billion US $)

	1990	1991
Bulgaria	0.1	0.7
Czechoslovakia	1.2	3.3
Hungary	1.2	4.0
Poland	4.9	3.8
Romania	1.6	0.3

Sources: Press Articles and IMF data.

A key achievement in 1991 was the conclusion by Poland, Czechoslovakia, and Hungary of association agreements with the European Community. These agreements call for lowering trade barriers on many East European goods. The EC will cut tariffs on some agricultural products 20 percent annually for three years and increase quotas on other goods 10 percent annually for five years. The East Europeans will have a few years longer to increase EC members' access to their markets. The association agreements also raise the possibility of eventual EC membership for the East Europeans. No timetable was agreed for membership, however, which will be late in the 1990s at the earliest. All of the EC member states and the East Europeans still need to ratify the agreements, but several trade provisions took effect in March 1992.

Foreign investment was another bright spot in 1991 as the region attracted more than $2 billion, compared with several hundred million dollars in 1990. Budapest won the lion's share, and there was growing interest in Czechoslovakia. Despite passage of the region's most liberal law in June 1991, Poland had little success in attracting direct foreign investment. The Balkan countries also concluded few deals. Several East European governments have indicated growing ambivalence toward foreign investment in their economies. They alternate between disappointment at the low rates of capital inflow and a nativist attitude that rejects foreign investors' control over their economies. German firms have invested the largest amounts in the region, followed by those from the United States, Austria and France.

Eastern Europe: Direct Foreign Investment through 1991

(million US $)

Total	4748	
Bulgaria	50	(1)
Czechoslovakia	760	
Hungary	3000	
Poland	670	(2)
Romania	268	

1. Estimated
2. October 1991

Eastern Europe: Major Sources of Foreign Investment (1)

(mln US $)

	Total	Czechoslovakia	Hungary	Poland	Romania
Germany	1219	532	500	157	30
US	1131	42	1000	57	32
Austria	446	28	380	38	
France	401		300	66	35
Switzerland	80	80			
Sweden	53			53	

1. Data not available for Bulgaria.

Outlook

The next year will be pivotal for Eastern Europe's transition. Several economic trends and forces now at work will advance the process, but countervailing developments could lead to setbacks in some countries. Political factors--government leadership, stability, and popular attitudes--will be the primary determinants of the outcome.

Economic Forecast

The regional outlook for this year is for further economic decline, although the slide will not be as steep as in 1991. Indeed, after several years of recession, GNP should bottom out in at least some East European countries within the next year. The factors and events that made 1991 such a tough year--particularly the plunge in exports to the former Soviet Union--probably will not worsen or recur, and some positive trends will continue. The primary reasons for the expected slower decline this year are the continued brisk growth of the private sector, emerging benefits from reforms and privatization undertaken so far, further gains in foreign trade with the West and the absence of the Soviet trade shock. Moreover, economic reform programs may finally pay sufficient dividends to overcome negative factors. Legislation and other groundwork put in place in 1990-1991 has set the stage for reforms to take root. Economic actors now have had at least a year--more than two years in Poland--to adjust to new rules of economic

behavior. Enough time has passed to incorporate key adjustments and to encourage producers and consumers to react more to prices and other market signals.

The region still will face economic problems in the next year. Industrial output will continue to fall sharply, Particularly if privatization plans are implemented, Unemployment is the greatest concern; rates are likely to surge this year after a large jump in 1991, and the safety net will be stretched by budget problems. Nearly all of the countries could experience double-digit rates of joblessness before the end of the year. The battle against inflation will once again be tough in all but Hungary and Czechoslovakia.

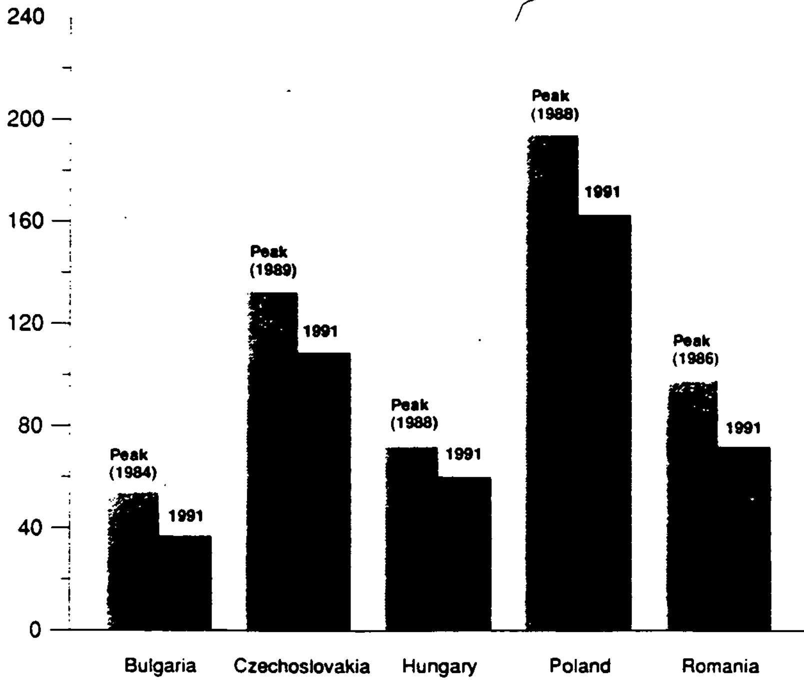
The prospects for individual countries are tied closely to the maturity of their reforms programs; those that started earliest will generally be the first to emerge from the recession.

- Hungary stands the best chance of leading the region out of recession because of its headstart and steady, albeit slow, implementation of reforms; its continuedsuccess in managing its external finances; and the encouraging flow of foreign investment.
- Poland will have difficulty sustaining the late-1991 upturn in output and real income in the face of a wide range of difficulties and political uncertainty; we expect no growth or slightly negative growth this year.
- Czechoslovakia and the Balkan countries may have to wait until 1993 before reaching bottom although the rate of decline is likely to slow in 1992.

Even those countries that emerge from the recession will see only a spotty and anemic recovery that could still be dashed. After they bottom out, they face a long climb to prosperity. Although measurement and quality problems exaggerate the gap, GNP in 1991 in the five countries was from 16 percent to 32 percent below the peak years of the 1980s. Most of the countries will be even deeper in the hole after this year. Recovery, moreover, is likely to be constrained or even aborted by several factors:

- The inefficient state sector will hinder growth and productivity.
- After rapid growth in the service and retail sectors, the rise of the private sector will stall if entrepreneurs fail to make inroads in manufacturing.
- Dependence on Russia for energy supplies leaves the region vulnerable to shortages that would disrupt industrial output.
- Hard currency constraints will hold down imports needed for restructuring and supplying the population.
- Continued violence from the breakup of Yugoslavia and uncertainty about the course of the new CIS will possibly make foreign investors and lenders cautious about Eastern Europe.

Eastern Europe: Gross Output, Peak Years and 1991



Prospects for Reforms

Reform programs will make additional progress in most countries but at a slower pace. The easiest steps have already been taken, and governments must now tackle increasingly complex and difficult measures. For example, although price liberalization is largely complete, the controls that remain are on very sensitive goods. Bulgaria and Romania will achieve the most dramatic progress in the short run, in part because their programs are a year or so behind those of the northern tier.

The greatest danger is that reforms will not be in place long enough to work. Political leaders will face the challenge of convincing populations that have already endured heavy sacrifices to hold out longer. Many in Eastern Europe now associate reforms with recession and soaring unemployment, and the benefits are less visible than the costs or are not yet present. External pressure--from the IMF, the World Bank, and Western governments and private investors--will be key to keeping reforms on track. East European leaders understand that reforms are vital to the flow of short-run economic assistance as well as to the arrival of long-run prosperity.

The primary issue faced by East European reformers is the privatization of large state-owned enterprises. The outlook is brighter with the recent launching of Czechoslovakia's voucher program and the passage of legislation in Bulgaria. The actual transfer of ownership in all countries, however, will take several years even if present timetables are met. Fears of unemployment are likely to force delays, and the rate of inflation of foreign investment will also be a major factor in the pace of privatization.

Banking reform will become an increasingly important issue after being neglected in the initial phases of reforms. All of the countries have far to go to develop a system of privately owned commercial banks able to make sound lending decisions. Privatization programs and the bankruptcy of many state enterprises will put banks under pressure to curb lending to favored customers and to write off bad loans, and governments in many cases will have to take these over. Meanwhile, entrepreneurs will need wider access to promote business expansion.

Emerging Policy Agendas

Stabilization programs, in particular the fight against inflation, are at greatest risk from voter dissatisfaction with reform programs. Dealing with the social costs of unemployment, which is likely to continue to rise well after production bottoms out, in the face of tight budget constraints will be a major problem this year. The budget battle in Poland is the clearest example of growing pressure for increased government spending to expand the social safety net, for an easing of credit and exchange rate policies, and for adoption of protectionist measures. The Polish trend may have some spillover to the rest of the region.

Most European countries will not derive much economic benefit from relaxing tight economic policies. Putting more money into the economy without first improving the supply of goods will rekindle inflation and exacerbate already unmanageable budget deficits. Propping up inefficient producers to save jobs will only delay privatization and add to the heavy debt from subsidizing lossmaking firms. Such an approach would slow the increase in the unemployment rate, but will do little to reverse the regionwide recession. Inflation would undermine the competitiveness of the region's exports, deter foreign and domestic investors, and hinder moves toward efficiency.

Hungary and Czechoslovakia are the most likely exceptions. Both have cited the plunge in domestic investment as a major cause of the recession. With inflation under better control in these economies, economists increasingly are calling for credit expansion to boost investment. Czechoslovakia Finance Minister Klaus, until this year a staunch opponent of inflation, now argues that the battle is essentially won and the economy is ready for stimulus. Similarly, a National Bank of Hungary official said in April 1992 that the credit crunch has kept interest rates high and has made banks too cautious to lend.

The East Europeans will also move to shore up economic regulation and tax systems in the next year. Financial abuses have been uncovered in several countries already, and the risk is growing as the private sector grows and financial markets develop. New tax measures are also likely as governments look for new sources of revenue to close budget gaps. Enforcement and compliance in both areas will lag legislation.

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Country Surveys

Poland

Poland has been the focus of reform watchers attention, although Warsaw's progress is arguably behind Budapest's. Poland is the region's largest country, strategically located, and its Big Bang reform of January 1990 was the region's most dramatic reform experiment. Poland illustrates the best and worst of the impact of reforms which have Poland split into two economic realities (map).

- **The new Poland** is centered in a few big cities. Unemployment is low, and shops--8O percent of them privately run--are filled with consumer goods. Poland's entrepreneurs and other beneficiaries of market reforms have prospered and are the strongest supporters of further reforms.
- **The old Poland** dominates rural areas, and unemployment exceeds 20 percent in some provinces. Workers and management in inefficient, overstaffed state enterprises worry that privatization and foreign investment will lead to even greater layoffs. The collapse of trade with the former Soviet republics has crippled Poland's textile capital Lodz and many small one-industry towns.

Economic Reforms

Support for shock therapy policies launched in January 1990 waned last year as parties calling for antirecessionary policies won a majority of the seats in the October parliamentary elections. The government formed in January 1992 has struggled unsuccessfully to cobble together support for its economic program from the fractured 29-party legislature. Since the passage of a very liberal foreign investment law in June 1991, most major reform measures, including privatization, have made little progress.

Tax measures are one of Warsaw's most important recent achievements. Poland introduced a corporate income tax in January 1991 and replaced five mostly employer-paid taxes with a personal income tax in January 1992. The Finance Ministry expects a revenue shortfall during the changeover but little long-term impact. The new Western-style personal income tax offers deductions to encourage home ownership and is expected to contribute about 5 percent of budget revenues although the 40 percent maximum rate could reduce take-home income of affluent Poles by 10 to 15 percent. Most tax revenues are expected to come from the corporate income tax and turnover taxes. The government in May 1992 broadened the turnover taxes to cover processed foods, construction materials and services, children's goods, and automobiles in order to raise an additional $900 million in revenues.

The Economy: A Review

After Poland's success in 1990 in ending queues, balancing the budget, and raising hard currency exports, the government was caught off guard by the depth of the recession in 1991.

- Gross domestic product fell by 8 percent in 1991, following a 12 percent decline in 1990.
- The unemployment rate doubled--from 6 percent in January to 12 percent in early 1992.
- The recession reduced business tax revenues and increased social spending. Many private and state enterprises stopped paying taxes and utility bills. The budget deficit soared to nearly $3 billion--nearly eight times the original

projection--and Warsaw fell out of compliance with the terms of its three-year, $2.5 billion IMF program.

- The recession and tight monetary policy brought inflation down to 60 percent in 1991, but high interest rates and a debt-ridden, inadequate banking system forced nearly all private entrepreneurs to rely on their own savings and loans from friends and family to start new businesses.

State Companies Bear the Brunt. While the private sector's share of industrial output rose to 24 percent in 1991, only a few large state enterprise sectors--notably chemicals, metallurgy, food processing, and communications--held up relatively well. Industrial production in the state sector fell nearly 20 percent, with the textile, transport, electronic and electrical engineering industries suffering the most. These sectors were highly dependent on sales to the Soviet Union. Agricultural and mining districts suffered subsidy cuts, and defense spending has fallen 56 percent from its peak in 1987.

Trade Balanced. Warsaw was hard-pressed to keep trade balanced. Hard currency imports rose 73 percent and exports only 18 percent in 1991. Poland devalued the zloty by 17 percent in May 1991, and in October introduced a "crawling peg" to devalue the currency automatically by 1.8 percent monthly. Poland's 12 percent devaluation this past February has helped raise foreign reserves and exports. Poland raised tariffs for cigarettes, electronics, and automobiles this January to bolster tax revenues, protect domestic firms, and encourage foreign investment.

Foreign Investment Warsaw made uneven progress in attracting foreign investment. Negotiations with foreign automakers received a boost when Warsaw implemented a new law last July to improve conditions for foreign investors, and when Warsaw increased tariffs on cars to 35 percent in January to protect domestic production. Industry analysts foresee a growing domestic market with car ownership in Poland expected to double in the next 12 years.

- Fiat promised in spring 1992 to invest $2 billion over 5 years.
- General Motors plans to invest at least $75 million.
- Warsaw is negotiating with Peugeot onautomobile assembly and with Volvo, Chrysler, and Renault on truck production.

A more broadly based increase in foreign investment was hindered, however, by political instability, unresolved property ownership claims, and excessive bureaucracy. Polish officials called for tough job protection clauses and accused the previous government of negotiating away too much to strike deals with foreigners. Foreign investors were also wary of labor unrest, such as the strike threatened by Polish autoworkers to protest layoffs under the Fiat deal.

Other Foreign Ties. Poland achieved several breakthroughs in international economic relations. The Paris Club in May 1991 agreed to forgive 50 percent of Poland's $33 billion official debt. The agreement calls for an immediate 30-percent reduction, followed by an additional 20 percent in 1994--as long as Poland adheres to its IMF agreement. Few countries made commitments to Poland's debt-for-environment fund, however, and negotiations with the London Club of Poland's bank creditors remained deadlocked after Poland called for a 50-percent forgiveness of its $12 billion commercial debt to parallel the Paris Club agreement. The London Club wanted payment of about a fourth of Poland's $1.5 billion in outstanding interest as a good-faith gesture.

Poland and the European Community in December 1991 signed an association agreement that improves Poland's access to EC markets more quickly than it opens Poland to EC exporters. The agreement took effect in March 1992 but must still be ratified by the Polish legislature and most EC countries. Poland reduced tariffs on EC-and EFTA-origin agricultural, machine tool, computer, and consumer goods while leaving higher tariffs in place for US and other competitors. In addition:

- Warsaw in early 1992 renegotiated a barter agreement with Russia after Russia cut natural gas deliveries by 45 percent in January. Russia is Poland's only source of natural gas imports, providing two-thirds of polish consumption. The shortfall had caused Poland to idle most of its heavy industry during a cold spell in late January.
- Poland ratified a bilateral investment treaty with the United States in August 1991, but instruments of ratification have not yet been exchanged.

Economic Outlook

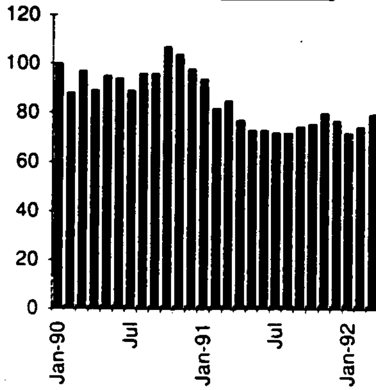
Stagnation. The economy is likely to continue to struggle throughout 1992, with GDP expected to remain at 1991 levels or contract by 5 percent. The unemployment rate leveled out in the first quarter because of a slight upturn in industrial production and tighter scrutiny of unemployment recipients. The government, however, still expects unemployment to peak at 17 percent late this year as unprofitable state enterprises lay off workers or go bankrupt. Inflation is likely to continue at roughly its early-1992 annual rate of 40 percent, and Warsaw will probably devalue the zloty again to compensate.

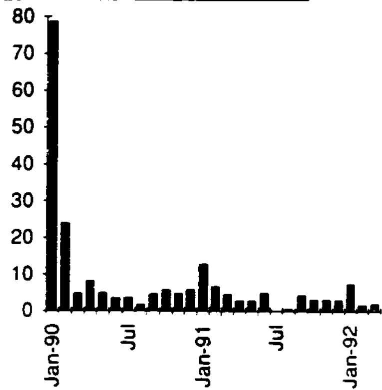
Budget Worries. The government's proposed economic program contains several antirecessionary measures, including tax incentives for exports, restructuring assistance for selected state enterprises, guaranteed minimum agricultural prices, and subsidized credit for farmers. To contain the deficit, the government wants to cut energy and housing subsidies, as well as defense, education, and health spending. The government is tightening eligibility requirements for unemployment benefits to weed out cheaters and wants to reduce benefits to about 35 percent of average wages.

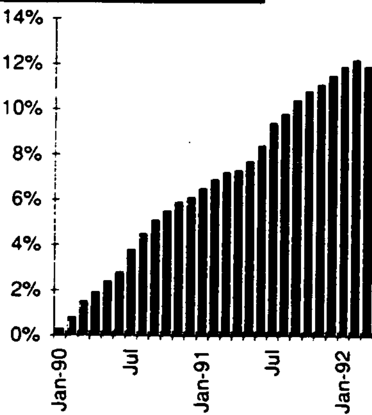
The budget deficit of $921 million through April was below the rate of the IMF's tentative annual target, but the government still expects to it to reach $5 billion, about 5 percent of GDP. Warsaw's budget plans received a setback in May when the legislature upheld court rulings which require indexation of pensions and government salaries. The rulings will increase spending by $2 billion annually, according to the Finance Ministry, and payment will probably be postponed until 1993.

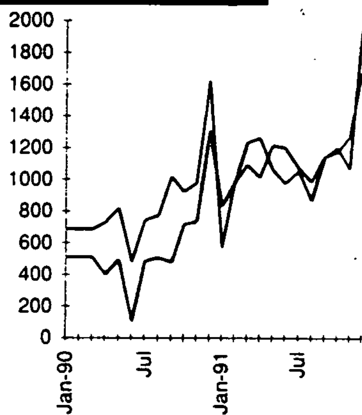
Reforms on Hold. Poland's divided legislature will almost certainly hobble reform. Slow legislative progress is likely on privatization, property ownership claims, banking and agricultural reforms. Warsaw is unlikely to win a new 20-month IMF standby program or a restructuring of its $11.8 billion in commercial debt until the legislature approves the 1992 budget and the government promises to limit the 1993 deficit. Warsaw has little money for infrastructure spending, and its dependence on domestically produced coal limits environmental protection efforts. On the bright side, the parliament will probably adopt a Western-style value-added tax in late 1992 or early 1993 to replace turnover taxes, which generate nearly a quarter of Poland's tax revenues. Moreover, Poland's private sector is likely to grow, providing a greater variety of retail goods and services and further developing Poland's entrepreneurial base.

Poland: Economic Trends









Hungary

Hungary started its reforms long before the end of Communism, and Budapest has been able to proceed at a steadier pace than those countries that had to implement "shock therapy" to initiate reforms.

Economic Reforms

Privatization. Hungary launched its drive to privatize state firms in 1988, nearly one year before the collapse of the Communist regime. Official plans call for sale of half of all state assets by 1994. Despite a series of programs, however, the pace of privatization has been disappointingly slow.

- Hungary has 2,244 firms to sell. By the end of February 1992, Budapest claimed to have completed 630 privatization transactions, representing 8.2 percent of the book value of state-owned assets. However, this overstates the amount of property transferred to private hands because the state is still the majority owner of many firms.
- Budapest has auctioned lease rights to 2,000 small shops and hopes to sell 10,000 by 1994.

The process has been plagued by popular concerns that the former nomenclature will benefit unduly, fears of rising unemployment, and excessive state regulation. Other problems--determining asset valuation and property rights as well as inadequate capital markets--are slowing the process.. The State Assets Agency, responsible for overseeing the process, has been criticized as an obstacle to privatization. Officials insist on prices higher than investors are willing to pay and are slow to reach decisions on sales.

Privatization has depended on foreign participation. Hungary wants to raise foreign ownership from the present 4 percent to 30 percent by 1995 and has pursued policies to encourage foreign investment, including tax incentives, liberal foreign investment rules allowing full repatriation of profits, and policies of political and financial stability. Most privatization revenues have come from sales to foreigners.

Concerned with the slow pace of privatization, Budapest is reviewing its strategy. Early this year Prime Minister Antall appointed a close political confidant Tamas Szabo Minister without Portfolio for Privatization. New legislation on privatization presented to the National Assembly in April would modify the strategy. It has spurred heated debate between those committed to rapid reform and others nervous about the economic and social consequences:

- The legislation would decentralize the process allowing firms to identify prospective buyers and prepare their own privatization plans with the help of advisors approved by the State Property Agency.
- To address the problem of unsalable enterprises, the legislation proposes creation of a state assets holding agency which would put on hold from privatization as much as one-third of all assets.

Hungary still has far to go also in privatizing agriculture. Uncertainty about land ownership, lack of a market for agricultural land, poor financial situation of farms, and inability of cooperative members to take land from the organization have slowed rural privatization. Budapest was successful in limiting the compensation law to avoid restitution of original property which would have all but stalled the privatization process as the government arbitrated individual claims. The SPA has issued vouchers that

claimants can exchange for land, apartments, shares in privatized firms, or cash. The program could increase inflationary pressures if many voucher holders decide to turn them in for cash. The National Assembly in January 1992 approved a temporary bill on cooperatives--which account for 75 percent of agricultural output in Hungary. It also passed a broader law going into effect next year that will require transformation of co-operatives into private entities. In the meantime, farms are in financial crisis and many face bankruptcy. These uncertainties will contribute to declining output this year.

A new bankruptcy law spells trouble for weak firms. Hungary has had a law on the books since 1986--the number of firm liquidations increased from 187 in 1986 to 1,314 last year--but the largest, most inefficient firms have continued operating with state support and inter-enterprise and bank credit. Hungary's new accounting law makes it mandatory for firms whose debts are 90 days overdue to declare bankruptcy or be liquidated. The legislation is producing results. Some 836 firms filed for bankruptcy in Budapest courts in the first week of April as compared to 202 in the first three months. While an increase in small-firm liquidations is likely, large inefficient state firms will be less affected. Banks are reluctant to endanger their own profitability by writing off bad loans to state enterprises.

Financial Sector Reform. Hungary is gradually establishing a market-oriented financial system, but much remains to be done. Several steps were taken last year, including a central banking law that ensures the relative independence of the National Bank of Hungary. The National Assembly also approved a law on financial institutions which provides for a regulatory framework consistent with international guidelines. It also requires the state to reduce its ownership in banks to 25 percent by 1997.

Budapest is just starting to tackle the politically contentious issue of bank privatization, however. A key question will be the extent of foreign participation allowed. Factions within the government coalition are adamantly opposed to allowing foreign majority ownership in major banks.

Trade and Price Liberalization. Price liberalization has moved far. Over 90 percent of producer and consumer prices have been set by the market since January 1991. Consumer price subsidies have been eliminated with the exception of those on transportation. Rents are determined by owners or local governments, but central state subsidies for rents ended when the housing stock was turned over to local authorities under legislation adopted last year. Substantial subsidy cuts have been made, but the state budget still calls for 138.8 billion forints in subsidies this year as compared to 170.9 billion last year. Moreover, state support to enterprises continues through toleration of tax and social security payment arrears, for example, and commercial banks often roll over loans of weak enterprises.

Hungary has also made significant progress liberalizing foreign trade. Some 93 percent of imports no longer require licenses although a global quota on imports of some consumer goods remains. Tariff rates have fallen from 16 to 13 percent. The forint is internally convertible for business purposes, but Hungarian citizens may only convert about $50 annually. National Bank President Bod announced in February that the forint will be fully convertible by the end of 1993. Budapest will first want to ensure a cushion of foreign exchange reserves as well as have inflation under control.

The Economy: A Review

Hungary's economy contracted sharply in 1991, the fourth year of recession. We estimate that GDP fell 7 to 9 percent, the most severe drop in decades, largely due to the loss of Hungary's markets in the East. State-owned firms, faced with inability of customers in the former USSR to pay for goods in hard currency, cut back production. Industrial output fell almost one-fifth as compared to the previous year as declines were experienced in virtually all sectors of industry. Hardest hit were metallurgy and machine-building, probably the most obsolete sectors and in need of restructuring. The situation was little better on the farm--agricultural output dropped by almost a fifth as price liberalization resulted in higher prices for farm inputs and lower prices for crops and animal products. The drop in CEMA trade also wreaked havoc with efforts to meet the IMF target for the budget deficit; revenues were 7 to 8 percent lower than planned and the deficit amounted to almost 5 percent of GDP.

Hungarian consumers faced a difficult year also. Prices were 35.2 percent higher than in 1990. Unemployment soared from 2 percent at the end of 1990 to 7 percent by the end of 1991. Such figures mask a wide variation in rates; unemployment in the more industrial northeast hit 16 percent in some counties.

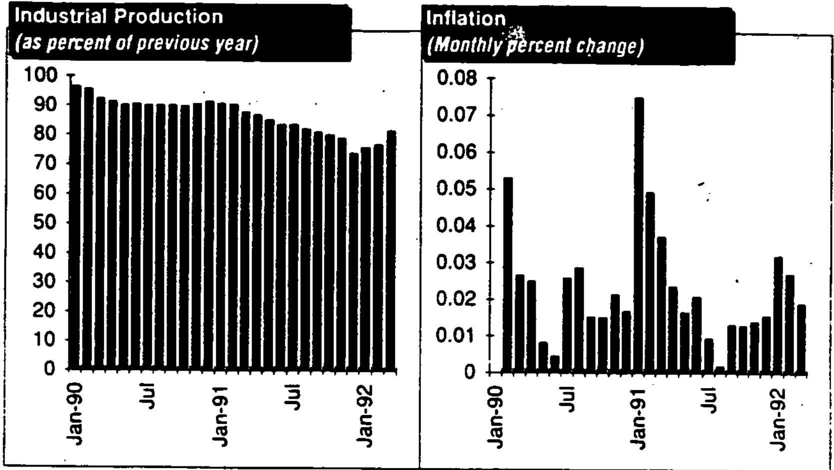
Nonetheless, a number of indicators suggest that the economic situation is less drastic than indicated by official statistics. These data do not include the burgeoning private sector. The private sector accounts for one-third of economic activity, according to some estimates. Although small, it is expanding; output increased by 50 percent last year, according to some estimates. Furthermore, Hungarian citizens added unprecedented amounts in their bank savings in 1990 and 1991, suggesting significant incomes from entrepreneurial activity.

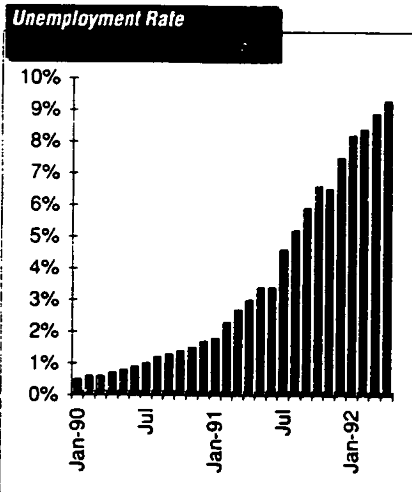
A number of trends on the external economic front were also more positive. Hungary continues to be the number one East European choice of foreign investors, attracting some $1.5 billion in 1991--more investment than any other country in the region. As many joint ventures were formed in 1991--over 5,600--as in all of 1977-1990. The United States is the largest single investor in Hungary, followed by Germany and Austria.

Hungary enjoyed considerable success in increasing exports to the West. While half of all exports went to the former CEMA as recently as 1988, these countries now account for only about one-fifth of Hungarian exports. Hungary has been especially successful in selling to the EC, which bought half of Hungarian exports last year; Germany has replaced the former USSR as Hungary's number-one trade partner.

Hungary's financial situation improved substantially. An expected current account deficit of $1.2 billion failed to materialize because of higher-than-expected exports to the West and lower world oil prices. Hungary's National Bank reported a current account surplus of $267 million. Hungary's strong credit standing enabled it to tap international bond markets for some $1 billion. The favorable current account performance and greater financial assistance from official and international organizations allowed Budapest to almost quadruple official reserves over the year to $3.9 million.

Hungary: Economic Trends





Economic Outlook

Economic prospects seem better for 1992. Hungary's trade with the former CEMA has probably bottomed out. Although unemployment may reach 13 percent this year, this has not translated into serious labor unrest or popular opposition to reforms. The Hungarian official forecast is for up to 2 percent growth in GDP. Even the most optimistic officials, however, do not expect an upturn until the second half of the year.

Budapest is counting on an export-led recovery. A major question is Hungary's ability to maintain the recent surge. The greater role of private firms in exporting to the West, improvements in product quality due to import liberalization and foreign investment, and improved access to EC markets will help. However, some of the export growth probably also resulted from state firm's having sold off goods below cost, a strategy that cannot be sustained.

- As of March, the majority of Hungarian industrial goods will be exported duty free to the EC.
- Exports grew 13 percent in the first quarter of the year as compared to the same period last year, contributing to a trade surplus of $400 million, according to the Ministry of International Relations.

Hungary intends to maintain tight monetary and fiscal policies in 1992 with the goal of reducing inflation to 20 to 25 percent. Budapest is already having trouble with the state budget deficit, however, as revenues have fallen far short. Finance Minister Kupa announced that the full year budget deficit called for in Hungary's agreement with the IMF had already been reached by April. The IMF will be carefully monitoring Budapest's efforts to rein in the deficit and probably will warn that future loan disbursements will depend on compliance. Nonetheless, we believe that Hungary will have little trouble this year raising needed financing of its external debt and will also draw Western investment on the same scale as last year. Hungary already attracted $400 million in the first four months of 1992.

Czechoslovakia

Economic Reforms

Prague launched its economic reform program one year later than Warsaw and Budapest, but it is now instituting reforms at a more rapid pace than its neighbors. Prague began in January 1991 by freeing most prices, unifying exchange rates and permitting almost full current account currency convertibility, and liberalizing foreign trade. At the same time, private business was legalized, and the government began auctioning off small state businesses.

Prague has given high priority to reforming the financial sector. The state bank is now independent, enjoying powers similar to those of Germany's Bundesbank. The commercial banks have been legally separated from the central bank although they are still financially weak and lacking in experienced personnel. Enterprise debt remains a burden although the government has arranged for privatization revenues to pay off the debts of the most promising enterprises. Legislation establishing a VAT tax and reducing enterprises profit taxes from 55 to 45 percent goes into effect in January 1993.

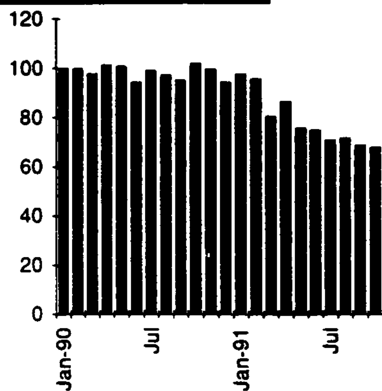
The private sector remains small, contributing roughly 7 percent of GDP in 1991. Over 1 million individuals are registered entrepreneurs--11 percent of the adult population--but most are engaged in part-time work in retailing, services, and construction. By the end of March 1992, 18,000 small enterprises had been auctioned off under the small privatization program, still less than one-third of the total. Czechoslovakia's highly socialized agriculture is being privatized through the return to original owners or heirs of land expropriated under the Communists. Remaining land and assets will be divided among collective farm members or used to form new private cooperatives.

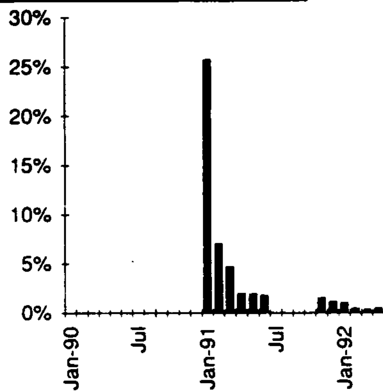
Czechoslovakia's greatest success story may be its unique large-scale privatization program. Czechoslovak citizens may use vouchers purchased for the equivalent of $35 to bid for shares in individual enterprises or place them with investment funds. Some 75 percent of those eligible have chosen to participate in the first wave of voucher privatization, in which roughly one-third of state enterprises are being sold. Another one-third of enterprises will be sold in the second round, scheduled to begin later this year. Although many poorly capitalized investment funds could go under, the program has the virtue of moving the bulk of state enterprises to the private sector and so speeding economic restructuring and recovery.

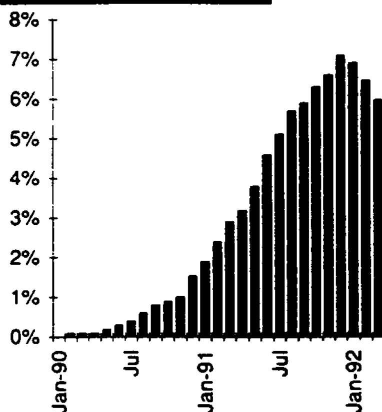
The Economy: A Review

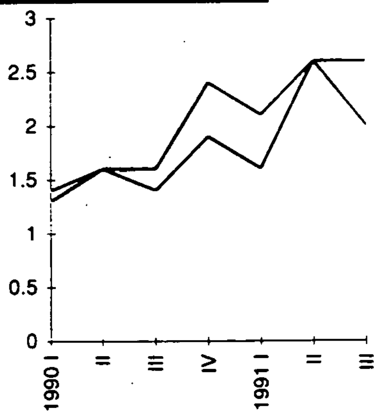
The introduction of Finance Minister Klaus's economic stabilization program in January 1991 delivered a shock to the Czechoslovakia economy. The liberalization of 95 percent of prices by the end of the year resulted in an annual inflation rate of 53.6 percent while strict wage regulations caused a drop in real wages of 19 to 20 percent. The resulting decline in domestic demand combined with the loss of much of the Soviet market led to an estimated drop in GNP of 16 percent. Budget and credit constraints forced sharp cutbacks in state housing, construction, and industrial investment. Unemployment reached 6.5 percent at the end of the year with wide regional disparities.

Czechoslovakia: Economic Trends









The Czechoslovak economy has now recovered from the initial shocks of stabilization. Inflation at the end of April of this year was running at an annualized rate of 6.5 percent, and unemployment has dropped the past three months in response to sharp cutbacks in unemployment benefits and the creation of new jobs in the private sector. The shocks of economic restructuring, however, are still to come. Bankruptcy in Czechoslovakia is rare, and financial institutions are still trying to straighten out the tangled network of inter-enterprise debt. Current unemployment is the result of enterprise financial difficulties rather than shifts in the economy. Labor redundancy is still high, resulting in a 27.8-percent drop in labor productivity in 1991. The privatization of roughly one-third of large state enterprises by mid-year is likely to result in deeper economic pain as these enterprises are restructured later this year.

The Slovak Republic--with one-third of Czechoslovakia's population and land--was hit especially hard by stabilization and reform.: Continued price controls on some intermediate goods, many of which are produced in Slovakia, kept enterprise profits low. At the same time, Slovak enterprises import many raw materials from the former Soviet Union and were hurt by the switch to world prices and the devaluation of the koruna. The rapid deterioration of enterprise finances in Slovakia caused a swift rise in unemployment which hit 12.3 percent at the end of the year compared to 3.7 in the Czech Republic. The Slovak Government has also done less than the Czech Government to build public support for reform and stimulate private sector growth. The deteriorating economic situation has demoralized the populace and dampened public support for reform.

Czechoslovakia's foreign trade performance in 1991 was much better than expected. Although the IMF originally forecast a trade deficit of $2.3 billion, the country earned a surplus of $1 billion due mainly to a large boost in exports to the West. Prague improved its trade performance through a sharp devaluation of the koruna and the removal of most trade restrictions at the beginning of the year. As a result, Czechoslovakia has had no difficulty managing its $9.3 billion in debt. Although Czechoslovakia ended 1991 with a budget deficit of $620 million, missing one of the IMF's criteria, the IMF was pleased overall with Prague's otherwise strict austerity measures.

Czechoslovakia also made strides in integrating its economy with the West. Prague signed an association agreement with the EC in February, and a trade agreement with the EFTA countries will go into effect on 1 July. Both agreements will allow greater access to European markets for Czechoslovakia goods. At the same time, Prague has been successful in attracting direct foreign investment, which totaled $600 million to $1 billion in 1991, most of it from Germany. Czechoslovakia officials anticipate even greater investment in 1992 under the large privatization program.

Outlook

Support for reform in the Czech Republic remains high, thanks in part to Finance Minister Klaus's aggressive promotion of his program, as well as the lead held by Klaus's strongly free market Civic Democratic Party in the 5-6 June parliamentary elections. Slovak politicians, on the other hand, have exploited Slovakia's economic woes to advance their nationalist agenda, undermining support for reform with attacks on "Pragocentric" economic policies. The nationalists are likely to win in Slovakia and attempt to implement more interventionist policies, using deficit spending to stimulate

economic recovery. The clash between differing Czech and Slovak policies probably will slow the implementation of additional reforms and seems increasingly likely to lead to the separation of the Czech Republic from Slovakia. However, many of the key reforms have already been implemented, and economic restructuring is likely to continue, particularly in the Czech lands, despite political wrangling.

Bulgaria

Prime Minister Dimitrov's government is committed to accelerating economic reform. Since the parliamentary election of October 1991, his government has secured privatization, banking, and land reform laws and is continuing tight monetary and fiscal policies to stabilize the economy. Early results include sharply reduced inflation, increased support from international financial institutions, and the emergence of small private business.

Economic Reforms

Privatization.--The New Law. Competing privatization bills submitted by the government and trade union sympathizers bogged down in parliamentary debate for more than a year, but popular opinion and outside pressure--including the World Bank's delay of the second $100 million installment of its structural adjustment loan--pushed the legislature to pass a compromise law in April 1992. Under the law, all or a portion of the shares of about 1,000 joint stock companies--formed in 1991 when 130 of the largest state-owned firms were broken up--will be sold to domestic and foreign investors. Employees will receive preference, but their holdings will be limited to less than 20 percent of total firm assets to expand ownership opportunities. Small businesses with capital valued up to about $550,000 could be auctioned off within a year while large firms would be privatized over a period of five to 10 years. The law addresses workers' concerns by providing guarantees against Communist-era managers benefiting from rapid privatization and by separating oversight of the process from the Ministry of Industry. The cabinet, restructured in May 1992, is drawing up plans to begin implementation of the privatization law.

Firms in the agriculture and food processing sectors are to be the first to undergo privatization. Recent laws that return property rights to owners of small shops and warehouses compulsorily sold to the state in 1975 are likely to provide an additional stimulus toward privatization and begin the creation of real estate markets in large urban centers.

The ability of Bulgaria's emerging financial markets to raise and allocate capital will be vital to the success of the privatization program. Bulgarian entrepreneurs have established the first Bulgarian Stock Exchange and the Sofia Stock Exchange in anticipation of the sale of large state-owned enterprises. The Sofia Stock Exchange will use facilities provided by the 35 Bulgarian commodity exchanges that began operation in late 1991. US brokers are training the stock exchanges' staff. The exchanges are trading government bonds, bank obligations, and shares issued by banks and new private companies.

Land Reform. An agricultural land law passed in March 1991 establishes property rights and provides for the return of land to former owners. By early 1992, however, only 250,000 applications had been submitted for the return of land; before collectivization, there were 2.5 to 4 million private landowners in Bulgaria. Prime Minister Dimitrov criticized the slow time frame for implementing the legislation--estimates are that it will take two to three years to sort out ownership records. Amendments passed in April 1992 addressed most problems with the Land Reform Law and provide for liquidation of Communist-era collectives. As of May 1992, almost 98 percent of the land available for restitution had been claimed, but some problems remain:

- The Bulgarian Socialist Party is working to undermine the breakup of collective farms by re-establishing collectives under old management and in some cases by threatening violence.
- Local governments and land commissions almost certainly will try to manipulate land redistribution in favor of local officials.

Financial Reforms. The government took the first steps towards dismantling the central planning system in February 1991 with the removal of price controls on most goods. Controls on most of the remaining 14 "observed" commodities were lifted in May 1992. Some energy prices, such as that of electricity, are still fixed by the government. Electrical utilities requested price increases of 300 percent to help them meet production costs but were only given a 30-percent rise. Prices in Bulgaria are based on world prices converted into leva at the exchange rate of the lev against the dollar.

Limited currency convertibility has been pursued to build confidence in the lev and increase state hard currency reserves. The economic reform program also encourages local entrepreneurs and opens the economy to foreign investment by allowing full repatriation of profits and 100-percent foreign ownership.

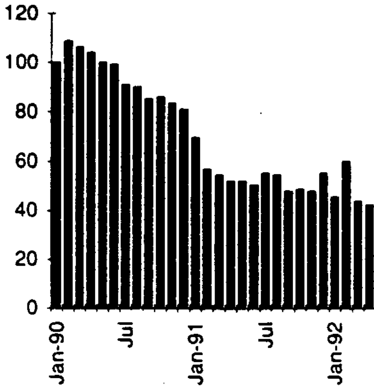
Banking Reform. A law passed in February 1992 provides deposit insurance and regulates bank profits, both of which are essential for bolstering public confidence in banks and creating a modern financial system. The law calls for strong central bank regulation, but success depends on forceful implementation of regulations, training, and the introduction of foreign bank competition to provide a competitive push.

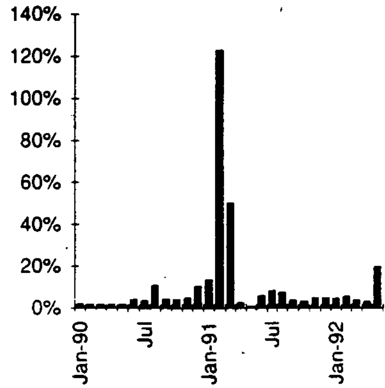
The Economy: A Review

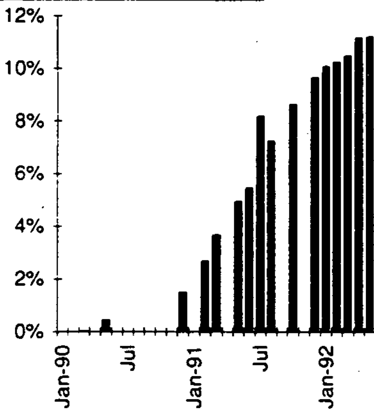
The transition from central planning has had a severe impact on Bulgaria's economic performance.

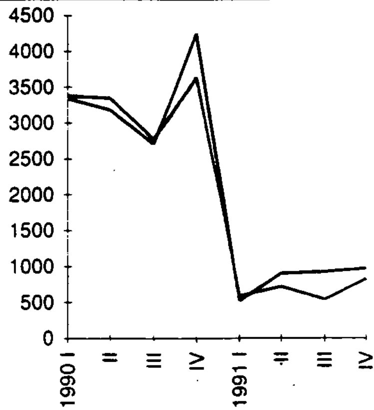
- Bulgarian statistics indicate that GDP fell by almost 22 percent in 1991. Industrial output was down 29 percent, with production of producer and consumer goods dropping 23 percent and 36 percent, respectively.
- Unemployment increased from less than 2 percent at the beginning of 1991 to its current level of more than 11 percent.
- Tax revenues in the first half of the year were less than 60 percent of the amount specified in the 1991 budget because of declining enterprise profits. Nevertheless, with creative financing the government kept the deficit within the target of 8.5 billion leva ($475 million); including foreign debt service would have caused the deficit to balloon to 22.5 billion leva ($1.4 billion). In addition to bank borrowing, the government issued over one billion leva ($55 million) in bonds to finance spending.
- Inflation slowed soon after the shock of price liberalization in February 1991, but prices stood at least 400 percent higher at the end of 1991, far greater than the government's target rate of 234 percent. Removal of most remaining price controls in May 1992 caused prices to jump another 20 percent.
- According to official Bulgarian statistics, exports to the developed West in the first 9 months of 1991 were 46 percent lower than in the same period of 1990. Imports virtually collapsed, posting a 68-percent loss. The drop was even more pronounced in total trade due to the loss of the Soviet market; total exports and imports fell 75 and 80 percent, respectively.

Bulgaria: Economic Trends









Finance. Parliament's recent mandate to the government--as required by the constitution--to negotiate debt relief offers hope for an improvement in Sofia's standing with its creditors. Bulgaria must come to terms with its commercial banks, to which it owes more than $10 billion (or 90 percent of its total debt), before it can regain access to world financial markets. Negotiations with creditors have begun to move ahead, but the sides open talks far apart on terms.

Foreign Investment. Bulgaria liberalized the foreign investment law in January 1992 to remove restrictive regulations on land ownership enacted by Socialists in 1991. The new law permits foreign ownership of nonagricultural land, removes the remaining restrictions on repatriation of profits from investments, and provides guarantees against expropriation of property by the government.

The new law should facilitate foreign capital inflows when privatization begins and should help to overcome Sofia's lack of success to date in attracting foreign interest. According to OECD data, Bulgaria attracted only $74 million in committed foreign investment in 1990, the smallest amount in Eastern Europe. Commitments in 1991 probably were no more than $50 million.

Economic Outlook

The Bulgarian economy entered 1992 in sharp decline but probably will begin to bottom out by the end of the year. According to most forecasts, the total drop in GDP for 1992 is expected to slow to between 3 and 6 percent, and slow growth could resume in 1993. This somewhat brighter outlook assumes that privatization will begin to generate more entrepreneurial drive, international capital inflows will pick up, and that industries have experienced the worst of the adjustment away from central planning and will be starting to produce for markets. Finance Minister Kostov has vowed to maintain tight monetary and fiscal policies through the end of 1992. The government continues to hold wage growth to 70 percent of the growth of prices, and interest rates remain above 70 percent.

Even if the economy turns around in the next year, however, unemployment is likely to continue growing, perhaps to as high as 15 to 20 percent in 1992, because of the pressure for greater efficiency and the large amount of redundant labor. Moreover, social tensions from widening disparities between the "haves" and "have nots" will continue to mount.

Financial problems will remain a major constraint on the economy. Bulgaria will have difficulty acquiring needed imports and servicing its debt once an agreement with banks is reached. Sofia will not be able to support full currency convertibility until the economy--exports in particular--pick up and international reserves can be built up. Exports are vital to economic recovery because of Bulgaria's small internal market of fewer than 9 million people. Overseas sales, however, are likely to expand slowly as long as Western banks are wary of loans to Bulgarian firms to improve production technology and the quality of their goods. Foreign investors are likely to supply new capital to export industries, but long lead times necessary for retooling obsolete factories and developing new markets will delay export growth. Bulgaria, in our view, could eventually prove attractive for investors in view of its educated workforce and relatively low wages. Its products are likely to eventually compete with commodities from developing countries, particularly in marketing food, petroleum products, consumer goods, and basic chemicals, such as fertilizers.

Romania

The return of violent coal miners to Bucharest in September 1991 brought an end to the quasi-reformist government of Petre Roman and underlined the limits of public support for painful economic change. While unemployment still had yet to appear in earnest, a year of almost uninterrupted triple-digit inflation had eroded real incomes and support for the government. Roman's party had won the 1990 election overwhelmingly by campaigning under the promise of stability and tranquility--an implicit rejection of shock therapy. Opinion polls consistently find the Romanian electorate less supportive of the move to a market economy than other East European peoples. Following Roman's ouster, reformer Theodor Stolojan assumed leadership of a caretaker government, pledging to continue Romania's economic reform program despite the miners' visit.

Economic Reforms

Privatization. While many retail stores have been leased or sold to private operators, the privatization of the industrial sector has yet to really get under way in Romania. Bucharest passed legislation to establish the National Agency for Privatization and begin privatization of the thousands of large state enterprises last August, but implementation has moved slowly because of the government's limited resources, political instability, and concern about growing unemployment. As of May 1992 authorities had sold only 236 of 4,837 state assets.

Price Liberalization. In April 1991, Romania freed many prices and raised ceilings on most others. In August, the prices of basic subsidized foods were increased sharply. Many other controls, however, continue to affect prices.

- Rents and household energy producers remained heavily subsidized.
- Prime Minister Stolojan announced in November 1991 a maximum markup of 30 percent between producer and final retailer in an attempt to prevent abuses by monopolist trading firms.
- State firms are required to announce price increases 90 days in advance of the effective date and document the costs forcing them to raise their prices.

Currency Convertibility. Romania made progress toward convertibility during 1991, spurred by pressure and technical assistance from the IMF and World Bank. In February 1991, Romania set up an interbank exchange market establishing rates based on supply and demand to run parallel to the official exchange. In August, access to the interbank rate was expanded as Romanian citizens were allowed to open private foreign exchange houses. On November 11, the Stolojan government devalued the leu by 67 percent and announced that the official rate, which applies to government and a few other transactions, would be adjusted to reflect the interbank rate to narrow the gap between exchange rates and make the leu internally convertible.

The official rate never approached the interbank rate, however, and Romania continued to juggle two exchange rates. Moreover, in November 1991 the National Bank of Romania undermined confidence when it required account holders to exchange hard currency accounts for lei and required that all further export earnings be exchanged. Exporters soon proved adept at circumventing the requirement, and it became increasingly difficult for the NBR to gain access to hard currency. In April 1992, to reinstill confidence in the banking sector, the government raised interest rates significantly and revoked November's requirement to fully surrender hard currency.

Banking Reform. The Romanian banking system is evolving slowly toward its role in a market economy. Legislation has established former state banks as commercial societies, but the state remains the sole stockholder. While Romania now has five operating private banks, operations are primitive and transactions face long delays.

Banking reform began in the fall of 1990 with government decrees to separate sector banks from the NBR. In February 1991 the NBR was given independent authority over the exchange regime and licensing private banks. Interest rates were freed two months later, but remained significantly negative in real terms throughout the year. In an effort to restrain inflation, the National Bank imposed credit ceilings on the independent banks. The National bank relaxed these constraints in the fourth quarter, guaranteeing loans to state enterprises to liquidate the large accumulation of inter-enterprise debts, a problem that continues to thwart the development of an effective banking system.

Trade Liberalization. The state renounced its monopoly on trade in 1990 and since then the private sector has enjoyed its greatest success in this sector. During the first two months of 1992, the private sector accounted for 21.5 percent of exports and 27.4 percent of imports, up from in 7.1 and 5.6 percent, respectively, for the same period in 1990. While exports were readily approved in most cases, securing hard currency to meet import contracts grew more difficult after the attempt to unify the exchange rates in November.

The Economy: A Review

The Romanian economy contracted sharply in 1991 as continued disruption and uncertainty, aggravated by a current account crisis, depressed industrial production by 18.7 percent. Periodic shortages of energy--still imported by the government at a subsidized exchange rate--forced periodic layoffs and shutdowns, while shorter work weeks contributed to the decline in worker productivity. Neither the agricultural sector nor the service sector was able to offset this decline and GDP for the year fell 13 percent.

Despite tight credit ceilings imposed by the NBR during the first half of the year, monthly inflation averaged 10.3 percent during 1991 as the government liberalized prices and monopolistic enterprises responded with higher prices but faced obstacles to increasing levels of production. Strict restraints on credit limited the impact on lending practices of reform in the banking sector, as did the National Bank's refinancing rate, which remained significantly negative in real terms. After the government extended bank loans to cover inter-enterprise debts inflation reached 19.5 percent in January, 1992 and 12.46 percent in February, 1992.

Workers in the state sector suffered unemployment and falling real wages during 1991. By December 31, 265,978 persons were receiving unemployment compensation, and an additional 71,462 had registered with unemployment offices but were ineligible for compensation. While an estimated 700,000 jobs were lost in the state sector, the number of employed reported in the private sector numbered only 164,000. Restrained by a restrictive incomes policy, real wages fell by 25 percent from October, 1990.

Agriculture. Agriculture suffered from a myriad of ailments during 1991. Delays in implementing the land reform bill--local councils have still only distributed 100,000 out of an estimated 5 million titles--have led to confusion. Farmers unsure of whether they would own their crops have reduced plantings, so that food surpluses needed to

spur the development of exports and private markets have not materialized. Low state prices have contributed to the agricultural decline by encouraging private farmers to withhold produce from the market. Private producers face inadequate supplies of fertilizer, fuels, and seeds because the state supply system favors state farms. Moreover, summer downpours contributed to declines in output of fruits and wheat in 1991, but Romania enjoyed a record corn harvest.

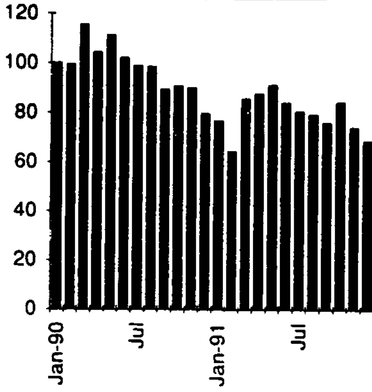
Foreign Trade and Finance. The current account deficit was a critical problem during 1991. Romanian exporters suffered both external and internal shocks. Many of Romania's traditional export relationships evaporated with the end of Eastern Europe's CEMA trading block. Agricultural exports remained only a fraction of past exports, as production declines forced Romania to import crops which once earned valuable hard currency. With the depletion of domestic resources, Romania now imports 30 percent of its energy requirements.

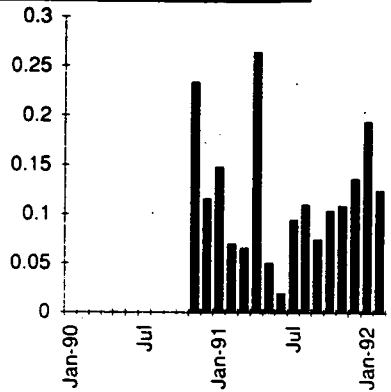
Economic Outlook

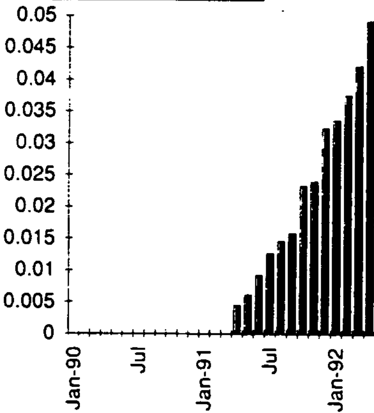
The Romanian Government has projected zero growth for 1992. While improved industrial performance in early 1992 indicates the economy responds quickly to added imports, much of Romanian industry has survived to date largely through hidden or overt subsidies, such as the state's importing raw materials for industry at a more attractive exchange rate and the financing of inter-enterprise credits. Further loans from the IMF and BIRD are likely to be contingent on scaling back or ending such subsidies.

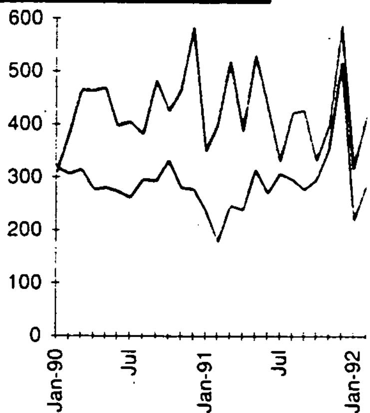
Foreign investment was another bright spot in 1991. Poland passed the region's most liberal law in June 1991. Laws to attract foreign investment have proved insufficient to lead to the boom attract East European governments have indicated growing ambivalence toward foreign investment in their economies. They alternate between disappointment at the low rates of capital inflow in the past two years and a nativist attitude which rejects foreign investors' control over their economies. Hungary is the exception on both counts: Budapest has attracted the lion's share of the direct foreign investment in Eastern Europe in the past twoyears, and the Hungarians continue to actively seek more.

Romania: Economic Trends









Annex

Eastern Europe: Status of Reforms

- *Poland*
- *Hungary*
- *Czechoslovakia*
- *Bulgaria*
- *Romania*

Poland: Status of Reforms

Privatization

Role in the Economy

- The private sector's share in the economy is growing rapidly, largely through the creation of new businesses and the decline of state enterprises, rather than formal privatization.
- Enterprises that in 1989 accounted for 14 percent of the assets and 10 percent of employment in state enterprises have been privatized.
- Private ownership now covers
  - 80 percent of retail shops.
  - 75 percent of farm output.
  - 24 percent of industrial production.
  - 40 -45 percent of non-agricultural production.

Key Laws

- Privatization Act of 1990 created the Ministry of Ownership Transformation.
  - Article 37 allows for liquidation of profitable state enterprises.
- State Enterprises Act provides approval for liquidation of bankrupt state enterprises.

Foreign Role

- The Law on Foreign Investment, effective July 1991, dramatically improved conditions for foreign investors.
  - Foreigners can repatriate all profits freely.
  - Wholly foreign-owned subsidiaries are legal.
  - Foreigners may purchase land with the approval of the Interior Ministry, but in some cases there is uncertainty in establishing property ownership.
- The State Agency for Foreign Investment, with a staff of 15-30, was created in 1992 to replace the Foreign Investment Agency and facilitate investment.
- The legislature in May 1992 approved a bill requiring foreign investors to divest their holdings in Polish casinos.

Mass Privatization

- Goal is to privatize half of industry by 1994.
  - Only $315 million in privatization revenue in 1991.
  - Liquidation--selling off assets of bankrupt state firms or sale or lease of state assets to workers or managers--is the most effective route to privatization.
  - Only 18 firms have been sold through public share offerings.
- The government is developing a "privatization map" to specify which sectors are to remain wholly- or majority-owned by the government or Polish citizens.
- Sectors under consideration include defense, transport, communications, energy, and metallurgy.
- Proposal of June 1991, revised in February 1992, calls for mass privatization.
  - Legislature has not acted.
  - Originally slated to cover 400 firms, most recent plan applies to 200 for the first round, to start in the second half of 1992.
  - Under the proposal, sixty percent of the shares would be transferred to 12 National Investment Funds, managed by Poles and foreigners.
  - After about a year, Polish citizens would be able to purchase shares in the Funds for a nominal fee.
  - Workers would receive 10 percent of their company's stock, and the Treasury would retain the remaining 30 percent.
- Many firms were converted to joint-stock companies owned by the Treasury over the past year.
  - Will simplify privatization if plan is approved.

Agriculture

- Most farmland was privately-owned even under communist regimes.
  - Warsaw has not yet developed a plan to consolidate its small, inefficient private farms, but has promised agricultural price supports and subsidized credit.
- A new Agricultural Property Agency will take-over administration of Poland's state farms over the next two years.
  - The change is an attempt to rescue the 1,100 highly-indebted state farms that hold 25 percent of Poland's agricultural assets.

Poland: Status of Reforms (continued)

Restitution

- The Ministry of Ownership Transformation has received 70,000 reprivatization requests.
  - Ministry has issued only about 300 decisions which returned property.
- Privatization Ministry wants to settle property claims before making foreign deals.
  - The government is considering partial compensation, privatization vouchers, or government securities as means of payment in order to hold down the budget deficit.
- For property seized in violation of even the communist laws, the courts can make restitution quickly.
  - After 1989, many small food processing companies, factories, pharmacies, hotels, and other real estate were returned to their original owners.

Price Liberalization

- 90 percent of prices freed on 1 January 1990.
- Increases in Administered Prices
  - January 1991--energy prices
  - January 1992--natural gas, electricity, hot water
  - Spring 1992--rents, public transport
- Goods Still Controlled
  - Energy, housing
- Scheduled Decontrol
  - Further reductions in coal, energy subsidies

Banking

- The Banking Law of 31 December 1988 created a two-tier structure.
  - 5 state-owned commercial banks split from the central bank.
  - Central bank remains in charge of the money supply.
- In 1989, 23 new banks were set up, part of them with private capital.
  - By October 1991, 70 institutions, including branches of foreign banks and private banks, had banking licenses.
  - Warsaw plans to privatize three of the large state-owned banks this year.
- State-owned banks continue to dominate lending.
  - Credit availability is limited by high interest rates, antiquated technology and management, and high levels of state enterprise debt.
- Poland tightened banking laws in September 1991 after financial scandals that led to the arrest of the national bank president and seven senior bankers.
  - The new rules limit to 15 percent the assets a bank may lend to a single customer.
  - The law requires a six month waiting period before a foreign bank can begin foreign exchange operations.

Currency Convertibility

- The zloty has been fully convertible for current account transactions (goods and services) since 1990.
  - Since 1991, also convertible for profit repatriation by foreign firms in Poland.
  - A stabilization fund of $1 billion to support the zloty has not been drawn upon.
- Capital account convertibility is restricted.
  - A license from the national bank is required to grant or receive foreign exchange credits.
- Exchange Rate Management
  - The zloty was pegged to the US dollar from January 1990 to October 1991.
  - At the same time, a crawling peg introduced, devaluing the zloty bu 1.8 percent per month in line with inflation.
  - Developed 17 percent in May 1991 and 12 percent in February 1992.

Hungary: Status of Reforms

Privatization

Role in the Economy

- The private sector's share in the economy is growing rapidly, largely through the creation of new businesses and the decline of state enterprises.
  - Hungarian officials estimate that one-third of GDP comes from the private sector.
  - Estimates of private activity are imprecise because most entrepreneurs are reluctant to register or pay taxes.

Key Laws

- Act on Economic Associations of 1988 allowed for creation of limited liability companies, joint stock companies, unlimited partnerships and other forms of business associations.
  - Provided guarantees for private and foreign investors.
- Law on Foreign Investment of 1988, amended in 1989 and 1990, provided for foreign participation and even 100 percent foreign ownership of Hungarian enterprises, full repatriation of profits , generous tax allowances.
- Transformation Act of 1989 allowed Hungarian state-owned enterprises to transform themselves into Western style companies.
- Act on Foundation of State Property Agency and Act on Protection of State Assets of 1990 allows transfer of most property rights to State Property Agency.
- Bankruptcy Act of 1986, amended in 1990 and 1991, enables creditors to initiate bankruptcy proceedings.
- Act on the Prohibition of Unfair Marketing Practices of 1990 provides a framework for controlling anti-competitive practices and mergers.
- Land Compensation Act of 1991 provides partial compensation in the form of land or vouchers to former land-owners up to 5 million forints per claimant.

Foreign Role

- The foreign investment regime is liberal by international standards.
  - Hungary allows 100 percent repatriation of capital and profits.
- Hungary provides significant tax incentives.
  - Joint ventures with at least 50 million forints ($666,000) in total capital, 30 percent foreign participation, and half of the income earned in manufacturing or hotels receive a 60 percent tax reduction in the first 5 years and 40 percent in the second 5 years.
  - In some key sectors such as the automotive industry, 100 percent tax holidays have been granted for as long as 10 years.
- A foreign-owned company with a Hungarian partner may acquire land and property needed for business without government approval.
  - In practice, purchase of property has been hampered by unclear property rights.
- Ownership in key sectors--oil refining, banking, shipping, telecommunications infrastructure, and pharmaceuticals is either limited to minority ownership or discouraged in practice.

Agriculture

- As a result of Hungarian agriculture reforms during the 1970s, this sector has operated relatively efficiently.
  - Nonetheless, Hungarian agriculture needs effective incentives and Western capital.
- Cooperatives control 70 percent of arable land and produce 73.2 percent of all agricultural output.
  - 300-400 of Hungary's 1300 cooperatives face bankruptcy this year.
  - Input prices--pesticides, energy, fertilizer, and labor--have more than double since 1989, while output prices have risen less than 30 percent.
- Privatization in agriculture has moved slowly.
  - A Transitional Act on Cooperatives was adopted in January 1992 to protect the ownership rights of the cooperative's members from cooperative leaders until a law on cooperatives is approved.
  - The Act on Cooperatives adopted this year goes into effect in 1993 and will provide the basis for restructuring the cooperatives into private entities.

Restitution

- The National Compensation Office is implementing the compensation law passed in June 1991.
- It received 826,000 requests for compensation by the December deadline--over half lack the necessary documentation--while 200,00 requests had been granted by mid-February.
  - Roughly 14,000 people have requested land coupons involving requests for 25 percent of all agricultural land.
- Cooperatives have been told to set aside land to be offered in exchange for the coupons at auctions to be held starting this summer.
- The State Property Agency has chosen six companies whose shares can be purchased with compensation coupons.
  - They estimate that 20 percent of claimants will choose to purchase shares.

Hungary: Status of Reforms (continued)

Price Liberalization

- 90 percent of consumer prices liberalized 1 Jan 1991.
  - Fuel and electricity prices increased in 1992.
  - All subsidies on consumer prices except transportation were lifted 1 Jan 1992.
  - Significant distortions in energy pricing--especially for coal and electricity--persist.

Banking

- A two-tier banking system was introduced in 1987.
  - Provided clear differentiation between macroeconomic management, to be undertaken by monetary authorities, and business authority, to be carried out by commercial banks.
- At the beginning of 1991, there were 37 Hungarian commercial banks.
  - Sixteen have foreign participation and three joint venture banks had been formed.
  - The majority of household deposits are channelled through the National Savings Bank and 262 savings cooperatives, rather than through commercial banks, hampering the mobilization of capital.
- The Central Banking Law of 1991 provides for a regulatory framework in line with standards of the Bank of International Settlements (BIS).
  - It increases the capital adequacy ratio of banks to 8 percent and classifies loans according to risk. Banks this year have begun increasing reserve levels in compliance with the law.
  - Under The Law on Financial Institutions and their Activities of 1991, government permission is required for foreign participation of more than 10 percent in any financial institution.
- Budapest plans to begin privatization of major commercial banks this year.
  - The state or state-owned institutions own most banks and dominate lending.
  - Competition in banking is still limited.
  - Credit is largely allocated to the largest--and often the most inefficient state firms due to the persistence of close links among borrowers, bank boards, and shareholders. High interest rates also limit access of small, emerging firms to credit.

Currency Convertibility

- The forint is internally convertible for business purposes--Hungarian firms may hold hard currency accounts and purchase hard currency from authorized dealers to pay for imports.
  - Hungarian citizens may only convert $50 annually worth of forints.
  - This limit is planned to be raised this year and will be eliminated in 1993.
- The forint is pegged to a basket of convertible currencies--half dollars and half ECUs.
  - This rate has been adjusted periodically to account for inflation.
  - In January 1991 the forint was devalued 15 percent and in November by 5.8 percent.

Czechoslovakia: Status of Reforms

Privatization

Role in the Economy

- The private sector should rapidly expand in 1992 as a result of the privatization of roughly one-third of large state enterprises.
- In 1991 the private sector's share if the economy accounted for:
  - 6 percent of GDP.
  - 10 percent of employment.
  - 23 percent of retail trade.
  - 2.5 percent of industrial output.

Key Laws

- The Small Privatization Law passed on 18 September 1990 authorizes the sale of small stores and businesses to Czechoslovak citizens through dutch auctions, in which the price starts high and is bid down.
- The Large Privatization Law of 26 February 1991 permits the sale of large state enterprises through public tender, auction, or voucher privatization.

Foreign Role

- The November 1988 Law on Enterprises with Foreign Capital Participation permitted the creation of joint ventures with foreign partners. Opportunities for foreign investment have since expanded substantially:
  - Foreign investors may repatriate profits freely.
  - Although foreigners may not own land, they may establish a wholly-owned Czechoslovak subsidiary with the rights to landownership.
  - They may purchase firms directly from the government or buy shares when the Prague and Bratislava stock exchanges open later in 1992.
- Although Prague continues to emphasis its need for foreign capital, it has begun to take a more guarded approach to foreign investors:
  - Foreign owners could apply for two-year tax reductions in the past, but these benefits will no longer be available under the new tax code going into effect on 1 January 1993.
  - The Czech Republic, in particular, has made efforts to ensure that the country's most valuable companies are not available to foreign investors.

Mass Privatization Approach

- Prague has set tight deadlines for enterprises and government agencies to ensure that the whole process is completed sometime in 1993.
- Privatization is scheduled to take place in two waves, in which designated enterprises must file privatization plans for government approval.
  - Roughly two-thirds of state enterprises are being sold in the first and second waves of privatization.
  - Another third, including enterprises such as utilities, railroads, and schools, will be held in state ownership until 1995 at least.
  - Outsiders may file rival projects.
- Prague is using a combination of methods to privatize large state enterprises.
  - Enterprises may be sold directly to foreign or domestic investors.
  - Enterprises may be sold though "voucher privatization" in which Czechoslovak citizens may purchase $35 vouchers to use in computerized bidding for enterprise shares. They may also place them in investment funds.
  - A combination of the above methods may be used, and the state may also retain partial ownership.

Agriculture

- Czechoslovakia's agriculture was highly socialized under the Communists. 65 percent of agricultural land was held by cooperatives, 22 percent by state farms, and only 4 percent by private framers.
  - According to the 21 December 1991 Transformation Law, cooperative members--includimg landowners and cooperative workers--have until the end of 1992 to reestablish the cooperative or disband.
  - State farms are being privatized under the large privatization law.

Czechoslovakia: Status of Reforms (continued)

Restitution

- The federal Assembly has passed bills providing for restitution of some property.
  - The May 1991 Land Law, as amended, permits the restitution of land up to 500 hectares that was expropriated after the 25 February 1948 Communist coup.
  - The Restitution Law of 1 October 1990 permitted restitution of small business and homes. Czechoslovak citizens had six months from 1 November 1990 to apply. After that, applicants may receive compensation but not restitution.
- But the issue remains open.
  - A bill for the restitution of church property has repeatedly failed.
  - Exiled Sudeten Germans and church advocates continue to lobby for more extensive restitution.

Price Liberalization

- Most prices were freed on 1 January 1991.
- As a result of additional price liberalization, 95 percent of prices are now set by the market.
  - Ceilings on prices for food and many wholesale materials have been eliminated.
  - Energy and utility prices are controlled but have been administratively increased. Additional price increases are expected.
  - Price controls remain on transportation, communications, energy, ferrous metallurgy, rents, and health care.

Banking

- The November 1991 banking bill made the State Bank of Czechoslovakia independent of government control. It is in charge of the money supply and bank supervision.
  - Prague has begun to privatize some commercial banks, although the state is retaining a minority share. Foreign investors may hold 25 percent of shares, no one investor may hold more than 10 percent.
  - There are 43 commercial banks operating in Czechoslovakia: 22 are domestically-owned, 9 are foreign-owned, and the rest a mix.
  - The government has transformed credits for enterprises revolving inventories to a consolidation bank. A debt-equity swap has also been used to reduce the level of remaining bad debt on the balance sheets of commercial banks.

Currency Convertibility

- On 1 January 1991 Prague unified its commercial and tourist exchange rates and pegged its exchange rate to a basket of currencies.
  - Enterprises may exchange korunas for hard currency for current account transactions, but may not hold hard currency accounts.
  - Individuals may hold hard currency accounts, but may not exchange more than 5,000 korunas ($172) annually.

Bulgaria: Status of Reforms

Privatization

Role in the Economy

- Rapidly growing private sector. Limited mainly to small retail trade and service industries.

Key Laws

- Privatization law of April 1992 sets the stage for sale of large state owned enterprises.
- Banking reform law of February 1992 regulates bank profits, establishes Bank Consolidation Company to consolidate small local banks.

Foreign Role

- Sofia offers:
  - Liberalized regulations on foreign investment.
  - Foreign ownership of land.
  - Full repatriation of profits.
  - Foreign investment to date has been limited, however, by commercial debt problems.

Privatization Approach

- Conversion of large state-owned firms into joint-stock companies.
  - Implemented in 1991.
- Sale of shares to domestic and foreign investors by auction or negotiation.
- Stock exchanges have been established in advance of privatization of large state-owned firms.
  - Currently trading shares in banks, newly established private firms, and securities.
- Workers may purchase up to 20 percent of shares at concessionary prices.

Agriculture

- Liquidation Commissions are tasked to break up collective farms.
- Amended land reform law passed in March 1991 establishes property rights and returns land to former owners.
- 98 percent of land available for restitution has been claimed.
  - About half of the land is ready for immediate return, the remainder faces litigation.
  - Only 12 percent of plots can be returned within their original boundaries.

Price Liberalization

- Prices on most goods freed in February 1991.
  - Prices jumped 235 percent.
- Prices freed May 1992 on most of the remaining 14 "observed" commodities.
  - Prices jumped over 20 percent.
  - Some energy still excluded.

Banking

- Consolidation of more than 70 local banks into 8 to 10 larger entities just beginning.
- Despite high inflation in 1991, real interest rates were positive for most of the year.
- Banks are to be privatized over the next three years.

Currency Convertibility

- The lev has been internally convertible since February 1991.
- Unified exchange rate system is based on interbank foreign exchange market.
- The National Bank quotes exchange rates daily based on developments in international currency markets.
  - The 1991 average rate was 16.71 leva/$1.
  - As of 5 May 1992, the exchange rate stood at 23.00 leva/$1.

Romania: Status of Reforms

Privatization

Role in the Economy

- Private sector accounts for 18 percent of retail sales, up from 1 percent in 1990.
  - The vast majority of manufacturing production remains in the state sector.

Key Laws

- Law 31/ 1990 of November 1990 converted state enterprises to commercial societies.
  - All shares held by government.
- Privatization Law of August 1991 developed the legal framework for distributing the shares of commercial societies now held by the state.

Mass Privatization Approach

- 30 percent of shares will be given to five public ownership funds.
  - Funds will distribute shares to all adult Romanians.
- Remaining 70 percent of shares will be surrendered to a State Ownership Fund.
  - State Ownership Fund will divest 10 percent of its assets each year.
- Initial funding for implementation is to come from the rapid privatization of 30 enterprises.

Foreign Role

- Foreigners are barred from owning shares in the private ownerships funds for a period of five years.
  - The law does not limit foreign participation in auctions and sales conducted by the State Ownership Fund.
- Law initially allowed foreign bids on the first thirty firms.
  - Two months later, the National Agency for Privatization ruled that only foreigners would be eligible to participate in the initial bidding.
  - If no acceptable bid is received during the first round, foreign investors will be eligible to participate in subsequent rounds subject to the approval of the National Agency for Privatization.
- The state ownership fund enjoys considerable latitude in methods of privatization.
- Foreign Investment
  - June 1991 incentives for foreign investment, approval required only in strategic sectors.
  - Rates of repatriation vary from 8 to 15 percent--differentiated by sector.
  - No restriction on percentage held by foreigner but foreigners legally barred from buying land.

Agriculture

- The 80 percent of agricultural land held by cooperative farms is to be distributed to workers, former owners and others on the basis of a February 1991 law, but implementation has lagged.
  - By May 1992, only 100,000 of a forecast 5 million actual titles have been distributed.
  - The government has resorted to distributing lots on a temporary basis.
- Agricultural land held by state farms will be privatized along with other state enterprises under the August 1991 legislation.

Romania: Status of Reforms (continued)

Price Liberalization

- Most food prices freed 1 April, 1991.
- Many industrial and consumer prices increased November 1990.
- Gasoline prices increased September, 1991.
- Subsidies reduced by 25 percent in May 1992 on basket of goods.
  - Prices increased by as much as 460 percent.
  - Meat removed from overseen products.
- Substantial controls remain.
  - Eleven basic food items are subsidized.
  - Ceilings still in effect for energy to households, public transportation, school supplies, and rents.
  - Many prices are "freely" negotiated by producer and consumer in the presence of a representative from the Ministry of Economy and Finance's Department of Prices and Protection of Competition or the Ministry of Trade and Tourism's General Department for the Consumer's Protection.
  - November 1991 law requires prices of goods, costs, and profits, in effect 15 February 1992 to be registered with the Ministry of Economy and Finance.
  - Final retail price may not exceed the price charged by the producer by more than 30 percent, unless approved by the Ministry of Economy and Finance's Department of Prices and Protection of Competition.
  - Price increases must be registered 90 days before they take effect, and must be justified to the Ministry of Economy and Finance.
- Bucharest plans to end all price subsidies by end of 1993.
  - The next reduction--by 25 percent--of subsidies on basic consumer items is scheduled for 1 September 1992.

Banking

- Law 34.1991 of 25 March, 1991 transformed the Central Bank into National Bank of Romania (NBR).
  - Made NBR responsible for monetary policy, foreign exchange regime.
  - Empowered to license and regulate domestic banks.
  - Government Decision 65 of January 23, 1991 empowered the NBR to set up a stock exchange--not yet established.
- Bucharest has moved to create several new sector banks separate from the NBR.
  - Government Decision 1178 of November 112, 1990 established the Romanian Development Bank.
  - Government Decision 1195 of November 12, 1990 established Romanian Commercial Banks.
  - Government Decision 189 of March 22, 1991 approved creation of the Romanian Export Import Bank.
- Romania has increased interest rates several times.
  - Interest rates liberalized 1 April 1991.
  - NBR lifted the discount rate from 17 to 28 percent in January 1992.
  - Government announced in April 1992 it would raise interest rates to 50 or 70 percent during 1992.
- But rates have remained consistently far below inflation.

Currency Convertibility

- Interbank currency market established February 1991.
- Private exchange houses allowed to open August 1991.
  - Empowered to conduct foreign currency transactions.
  - Exceptions include government transactions and payment for imports of energy and other major raw materials.
- Exchange Rate Management.
  - National Bank continues to set exchange rate.
  - Official exchange rate devalued 67 percent, 11 November 1991.
- Also on 11 November 1991:
  - NBR required surrender of export earnings increased from 50 percent to 70 percent.
  - Hard currency accounts of state firms and ventures converted at new rate.
  - Requirements largely circumvented, hard currency kept outside of country.,
- In April 1992, NBR pledged to allow lieu to float, once transactions currently in queue have cleared.
  - Also announced that export earners may retain all export earnings in domestic banks.
  - National bank depreciated leu by 13 percent, but interbank rate still nearly twice official rate.

SENATOR BINGAMAN. Mr. McLaughlin, why don't you go ahead and start. We appreciate your being here.

STATEMENT OF JOHN MCLAUGHLIN, DIRECTOR, OFFICE OF SLAVIC AND EURASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY: ACCOMPANIED BY JOHN GANNON, DIRECTOR, OFFICE OF EUROPEAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

MR. MCLAUGHLIN. Thank you, Mr. Chairman.

Today, I'll be speaking on behalf of my office at CIA which focuses on the Commonwealth of Independent States. I will also be speaking on behalf of Mr. Gannon's office, which addresses issues concerning Eastern Europe, and we will both be available for your questions after my testimony.

My testimony today differs, as you have noted, from those of previous years in several respects, beginning with the topic itself.

A political revolution has transformed the Soviet command economy, which has always been the subject of these hearings, into 15 separate economies. It is also leading to the rise of separate militaries and a substantial downturn in military production. The USSR's successors are all struggling to make the transition from command systems to open markets.

That revolution has had other effects on this year's testimony. The collapse of the Union's central institutions, the passing of the traditional central planning system, and the emergence of a fledgling private sector have created new biases and distortions in official economic statistics and made the changes in the economy's performance extraordinarily difficult to quantify.

This problem is of particular concern because the data do not permit development of the same kinds of estimates of economic performance for the former republics that we had for the USSR.

As a result, we must rely more heavily on official macroeconomic statistics that are issued by national and Commonwealth authorities than we have in past testimony. These statistics can be used to provide a broad understanding of changing economic conditions, but not to support precise or detailed analysis. Because this is a "revolution-in-progress," political calculations have never before played such an important role in our assessment of future economic performance.

This interaction of politics and economics often produces unexpected results, as the events of last August clearly demonstrated. In one of history's ironies, the attempted coup accelerated the trends that its plotters said they were trying to stop—the erosion of central political authority and the deterioration of the economy. By yearend, the Soviet Union had been replaced by the Commonwealth of Independent States—a loose alliance of 11 of the 15 former Soviet republics—and the economic picture had darkened.

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According to the Commonwealth's official data—which can provide only a rough sense of the actual decline—national income last year dropped by 15 percent.

Last year also witnessed a prolonged battle over the budget responsibilities of the Union and the republics. This has produced enormous fiscal problems. We estimate that the USSR's total fiscal deficit reached about 20 percent of GDP in 1991 and, depending on the definition used, the deficit may have been larger still. This was accompanied by an increase in retail prices which the official statistical authorities acknowledged to be as high as 140 percent.

Of the many consumer hardships last year, the most serious was probably the reduced availability of food. Inventories of food at factories and in the traditional distribution system were drawn down to rock-bottom levels. The State's reserves, designed for emergency situations, also had to be tapped.

A sharp drop in trade among the former Soviet republics and with the outside world was both a cause and effect of the production shortfalls. According to official data, which we can check by comparing them with other countries' statistics, imports from outside the former Union fell by about 40 percent and exports fell by about 30 percent.

After the attempted coup in August, the erosion of the Center's authority contributed to the economy's decline, but also gave a push to reform by allowing the republics to pursue their own reform programs.

Of all the republics, Russia had the most reform-minded leadership, and its reform program has set the pace for the other Commonwealth states. Russia has passed many of the laws and regulations required to establish market institutions and provide the necessary guidelines for private business activity. It has taken the lead on price deregulation, freeing the prices of some 95 percent of its goods and services, and sharply raising the prices of those goods, such as energy, that remain subject to controls. While few of Russia's firms and only 2 percent of its farmland have passed into private hands so far, an ambitious plan calls for more than half of its shops, restaurants and small factories in light industry, construction, and motor transport to be privatized by the end of the year.

Also, to encourage the development of foreign trade, Russia has set exchange rates at more realistic levels, reduced the number of goods requiring export licenses and quotas, and abolished import quotas.

Russia has also made the most serious effort in the Commonwealth to stabilize its economy. Government claims of deficit reduction are confusing at times because of definitional uncertainties. Even when measured by rigorous international standards, however, Russia's budget deficit, so far this year, is substantially smaller as a share of GDP than the USSR's 1991 deficit.

The Russian Government has accelerated the defense cuts initiated under the former Soviet Union. There is considerable uncertainty in our

estimates of Soviet defense spending in 1991 because of new policy directions, disarray in the military, and disruptions in industry. Taking all of the uncertainties into account, however, we estimate that the 1991 decline in overall defense spending was between 10 and 25 percent, with the best estimate of around 15 percent. This leaves spending at levels last seen in the early 1970s. Estimated procurement outlays dropped by 20 percent in real terms in 1991, and were one-third lower than at their high point in 1988.

The decline in defense spending is even more dramatic in 1992. A draft defense budget for the Commonwealth that was submitted to the Russian cabinet in early March appears to represent about a 50-percent cut from the 1991 Soviet defense budget. Even this budget is probably over optimistic, however, because it calls for substantial financing from non-Russian Commonwealth members. I must note, though, that even with these cuts, Russia will remain the predominant military power in Eurasia.

Despite Russia's progress on reform, it still has far to go to create a market economy. Its failure to permit the private resale of land, or even pass a law on bankruptcy, illustrates how much work lies ahead. Little progress has been made in privatizing state assets. And the government's fiscal and monetary restraint is showing signs of weakening in the face of pressures from the old establishment, especially the defense industry, for increased spending and easier credit.

Although other Commonwealth members have declared their intention to move toward market economies, they all lag far behind Russia. For example, the rest of the Commonwealth followed Russia's lead in liberalizing prices, but almost all of its members have left more extensive price controls in place. Compared with Russia, these states have also have made less progress in liberalizing foreign trade and in enacting legislation needed to support the transition to market economies. And few of the other Commonwealth states are off to as good a start at reducing inflationary pressures.

All of these fledgling nations are struggling with the legacy of economies oriented excessively toward defense production, and all have expressed interest in converting much of their defense industries. To date, however, the difficulties of conversion have kept actual progress minimal.

While Yel'tsin has taken a painful first step to replace the command system with a market, the Russian Government is coming under increasing pressure to adopt inflationary policies and slow the process of economic restructuring. Elements of the old establishment—industrial managers, farm bureaucrats and local government officials—are resisting reforms that reduce their influence.

Over the coming year, we believe events will generate additional pressures to slow the pace of reform both in Russia and the other Commonwealth states.

First, retail prices will probably rise substantially due, in part, to Russia's further increases in energy prices.

Second, unemployment will increase, perhaps dramatically, depending on how much heat the government is willing to take for removing its factories, especially in the defense industry, from the dole.

And third, overall output should continue to decline, although with a higher percentage of goods that actually serve the economy's needs.

These pressures pose a potential threat not only to the continued progress of economic reform, but also to the political stability of these independent governments. To ensure political survival, any leader who is determined to build a market economy will have to manage a delicate balancing act that is unlikely ever to leave opponents or supporters of reform, at home or abroad, entirely satisfied.

Meanwhile, the slow progress of defense conversion also poses a substantial threat in the international arena. Earlier this year, Yel'tsin endorsed conventional arms sales as an important means of earning hard currency to fund conversion. Russian officials have repeatedly assured the West that they will carefully control such sales and exercise discretion in their list of clients. But impoverished conditions could encourage individual plants or workers to attempt unauthorized sales, anyway, and it will be some time before comprehensive export controls can be enforced with great effectiveness.

In sum, the Commonwealth's transition from plan to market will depend in large part on the ability of its members to maintain the pace of reform at a time when consumers are still experiencing more of its costs than its benefits. Economic assistance from other countries can help to ease the pain, but most of the effort for the transition will have to come from the Commonwealth states themselves.

We expect the process of reform to continue moving forward in Russia and elsewhere. But as shown by the political furor at Russia's recent Congress of People's Deputies and continuing friction between the government and the legislature, the process will be contentious, it will move in fits and starts, and it will be marked by recurring crises.

At best, Mr. Chairman, we are probably looking at a decade-long process. And at the risk of underscoring the obvious, I would remind you that the downside risks are enormous and the range of possible outcomes wide, including extended political deadlock and instability so serious that it could derail reform in both the economic and political spheres.

Turning now to Eastern Europe, most countries are a year or two ahead in attempting the transformation that is just beginning in the former Soviet Union. This headstart has added to the lead that several of them already enjoyed over the Soviets when they began their transition following the revolutions of 1989.

Eastern Europe has made progress on reform in the last year. No country has yet achieved a market economy, and reforms have not yet

lifted these economies out of recession. But the private sector has become larger. There are fewer price controls. Currencies are more convertible. Property rights are stronger. And most governments are more strongly committed than ever to reform.

Poland, where political stalemate has stunted progress for the past year, is the key exception. Failure to cobble together an effective government from the fractured legislature has drained the momentum from Warsaw's initially strong reform efforts.

The rest of Eastern Europe has fared better:

Hungary's steady progress toward a market economy has made it the clear favorite of Western investors.

Czechoslovakia, which started later, is now instituting reforms at a more rapid pace than its neighbors.

Romania has advanced substantially in the past year under reformist Prime Minister Stolojan, but the government's penchant to intervene casts down on Bucharest's ability to stay the course.

Although advances often seem slow and uneven, the private sector—which for year has been much larger than in the former USSR—now accounts for half of the production in Poland and nearly as much in Hungary. Entrepreneurs have opened or bought businesses by the hundreds of thousands to meet the pent-up demand for consumer goods and services.

The transfer of large state-owned manufacturing firms to private ownership has moved much more slowly because of fear of steeper recession and higher unemployment.

Despite progress with reform, the region suffered another year of severe recession. GNP fell an average of 13 percent in 1991.

Most countries cut inflation, but unemployment soared. From virtually no unemployment in 1990, jobless rates in most East European countries jumped to 10 percent or more by the end of 1991, and rates in some one-company towns have topped 20 percent.

Although economic reforms contributed to the recession, the collapse of Eastern Europe's trade with the former Soviet Union was the most important factor in last year's decline. Eastern Europe, which was still heavily reliant on sales to the former USSR, saw its exports drop by more than half. Increased trade with the West, however, helped soften some of the blow from reduced trade with the former Soviet Union.

The outlook is for another tough economic year in Eastern Europe, although the slide will not be as steep as in 1991. Indeed, GNP should bottom out in some countries at least, most likely those in the northern tier. The factors that made 1991 such a difficult year, particularly the plunge in exports to the former Soviet Union, probably will not worsen or recur, and some positive trends will continue.

These include: the brisk growth of the private sector; a rise in foreign investment; and gains in trade with the West. Moreover, economic reform programs will probably begin to pay more dividends.

The region, however, will still face serious economic problems. Industrial output will continue to fall sharply, particularly if mass privatization of state industries takes hold. Unemployment is likely to continue climbing after a large jump in 1991, and the safety net will be stretched by budget problems. Nearly all of the countries could experience double-digit rates of joblessness before the end of the year. The battle against inflation will once again be tough in all but Hungary and Czechoslovakia, and even countries that emerge from the recession will see only a spotty and anemic recovery.

Continued progress with reforms will test the social fabric and political stability of the East European countries. The emphasis of reform programs will shift increasingly from passage of legislation to implementation of difficult measures, such as privatization of state industries and restructuring of inefficient firms.

Political leaders in Eastern Europe will face the challenge of convincing populations that have already endured heavy sacrifices to hold out longer. Poland and Romania are now in the shakiest positions. Warsaw will have to resolve its current political problems to move forward, and Romania will have to show more consistency in its reforms and policies. The other countries stand a better chance of advancing, but they may encounter problems similar to Poland's when their reforms are further along.

This past weekend's elections in Czechoslovakia, for example, revealed sharply divergent views between Czechs, who support accelerated movement toward a free market, and Slovaks, who prefer a slower pace of reform.

The most successful leaders will be those who can draw enough popular support to push reform measures through legislatures and persuade populations that near-term sacrifices are required to achieve the goal of long-term prosperity.

Moreover, external pressure—from the IMF, the World Bank and Western governments—will be key to keeping reforms on track. Those countries that are able to stay the course will begin to see more payoff in the next few years. By the mid-1990s, we expect that most East European Governments will:

Register economic growth; sell off a large share of state industry so that private-sector output eclipses that of the state; be more closely integrated with the European Community; and they will benefit from steady increases in foreign investment.

Mr. Chairman, in closing our discussion of these five new states in Eastern Europe and the eleven new states that have taken the place of the Soviet Union, let me make a final point about the context in which they are developing.

Although I have just focused on a series of specific programs and economic indices, intelligence analysts are acutely aware that they are dealing with something much greater and more complex than the sum

of these parts. An empire has collapsed, the dust has barely begun to settle, and the forces now at work—the forces that will both buffet and propel reform—are epic in proportion.

And so, we would not want to convey today a false sense of precision. While we are reasonably confident about the projections that we have made today, we are also acutely aware, Mr. Chairman, that the elements of uncertainty and unpredictability in this part of the world are greater than at any time since the Bolshevik Revolution of 1917.

And with that, I will give the floor to my colleague from DIA. [The prepared statement of Mr. McLaughlin follows:]

[The prepared statement of Mr. McLaughlin follows:]

PREPARED STATEMENT OF JOHN MCLAUGHLIN

The Transition to Markets in the Commonwealth States

Good afternoon, Mr. Chairman. My testimony today differs from those of previous years in several respects, beginning with the topic itself. A political revolution has transformed the Soviet command economy, which always has been the subject of these hearings, into 15 separate economies. It is also is leading to the rise of separate militaries and a substantial downturn in military production. And the USSR's successors are all struggling to make the transition from command systems to open markets.

That revolution has had other effects on this year's testimony. The collapse of the union's central institutions, the passing of the traditional central planning system, and the emergence of a fledgling private sector have created new biases and distortions in official economic statistics and made the changes in the economy's performance extraordinarily difficult to quantify. This problem is of particular concern because the data do not permit development of the same kinds of estimates of economic performance for the former republics that we had for the USSR. As a result we must rely more heavily on official macroeconomic statistics issued by national and Commonwealth authorities than we have in past testimony. These statistics can be used to provide a broad understanding of changing economic conditions but not to support precise or detailed analysis. And because this is a "revolution-in-progress," political calculations have never before played such an important role in our assessment of future economic performance.

This interaction of politics and economics often produces unexpected results, as the events of last August clearly demonstrated. In one of history's ironies, the attempted coup accelerated the trends its plotters said they were trying to stop—the erosion of central political authority and the deterioration of the economy. By yearend, the Soviet Union had been replaced by the Commonwealth of Independent States—a loose alliance of 11 of the 15 former Soviet republics—and the economic picture had darkened. According to the Commonwealth's official data—which can provide only a rough sense of the actual decline—national income last year dropped by 15 percent.

Last year also witnessed a prolonged battle over the budget responsibilities of the union and republics that has produced enormous fiscal problems. We estimate that the USSR's total fiscal deficit reached about 20 percent of GDP in 1991 and depending on the definition used, the deficit may have been larger still. This was accompanied by an increase in retail prices which the official statistical authorities acknowledged to be as high as 140 percent.

Of the many consumer hardships last year, the most serious was probably the reduced availability of food. Inventories of food at factories and in the traditional distribution system were drawn down to rock-bottom levels. The state's reserves, designed for emergency situations, also had to be tapped.

A sharp drop in trade among the former Soviet republics and with the outside world was both a cause and effect of the production shortfalls. According to official data—which can be checked by comparing them with other countries' statistics—imports from outside the former Union fell by about 40 percent and exports by about 30 percent.

After the attempted coup in August, the erosion of the center's authority contributed to the economy's decline but also gave a push to reform by allowing republics to pursue their own reform programs. Of all the republics, Russia had the most reform-minded leadership and its reform program has set the pace for the other Commonwealth states:

- Russia has passed many of the laws and regulations required to establish market institutions and provide the necessary guidelines for private business activity.
- It has taken the lead on price deregulation, freeing the prices of some 95 percent of its goods and services and sharply raising the prices of those goods—such as energy—that remain subject to controls.
- While few of Russia's firms and only two percent of its farmland have passed into private hands so far, an ambitious plan calls for more than half of its shops, restaurants, and small factories in light industry, construction, and motor transport to be privatized by the end of this year.
- Also, to encourage the development of foreign trade, Russia has set exchange rates at more realistic levels, reduced the number of goods requiring export quotas and licenses, and abolished import quotas.

Russia also has made the most serious effort in the Commonwealth to stabilize its economy. Government claims of deficit reduction are confusing at times because of definitional uncertainties. Even when measured by rigorous international standards, however, Russia's budget deficit so far this year is substantially smaller as a share of GDP than the USSR's 1991 deficit.

The Russian government has accelerated the defense cuts initiated under the former Soviet Union. There is considerable uncertainty in our estimates of Soviet defense spending in 1991 because of new policy directions, disarray in the military, and disruptions in industry. Taking all of the uncertainties into account, however, we estimate that the 1991 decline in overall defense spending was between 10 and 25 percent, with a best estimate of 15 percent. This leaves spending at levels last seen in the early 1970s. Estimated procurement outlays dropped about 20 percent in real terms in 1991, and were one-third lower than at their high point in 1988.

The decline in defense spending is even more dramatic in 1992. A draft defense budget for the Commonwealth submitted to the Russian cabinet in early March appears to represent about a 50-percent cut from the 1991 Soviet defense budget. Even this budget is probably overoptimistic, however, because it calls for substantial financing from non-Russian Commonwealth members. I must note, though, that even with these cuts, Russia will remain the predominant military power in Eurasia.

Despite Russia's progress on reform, it still has far to go to create a market economy. Its failure to permit the private resale of land or even pass a law on bankruptcy illustrates how much work lies ahead. Little progress has been made in privatizing State assets. And the government's fiscal and monetary restraint is showing signs of weakening in the face of pressures from the old establishment—especially defense industry—for increased spending and easier credit.

Although other Commonwealth members have declared their intention to move toward market economies, they all lag far behind Russia. For example, while the rest of the Commonwealth followed Russia's lead in liberalizing prices, almost all of its members have left more extensive price controls in place. Compared with Russia, these States also have made less progress in liberalizing foreign trade and in enacting the

legislation needed to support the transition to market economies. And few of the other Commonwealth states are off to as good a start at reducing inflationary pressures.

All of these fledgling nations are struggling with the legacy of economies oriented excessively toward defense production and all have expressed interest in converting much of their defense industries. To date, however, the difficulties of conversion have kept progress minimal.

While Yel'tsin has taken the painful first steps to replace the command system with a market, the Russian government is coming under increasing pressure to adopt inflationary policies and slow the process of economic restructuring. Elements of the old establishment—industrial managers, farm bureaucrats, and local government officials—are resisting reforms that reduce their influence.

- Over the coming year, we believe events will generate additional pressures to slow the pace of reform, both in Russia and the other Commonwealth states.
- First, retail prices will probably rise substantially, due in part to Russia's further increases in energy prices.
- Second, unemployment will increase, perhaps dramatically, depending on how much heat the government is willing to take for removing its factories—especially in defense industry—from the dole.
- And third, overall output should continue to decline, although with a higher percentage of goods that actually serve the economy's needs.

These pressures pose a potential threat not only to the continued progress of economic reform but also to the political stability of these newly independent governments. To ensure political survival, any leader determined to build a market economy will have to manage a delicate balancing act that is unlikely ever to leave opponents or supporters of reform—at home and abroad—entirely satisfied.

Meanwhile, the slow progress of defense conversion also poses a potential threat in the international arena. Earlier this year, Yel'tsin endorsed conventional arms sales as an important means of earning hard currency to fund conversion. Russian officials have repeatedly assured the West that they will carefully control such sales and exercise discretion in their list of clients. But impoverished conditions could encourage individual plants or workers to attempt unauthorized sales anyway, and it will be some time before comprehensive export controls can be enforced with great effectiveness.

In sum, the Commonwealth's transition from plan to market will depend in large part on the ability of its members to maintain the pace of reform at a time when consumers are still experiencing more of its costs than its benefits. Economic assistance from other countries can help to ease the pain, but most of the effort for the transition will have to come from the Commonwealth states themselves.

We expect the process of reform to continue moving forward in Russia and elsewhere. But as shown by the political furor at Russia's recent Congress of People's Deputies and continuing friction between the government and the legislature, the process will be contentious, it will move in fits and starts, and it will be marked by recurring crises.

At best, Mr. Chairman, we are probably looking at a decade-long process. And at the risk of underscoring the obvious, I would remind you that the downside risks are enormous and the range of possible outcomes wide, including extended political deadlock

and instability so serious that it could derail reform in both the economic and political spheres.

Reform in Eastern Europe

Turning now to Eastern Europe, most countries are a year or two ahead in attempting the transformation just beginning in the former Soviet Union. This headstart has added to the lead that several of them already enjoyed over the Soviets when they began their transition following the revolutions of 1989.

Eastern Europe has made progress on reform in the past year. No country has yet achieved a market economy, and reforms have not yet lifted these economies out of recession. But the private sector has become larger, there are fewer price controls, currencies are more convertible, property rights are stronger, and most governments are more strongly committed than ever to reform.

Poland, where political stalemate has stunted progress for the past year, is the key exception. Failure to cobble together an effective government from the fractured legislature has drained the momentum from Warsaw's initially strong reform efforts.

The rest of Eastern Europe has fared better:

- Hungary's steady progress toward a market economy has made it the clear favorite of Western investors.
- Czechoslovakia, which started later, is now instituting reforms at a more rapid pace than its neighbors.
- Bulgaria's new government has accelerated economic reforms, culminating in the passage in April of the long-delayed privatization law.
- Romania has advanced substantially in the past year under reformist Prime Minister Stolojan, but the government's penchant to intervene casts doubt on Bucharest's ability to stay the course.

Although advances often seem slow and uneven, the private sector—which for years has been much larger than in the former USSR—now accounts for half of production in Poland and nearly as much in Hungary. Entrepreneurs have also made important progress in Bulgaria and Romania in the past year. Entrepreneurs have opened or bought businesses by the hundreds of thousands to meet the pent-up demand for consumer goods and services.

The transfer of large state-owned manufacturing firms to private ownership has moved much more slowly because of fear of steeper recession and higher unemployment. Czechoslovakia stands the best chance of rapid mass privatization on the strength of its voucher program; Bulgaria and Romania now have laws on the books, but implementation will be slow.

Despite progress with reform, the region suffered another year of severe recession as GNP fell an average of 13 percent in 1991. Czechoslovakia and Bulgaria recorded the sharpest declines, while the downturns in Poland and Hungary were more moderate. Most countries cut inflation, but unemployment soared. From virtually no unemployment in 1990, jobless rates in most countries jumped to 10 percent or more by the end of 1991, and rates in some one-company towns have topped 20 percent.

Although economic reforms contributed to the recession, the collapse of Eastern Europe's trade with the former Soviet Union was the most important factor in last year's decline. Eastern Europe, which was still heavily reliant on sales to the former USSR,

saw its exports drop by more than half. Increased trade with the West, however, helped soften some of the blow from reduced trade with the former Soviet Union.

The outlook is for another tough economic year in Eastern Europe, although the slide will not be as steep as in 1991. Indeed, GNP should bottom out in at least some countries—most likely those in the northern tier. The factors that made 1991 such a difficult year—particularly the plunge in exports to the former Soviet Union—probably will not worsen or recur, and some positive trends will continue. These include:

- the brisk growth of the private sector;
- a rise in foreign investment; and
- gains in trade with the West.

Moreover, economic reform programs will probably begin to pay more dividends.

The region, however, still will face economic problems. Industrial output will continue to fall sharply, particularly if mass privatization of State industries takes hold. Unemployment is likely to continue to climb after a large jump in 1991, and the safety net will be stretched by budget problems. Nearly all of the countries could experience double-digit rates of joblessness before the end of the year. The battle against inflation will once again be tough in all but Hungary and Czechoslovakia, and even countries that emerge from the recession will see only a spotty and anemic recovery.

Continued progress with reforms will test the social fabric and political stability of the East European countries. The emphasis of reform programs will shift increasingly from passage of legislation to implementation of difficult measures such as privatization of State industries and restructuring of inefficient firms.

Political leaders will face the challenge of convincing populations that have already endured heavy sacrifices to hold out longer. Poland and Romania are now in the shakiest positions. Warsaw will have to resolve its current political problems to move forward, and Romania will have to show more consistency in its reforms and policies. The other countries stand a better chance of advancing, but they may encounter problems similar to Poland's when their reforms are further along. This past weekend's elections in Czechoslovakia, for example, revealed sharply divergent views between Czechs, who support accelerated movement toward a free market, and Slovaks, who prefer a slower pace of reform.

The most successful leaders will be those who can draw enough popular support push reform measures through legislatures and persuade populations that near-term sacrifices are required to achieve the goal of long-term prosperity. Moreover, external pressure—from the IMF, the World Bank, and Western governments—will be key to keeping reforms on track. Those countries able to stay the course will begin to see more payoff in the next few years. By the mid-1990s, we expect that most East European countries will:

- register economic growth;
- sell off a large share of State industry so that private sector output eclipses that of the State;
- be more closely integrated with the EC;
- benefit from steady increases in foreign investment.

Mr. Chairman, in closing our discussion of these five new States in Eastern Europe and the eleven new States that have taken the place of the Soviet Union, let me make a

final point about the context in which they are developing. Although I have just focused on a series of specific programs and economic indices, intelligence analysts are acutely aware that they are dealing with something much greater and more complex than the sum of these parts. An empire has collapsed, the dust has barely begun to settle, and the forces now at work—the forces that will both buffet and propel reform—are epic in proportion. And so, we would not want to convey a false sense of precision. While we are reasonably confident about the projections we have made today, we are also acutely aware, Mr. Chairman, that the elements of uncertainty and unpredictability in this part of the world are greater than at anytime since the Bolshevik Revolution of 1917.

SENATOR BINGAMAN. Thank you very much. Ms. Horste, why don't you go right ahead.

STATEMENT OF KATHLEEN HORSTE, SPECIAL ASSISTANT FOR RUSSIA/EURASIA, DEFENSE INTELLIGENCE AGENCY

MS. HORSTE. Mr. Chairman, I am pleased to offer Defense Intelligence perspectives on economic developments in Russia and in the other new states emerging from the former Soviet Union.

As in past DIA appearances before this Committee, I will focus my observations on the military dimensions of the economy. Specifically, I will address three key issues: new concepts for the armed forces; trends in defense spending; and the status of defense industries, weapons production, and arms sales in the Commonwealth of Independent States, or the CIS.

These issues are key indicators of continued progress in the reform process.

Since our appearance before this Subcommittee last year, the dissolution of the Soviet Union has irrevocably changed the context in which we assess military-economic developments.

For example, the economic resources of the former Union can no longer be mobilized as an aggregate to develop and sustain armed forces.

The Union's breakup also accelerated efforts to reduce the burden of the huge military sector on the economies of the successor states. This challenge has become all the more formidable because it must be undertaken simultaneously, with efforts to build new national institutions, consolidate democratic processes, and make the transition from centrally planned economies to market systems.

Progress so far has been remarkable when one considers that the USSR formally came to an end only five months ago. But the enormity of the economic, military and political problems that the new states face suggest many uncertainties and problems lie ahead.

Turning first to new concepts in the armed forces.

The newly independent states are struggling to formulate their security requirements in light of the changing international political environment and the economic constraints under which they must operate. Leaders in all of the new states do not perceive a threat from NATO.

Russia's leaders generally agree that their greatest military concern in the future will be from potential regional conflicts along the country's periphery. According to Russia's Defense Minister Grachev and other senior officials, Russia plans to draw down its armed forces to a strength of 1.5 million by the end of this decade. Russian military planners envision a smaller, more mobile force, with emphasis on qualitative improvements in weapons and personnel.

The bulk of Russian forces will no longer be concentrated, as in the old Soviet army in forward echelons, along traditional invasion routes. Rather, the Russians will be dependent upon sufficient warning time of any major regional threat to deploy a small rapid-reaction force and mobilize a strategic reserve.

Throughout the 1990s, Russia will continue to retain a smaller but still potent strategic nuclear force.

In Ukraine, the government has officially declared that its military doctrine is defensive, nonaligned, nonnuclear, and identifies no enemies. Current plans call for a transition to roughly a 200,000-man active army, based on a radical reduction of the former Soviet forces in Ukraine. Although other Commonwealth members have announced plans or have already begun to build national armies, only Russia and Ukraine are expected to have the resources to field sizable forces in the foreseeable future. Many former Soviet republics are fielding forces to defend against their neighbors—for example, in Armenia and Azerbaijan, who are virtually at war with one another.

A collective security treaty was signed in Tashkent last month by Russia, Armenia, Kazakhstan and three other Central Asian states. This treaty underscored the desire among some of the new states to maintain close cooperation on defense. For the non-Russian signatories, this desire stems, in large part, from their very limited economic potential to develop and sustain armed forces.

Turning to defense budgets.

The economic disarray and dissolution of the Union have thrown the defense budgeting process into turmoil. A February agreement among Commonwealth member states to fund a unified defense budget is falling apart due to the reluctance of most republics to participate in joint arrangements, the ongoing disputes over how to divide up the former Soviet forces, and wrangling over how much each member should contribute to the budget.

In the meantime, Russia is continuing to shoulder the major burden of financing the former Soviet armed forces. Ukraine and Byelarus apparently are supporting those general purpose forces over which they have claimed jurisdiction, while other Commonwealth members seem to be paying little more than some local stationing costs.

The military has been operating under chaotic financial conditions since last fall when some units went without pay and budgeting was essentially on a month-to-month basis.

For 1992, Russian defense spending will continue to fall. While the broad priorities of the budget are apparent, the specifics remain unclear. The largest cuts will be in procurement. Spending on military research and development will also be cut, but probably by less than procurement.

Press reports indicate that about two thirds of the defense budget will be for personnel and operations and maintenance. This reflects the

widespread agreement that the immediate priority must be given to improving the housing, pay and social services for military personnel.

Besides the budgeting turmoil, military planning in Russia and in the Commonwealth is further complicated by the uncertain future of the defense industry, which felt itself under increasing pressure as 1991 unfolded. A combination of factors, including budgetary shortfalls, supply disruptions and shrinking arms exports, probably led to an even steeper decline in weapon output in 1991 than had been planned.

By our estimates, which concur with my colleague's from CIA, overall weapons procurement fell by about 20 percent in 1991, compared to 1990. The most dramatic declines appeared in weapon systems for the general purpose forces.

The dissolution of the Union has broken up the huge, centrally administered defense industrial structure within which several thousand plants have produced weapon systems and components for the armed forces and for export.

Russia has about two thirds of this infrastructure; Ukraine, about 15 percent; and the balance is scattered among the other new states. Russia alone maintains a sufficiently broad R&D and manufacturing base to produce a full range of strategic and conventional weapons. Ukraine hosts some major arms factories, notably for the production of naval surface combatants, strategic missiles, tanks, transport aircraft, and several key research and development and test facilities.

Cuts in military orders have left many defense enterprises in critical financial shape. Plants are continuing to operate by using reduced supplies, making barter transactions, and going deeper into debt. Thus far, defense industry has avoided mass unemployment and major labor unrest. However, even if the Yel'tsin government loosens credit, plants cannot continue to run up debt while turning out products no one intends to buy. Russian officials warn that up to two million defense industry workers could lose their jobs by the end of the year.

Despite the conversion programs and defense cuts of the Gorbachev era, little real progress in defense conversion has been made. Russia and Ukraine are just beginning to confront the enormous task of down sizing, restructuring and converting the defense sector, a process that will take years and cost billions of rubles.

Help from Western governments and financial institutions will be important to this process. But successful conversion will depend much more on internal reforms and attracting private investment capital. Despite considerable activity, the defense industry has concluded few joint ventures or investment agreements with Western firms.

Foreign investors are inhibited by many remaining obstacles, including confusing and changing laws on property rights, repatriation of profits and tax requirements, unclear and overlapping lines of governmental authority, and the unstable economic and financial environment.

Confronted with the prospect of widespread unemployment and the daunting economic and social costs involved in defense industry restructuring, the Russian Government is re-evaluating its strategy.

In a concession to defense industrialists, who remain a potent political force, President Yel'tsin has named former defense managers to key posts in his cabinet, and appears ready to provide defense industry with credit and tax concessions even if it means giving ground in the battle to reduce the budget deficit.

In addition, the Russian Government is actively promoting foreign arms sales, seeing in them a means of generating much-needed hard currency and staving off unemployment in the defense sector. In a February 24 interview, President Yel'tsin termed arms sales as a "shock absorber" that will ease the impact of defense procurement cuts.

Russia, however, will face stiff competition in a shrinking world-arms market. Arms deliveries from the former Soviet Union in 1991 were less than one half the 1990 level, which followed a 30 percent decline from 1989. Moscow's concerted efforts to earn hard currency through arms sales over the last several years has proven, for the most part, to be unsuccessful.

In addition, the former Soviet Union slashed military grant aid in recent years, and the number of clients receiving major shipments of Soviet arms has steadily declined. The perceived poor performance of Soviet-made equipment in the Gulf War and the collapse of the former centralized arms sales apparatus have further aggravated Russia's marketing problems.

Russia will be by far the most important arms exporter among the Soviet successor states. To overcome buyer resistance, the Russians probably will offer more advanced systems—such as the SA-10 surface-to-air missile system and modern fighter aircraft—at lower prices, and will accept more barter deals.

Ukraine may also be an important exporter of some systems, such as transport aircraft. For most former republics, their own realistic opportunity to enter the arms market is by selling off the equipment of Commonwealth forces on their territory. However, arms sales alone will not provide sufficient capital to fund major defense industry conversion, nor can arms sales sustain the current size of the existing defense industrial complex.

Russia has made only limited progress in convincing other Commonwealth members to coordinate their military trade policies, and she is still in the process of establishing a system for managing military sales. President Yel'tsin and other Commonwealth leaders recognize, however, that they must balance their efforts to sell arms with assurances to the West that they will control weapon exports and prevent proliferation.

Government approval will no doubt be required for all legal sales. Nevertheless, the new states will have a more difficult time controlling

arms transfers than their Soviet predecessor, because many of the former controls over society have been removed, customs services are, as yet, largely ineffective, and a growing number of arms vendors are gaining direct access to the international market.

Russia has taken steps to prevent the unauthorized transfer of special weapons technology and expertise. Moscow and the West are actively cooperating to find alternative prospects for key Russian nuclear specialists. While several foreign powers are known to be seeking Russian nuclear weapons technology and expertise, we have no convincing evidence that they have succeeded. However, the difficult internal situation within Russian and other Commonwealth states requires continued intense monitoring of the proliferation danger.

Looking to the future, the course of economic reform is inextricably linked to success in restructuring and downsizing the former Soviet armed forces. The goal of Russia, Ukraine and most other Commonwealth members is to reduce the burden of military expenditures to 4 to 6 percent of their gross national product. Continued movement in that direction is essential to economic recovery.

The establishment of national militaries will consist primarily of radically downsizing and reorganizing the forces already in existence. The funds available for force modernization will be severely limited.

In the defense industrial sector, Russia and Ukraine will retain a core of the most modern final assembly plants, component suppliers, and research and development facilities.

For the majority of plants that do not fit into future procurement plans and cannot compete internationally, the government will have to begin the protracted, costly and socially disruptive process of their restructuring or elimination.

In conclusion, there are great uncertainties and significant challenges in the years ahead. On the positive side, we see signs of economic, political and military reform throughout the new states of the former Soviet Union. Price decontrol, the beginnings of commercial enterprise, and the demilitarization of the economy are beginning to take hold.

Free elections, political pluralism and legislative participation in the policy process are growing features of the political landscape in much of the former Union. The military threat to the West has been dramatically reduced, and the new leaders see little need for large, active armed forces.

The Russian Government, however, is under increased pressure from defense industrialists to slow the pace of reform. And continued reductions in defense programs will be a key indicator that such reforms remain on track.

That concludes my statement.

[The prepared statement of Ms. Horste follows:]

PREPARED STATEMENT OF KATHLEEN HORSTE

Mr. Chairman, distinguished members of the Committee, I am pleased to offer defense intelligence perspectives on economic developments in Russia and the other new States emerging from the former Soviet Union. As in past DIA appearances before this committee, I will focus my observations on the military dimensions of the economy. Specifically, I will address three key issues: new concepts for the armed forces; trends in defense spending; and, the status of defense industries, weapons production and arms sales in the commonwealth of independent states (CIS). These issues are key indicators of continued progress in the reform process.

Since our appearance before this committee last year, the dissolution of the Soviet Union has irrevocably changed the context in which we assess military-economic developments. For example:

The economic resources of the former union no longer can be mobilized as an aggregate to develop and sustain military forces.

The union's breakup accelerated efforts to reduce the burden of the huge military sector on the economies of the successor States. This challenge has become all the more formidable because it must be undertaken simultaneously with efforts to build new national institutions, consolidate democratic processes, and make the transition from centrally planned economies to market systems.

Progress so far has been remarkable when one considers that the USSR formally came to an end only five months ago. But the enormity of the economic, military, and political problems the new States face suggests many uncertainties and problems lie ahead.

New Concepts for the Armed Forces

The newly independent States are struggling to formulate their security requirements in light of the changing international political environment and the economic constraints under which they must operate. Leaders in all of the new States do not perceive a threat from NATO.

Russia's leaders generally agree that their greatest military concern in the future will be from potential regional conflicts along the country's periphery. According to Russian Defense Minister Grachev and other senior officials, Russia plans to draw down it's armed forces to a strength of 1.5 million by the late 1990s. Russian military planners envision a smaller, more mobile force with emphasis on qualitative improvements in weapons and personnel. The bulk of Russian forces no longer will be concentrated, as in the old Soviet army, in forward echelons along traditional invasion routes. Instead, the Russians will be dependent upon sufficient warning time of any major regional threat to deploy a small rapid-reaction force and mobilize a strategic reserve. Throughout the 1990s, Russia will continue to retain a smaller, but still potent, strategic nuclear force.

In Ukraine, the government has officially declared that its military doctrine is defensive, non-aligned, non-nuclear, and identifies no enemies. Current plans call for a transition to roughly a 200,000 man active army based on a radical reduction of the former soviet general purpose forces in Ukraine. This planned force already has been scaled

back considerably from earlier proposals that were unaffordable in light of Ukraine's declining economy and sharp budget constraints.

Although other CIS members have announced plans or already begun to build national armies, only Russia and Ukraine are expected to have the resources to field sizable forces in the foreseeable future. Many former soviet republics are fielding forces to defend against their neighbors; such as in Armenia and Azerbaijan who are virtually at war with one another. The collective security treaty signed in Tashkent in may by Russia, Armenia, Kazakhstan, and three central Asian States (Uzbekistan, Kyrgyzstan, and Tajikistan) underscores the desire among some of the new states to maintain close cooperation on defense. For the non-Russian signatories, this desire stems in large part from their very limited economic potential to develop and sustain military forces.

Defense Budgets

The new States are attempting to formulate new military doctrines and plans under conditions of extreme budgetary austerity and instability. The economic disarray and dissolution of the union have thrown the budgeting process into turmoil. A February agreement among CIS member States to fund a unified defense budget is falling apart, due to the reluctance of most republics to participate in joint arrangements, the ongoing disputes over how to divide up former Soviet forces, and wrangling over how much each member should contribute to the budget. In the meantime, Russia is continuing to shoulder the major burden of financing the former Soviet military forces. Ukraine and Byelarus apparently are supporting those general purpose forces over which they have claimed jurisdiction, while other CIS members seem to be paying little more than some local stationing costs.

The military has been operating under chaotic financial conditions since last fall, when some units went without pay and budgeting was essentially on a month-to-month basis, in stark contrast to the well-ordered budgetary and planning process that supported the military under the old Soviet system.

For 1992, Russian defense spending will continue to fall. While the broad priorities of the defense budget are apparent, the specifics remain unclear. The largest cuts will be in procurement. spending on military research and development will also be cut, but probably by less than procurement. Press reports indicate about two-thirds of the budget will be for personnel and operations and maintenance. This reflects widespread agreement that the immediate priority must be given to improving the housing, pay, and social services for military personnel.

Defense Industry, Conversion, and Weapon Sales

Besides the budgeting turmoil, military planning in Russia and the CIS is further complicated by the uncertain future of the Defense industry, which felt itself under increasing pressure as the dramatic events of 1991 unfolded. A combination of factors, including budgetary shortfalls, supply disruptions, and shrinking arms exports, probably led to an even steeper decline in weapon output in 1991 than planned. By our estimates, overall weapons procurement i fell by about 20 percent in 1991 compared to 1990. The most dramatic declines appeared in weapon systems for the general purpose forces.

The dissolution of the union has broken up the huge, centrally administered defense industrial structure within which several thousand plants have produced weapon

systems and components for the armed forces and for export. Russia has about two-thirds of this infrastructure, Ukraine has about 15 percent, and the balance is scattered among the other new states. Russia alone retains a sufficiently broad R&D and manufacturing base to produce a full range of strategic and conventional weapons. Ukraine hosts some major arms factories, notably for production of naval surface combatants, strategic missiles, tanks, and transport aircraft, and several key R&D and test facilities. Although several important military plants are located outside Russia and Ukraine, no other State possesses the industrial infrastructure or economic resources to support major arms industries.

Cuts in military orders have left many defense enterprises in critical financial shape. Plants are continuing to operate by using reduced supplies, making barter transactions, and going deeper into debt. Thus far, defense industry has avoided mass unemployment and major labor unrest. However, even if the Yeltsin Government loosens credit, plants cannot continue to run up debt while turning out products no one intends to buy. Russian officials warn that up to two million defense industry workers could lose their jobs by the end of the year.

Despite the conversion programs and defense cuts of the Gorbachev era, little real progress in conversion has been made. Russia and Ukraine are just beginning to confront the enormous task of downsizing, restructuring, and converting the defense sector, a process that will take years and cost billions of rubles. Help from western governments and financial institutions will be important to this process, but successful conversion will depend much more on internal reforms and attracting private investment capital. Despite considerable activity, however, the defense industry has concluded few joint ventures and investment agreements with western firms. Foreign investors are inhibited by many remaining obstacles including: confusing and changing laws on property rights, repatriation of profits, and tax requirements; unclear and overlapping lines of government authority; and the unstable economic and financial environment.

Confronted with the prospect of widespread unemployment and the daunting economic and social costs involved in defense industry restructuring, the Russian government is reevaluating its strategy. In a concession to defense industrialists, who remain a potent political force, president Yeltsin has named former defense managers to key posts in his cabinet and appears ready to provide defense industry with credit and tax concessions, even if it means giving ground in the battle to reduce the budget deficit.

In addition, the Russian government is actively promoting foreign arms sales, seeing in them a means of generating much-needed hard currency and staving off unemployment in the defense sector. In a 24 February interview, President Yeltsin termed arms sales a "shock absorber" that will ease the impact of defense procurement cuts.

Russia, however, will face stiff competition in a shrinking world arms market. Arms deliveries from the former Soviet Union in 1991 were less than one-half the 1990 level, which followed a 30 percent decline from 1989. Moscow's concerted efforts to increase hard currency arms sales over the last several years has proved, for the most part, unsuccessful. In addition, the former soviet union slashed military grant aid in recent years, and the number of clients receiving major shipments of soviet arms has steadily declined. The perceived poor performance of Soviet-made equipment in the Gulf War

and the collapse of the former centralized arms sales apparatus have further aggravated Russia's marketing problems.

Russia will be by far the most important arms exporter among the Soviet successor states. To overcome buyer resistance, the Russians probably will offer more advanced systems—such as the SA-10 Surface-to-Air Missile System and Modern Fighter Aircraft—at lower prices, and will accept more barter deals. Ukraine may also be an important exporter of some systems, such as transport aircraft. For most former republics, their only realistic opportunity to enter the arms market is by selling off the equipment of CIS forces on their territory. Hard currency earnings from arms sales, even though limited, could provide a substantial financial boost to some ailing defense plants. However, arms sales alone will not provide sufficient capital to fund major defense industry conversion, nor can arms sales sustain the current size of the existing defense industry complex.

Russia has made only limited progress in convincing other CIS members to coordinate their military trade policies and is still in the process of establishing its own system for managing military sales. President Yeltsin and other CIS leaders recognize, however, that they must balance their efforts to sell arms with assurances to the west that they will control weapon exports and prevent proliferation. Government approval will no doubt be required for incurred in disposing of weapons that are obsolete or proscribed by arms control agreements and in cleaning up the associated environmental damage. A shortage of funds will also hinder the Russian military's ability to move away from a conscript-based force.

As the defense industry is exposed to market forces, it is losing much of its previous character as a highly integrated, centrally directed, protected sector with priority claims on the economy's most productive resources. Russia and Ukraine will retain a core of the most modern final assembly plants, component suppliers, and research and development facilities. For the majority of plants that do not fit into future procurement plans and cannot compete internationally, the government will have to begin the protracted, costly, and socially disruptive process of their restructuring or elimination.

In conclusion, there are great uncertainties and significant challenges in the years ahead. on the positive side, we see signs of economic, political, and military reform throughout the new States of the former soviet union. price decontrol, the beginnings of commercial enterprise, and the demilitarization of the economy are beginning to take hold. Free elections, political pluralism, and legislative participation in the policy process are growing features of the political landscape in much of the former Soviet Union. The military threat to the west has been dramatically reduced, and the new leaders see little need for large active armed forces. The Russian Government, however, is under increased pressure from defense industrialists to slow the pace of reform. Continued reductions in defense programs will be a key indicator that such reforms remain on track all legal sales. Nevertheless, the new States will have a more difficult time controlling arms transfers than their Soviet predecessors because many of the former controls over society have been removed, customs services as yet are largely ineffective, and a growing number of vendors are gaining direct access to the international market.

Russia has taken steps to prevent the unauthorized transfer of "special weapons" technology and expertise. Moscow and the west are actively cooperating to find

alternative projects for key Russian nuclear specialists. while several foreign powers are known to be seeking Russian nuclear weapons technology and expertise, we have no convincing evidence that they have succeeded. However, the difficult internal situation within Russia and other CIS States requires continued intense monitoring of the proliferation danger.

Outlook

The course of economic reform is inextricably linked to success in restructuring and downsizing the former Soviet military. The goal of Russia, Ukraine, and most other CIS members is to reduce the burden of military expenditures to 4 to 6 percent of their gross national product. Continued movement in that direction is essential to economic recovery.

The establishment of national militaries will consist primarily of radically downsizing and reorganizing the forces already in existence. The funds available for force modernization will be severely limited not only by the urgent needs of the civilian sector, but also by the major bills remaining to be paid for withdrawing and resettling former Soviet forces remaining in Germany, Poland, and the Baltic States. In addition, large costs will be incurred in disposing of weapons that are obsolete or proscribed by arms control agreements and in cleaning up the associated environmental damage. A shortage of funds will also hinder the Russian military's ability to move away from a conscript-based force.

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In conclusion, there are great uncertainties and significant challenges in the years ahead. On the positive side, we see signs of economic, political, and military reform throughout the new states of the former Soviet Union. Price decontrol, the beginnings of commercial enterprise, and the demilitarization of the economy are beginning to take hold. Free elections, political pluralism, and legislative participation in the policy process are growing features of the political landscape in much of the former Soviet Union. The military threat to the West has been dramatically reduced, and the new leaders see little need for large active armed forces. The Russian Government, however, is under increased pressure from defense industrialists to slow the pace of reform. Continued reductions in defense programs will be a key indicator that such reforms remain on track.

SENATOR BINGAMAN. Let me start and ask any of you first, Mr. McLaughlin, and then any of the others that would want to respond, do you have an estimate of the number of uniformed personnel who are being let out of the Russian military this year?

MR. MCLAUGHLIN. The initial reports, when the Russian ministry of defense was created in early May, indicated that a large number of officers would be mustered out. At one point, the figure of 600,000 officers was mentioned.

Since then, our impression is—and I have to say, the information on this is fragmentary—but our impression is that Russian military planners have stepped back from such a rapid demobilization for a variety of reasons.

In fact, as we look at Russian statements in recent weeks on the future strength of military forces, we've seen Defense Minister Grachev change his projection slightly. At one point some weeks ago, the common expectation was that Russia would strive for an overall force level of about 1.5 million by the middle of the decade.

In recent weeks, that figure has been walked back a bit, so the aim now is to achieve a level of about 1.5 million sometime toward the end of the decade.

SENATOR BINGAMAN. What was the high? What was the figure last year for the number of people in uniform?

MR. MCLAUGHLIN. We put the current number in the CIS between 2.5 and 3.0 million.

SENATOR BINGAMAN. So that would be from 2.5 to 3.0 million, down to 1.5.

MR. MCLAUGHLIN. Down to 1.5.

SENATOR BINGAMAN. And the question is whether that happens by the middle of the decade or by the end.

MR. MCLAUGHLIN. The current indications are that Russian military planning aims for the end of the decade rather than the middle.

I think that reflects a variety of factors, including the sheer difficulty of dismantling a military apparatus quickly, the financial costs associated with it, and, obviously, a lot of the social and political costs that would go with that kind of rapid demobilization.

SENATOR BINGAMAN. We met with Deputy Premier Gaydar when Senators Nunn, Lugar, Warner and I were there in March. He mentioned a figure of 700,000 people being let out of the military this year.

I assume that he was talking just about Russia; although he may have been talking about the CIS. They didn't have a Russian defense ministry at that time.

MR. MCLAUGHLIN. Not at that point.

SENATOR BINGAMAN. So I guess it was probably the CIS, generally.

But what you're saying is not too inconsistent with that, I guess.

MR. MCLAUGHLIN. Our impression is that they're slowing the pace of that, and they're not going to move to demobilize that many that

rapidly, although I don't think we have a crystal clear estimate, which would have a lot of confidence in, about the pace of demobilization, except that it would be somewhat slower than that.

SENATOR BINGAMAN. Ms. Horste, did you have a different view?

MS. HORSTE. I agree with MR. MCLAUGHLIN. The only point that I would add would be that, the comments you got from Mr. Gaydar, which were reflecting a more rapid decline in the size of the Soviet military, and Mr. McLaughlin's point that Russian defense officials are trying to slow that pace, are an example of exactly the process we're seeing.

The latest numbers that we've seen are a reduction of about 600,000 by 1995, as opposed to within one year, which we were hearing from civilian officials earlier in the year.

There is clearly tension between the political side and the defense ministry leadership, as well as the legislative process. Legislators will weigh in on that as well.

I think we'll probably see some compromise between the very rapid decline and the defense ministry's desire to slow that down.

SENATOR BINGAMAN. Let me ask also about procurement. I think one of the more startling figures in your report on Moscow's defense spending cuts is this statement that the Russian legislature approved a first-quarter defense budget that cut overall procurement spending on the order of 85 percent.

That also is consistent with what Mr. Gaydar said about what they were intending to try to do this year. I think he gave us a figure that they were spending 14 percent as much as they did last year on procurement, and they thought that might go up to as much as 25 percent.

Is that in the ballpark? Do we really have that kind of dramatic elimination of procurement spending within the CIS?

MR. MCLAUGHLIN. Yes, there has been a dramatic drop in procurement, and we have seen weapons production go down across-the-board over the last year.

I think, between 1988 and 1991, we could document about a 40 percent drop in weapons, a range of somewhere between 30 and 70 percent in terms of the drop in weapons production. This was most pronounced in the land arms—artillery, armored vehicles, and so forth. But there has also been a drop in military production of other kinds of weaponry. The production of aircraft was cut in half, for example. The production of ballistic missiles has fallen. Certain categories of weaponry have stopped production. The figures you cite for 1992 are generally consistent with the trends we're seeing.

SENATOR BINGAMAN. Do we have an estimate as to the percentage of the work force in Russia and these other republics—that is, particularly Russia and Ukraine, since that's where the bulk of the defense industry is—the percentage of the work force in those two countries that is engaged in defense-related production?

MR. MCLAUGHLIN. Let me ask one of my colleagues to come forward and venture an answer on that one.

This is Mr. Jim Steiner.

MR. STEINER. I haven't seen you since I briefed you in March before you went out to Russia and Ukraine.

SENATOR BINGAMAN. Right.

MR. STEINER. The defense complex to the former Soviet Union accounted for about 15 to 17 percent of GNP, over 20 percent of industrial production, roughly 40 percent of the machine-building complex, which also produced producer durables and consumer goods.

The estimates of the size of defense industry vary widely. We see 3,000 to 5,000 plants, about 1,500 R&D facilities. Most estimates are in the range of 8 to 10 million workers in the entire defense complex in 1988.

Antonov—the Ukrainian in charge of defense industry and conversion—claims about a million workers in defense industry. In Russia, it's probably five to eight million. But there are many definitional problems and I wouldn't look for too much precision.

The bottom line is that their defense complex in their economy weighs three to four times larger than the defense complex in most industrialized western economies, and that's why conversion is such a critical issue for them.

SENATOR BINGAMAN. As the procurement budget has dropped in Russia and in Ukraine, 3,000 to 5,000 factories, which you referred to, are no longer producing anything, at least in some cases, and in some cases, they are still producing but at a much lower level.

Are there revenues going to support the workers in those facilities even though they're not selling anything?

MR. STEINER. You've put your finger right on probably the critical issue in defense industry right now. With the primary customer—the domestic military—slashing its orders, one would expect the defense complex to be in a state of financial ruin and going bankrupt. But we're not seeing that. We're not seeing massive lay-offs at defense plants, although, anecdotally, we are beginning to see a little bit of it now.

A couple of factors have helped defense industry buffer itself from having to engage in layoffs. First and foremost, they are borrowing massively from banks. Defense plants—

SENATOR BINGAMAN. The defense industries themselves—

MR. STEINER. The individual plants.

SENATOR BINGAMAN. —are borrowing.

MR. STEINER. Yes. In many cases, the individual plants actually have banks that are directly associated. They're a part of the enterprise itself. It goes back to the very different nature of their defense enterprises. It's almost a feudal approach, in that a defense plant is not only a plant, but it's also the apartment blocks, the schools, stores. It can be the entire social infrastructure.

What that means is that there are banks that are co-located with the plants and, in many cases, plant managers go to the bank when they have a payroll to meet, and the banks just provide them with the rubles.

SENATOR BINGAMAN. Did anyone else have a comment on that set of questions?

Mr. McLaughlin?

MR. MCLAUGHLIN. What Mr. Steiner has said, of course, is that there has been minimal progress in converting any of these plants to civilian production. And the problems go beyond even those he suggested, to include the fact that plant managers lack managerial expertise. They lack training and experience in producing for a civilian market or gearing production to market conditions, as opposed to production for state orders.

To date, we've seen minimal progress in this sphere. It's a major challenge for Yel'tsin and one that he'll have to overcome.

SENATOR BINGAMAN. I guess that, from an economic perspective, the difficulty that they have is both the Russian and Ukrainian leadership—if you have all these people on the payroll in the military and also are continuing to provide some level of support for defense plants, then you need substantial revenue to keep that going.

MR. MCLAUGHLIN. That's right.

SENATOR BINGAMAN. You either print money and experience inflation or you lay people off. And that's the horns of the dilemma that they're on.

Is that accurate?

MR. MCLAUGHLIN. Yes. I think that one of the principal problems for the Yel'tsin government, in its efforts to do what it must do in order to make reform succeed, to keep credit tight and the budget deficit down. Even though they have made some progress in this area, one of the principal pressures, and perhaps the principal one at the moment, comes from the direction of declining defense production that continues to demand high subsidies. This is a tightrope that President Yel'tsin will have to walk.

SENATOR BINGAMAN. Let me ask you about the status of our own efforts to assist. We passed some legislation last year in the Congress, I think, earmarking $400 million in the defense legislation for use in assisting with decommissioning of nuclear weapons.

How much of that has been expended to date, as far as you're aware?

MR. MCLAUGHLIN. I can't give you a figure on how much of that has been expended to date.

It is our impression that everything is in place to go ahead with decommissioning and destruction of those missiles. But I can't at this point put a figure on the amount that's been disbursed so far.

SENATOR BINGAMAN. OK. Maybe your answer implies the answer to this, too.

Do you know if there have been amounts that have been committed or expended by our government to assist in the maintenance of Soviet R&D activities, or keeping those scientists from being unemployed?

There's some statement, perhaps in Ms. Horste's statement, about efforts to find alternative projects. Perhaps that was in yours, Mr. McLaughlin.

Mr. McLaughlin. My impression, Mr. Chairman, is that the bulk of the aid or assistance that has been committed to the former Soviet Union has gone for other purposes.

If we looked at 1991, for example, there was a total of about $7 billion in humanitarian and food aid earmarked for the former Soviet Union and about half of that came from the United States. Now, in the run-up to the G-7 Summit in July, about $24 billion has been earmarked by the G-7 and other countries, contingent upon IMF approval of a Russian reform program.

I can elaborate on the breakdown of that intended assistance, if you wish, and other assistance that has been earmarked for the Soviet—

Senator Bingaman. This is the humanitarian assistance you're referring to?

Mr. McLaughlin. No. The $24 billion that has been earmarked by the G-7, which has not yet been disbursed, of course, and will not be until the IMF approves its disbursal, is based mainly on criteria that concern the level of the budget deficit and so forth.

That $24 billion consists of $10 billion that is earmarked for two things: A $6 billion fund to stabilize the ruble and lead toward convertability of the ruble, and a fund of about $4 to $5 billion that is earmarked for critical imports—humanitarian assistance. It's that part from which humanitarian assistance would come. The remaining $13 to $14 billion is aid that had been programmed by various countries for the former Soviet Union. That has now been reprogrammed for Russia.

That is the principal aid that is on the table now for consideration, but has not yet been disbursed.

Senator Bingaman. OK.

Ms. Horste. If I could add something to that. Regarding the $400 million in aid to assist in the nuclear dismantlement effort, Secretary Cheney's office would be the appropriate place to direct that question, and we can get some information for you on precisely how much has been obligated so far. But the Defense Department is examining setting up joint science centers in both Kiev and Moscow for the employment of former Soviet nuclear scientists, as well as a variety of other kinds of assistance to help them in the dismantlement of their weapons.

Senator Bingaman. Let me get any statement that you could give me about the prospects for this unitary CIS military command. Is that a dead letter at this point or does that still have any viability?

Mr. McLaughlin. I'm sure Ms. Horste has something to add to this, but essentially the state of that is that it does exist, but in our judgment,

it is of declining relevance as the individual republics proceed along the path of defining and establishing their own militaries. And that's a subject that we might discuss in more detail in a closed session.

SENATOR BINGAMAN. Ms. Horste, did you have anything?

MS. HORSTE. The only point I would add to Mr. McLaughlin's is to make a distinction between the strategic nuclear forces and the general purpose forces.

On the strategic side, the Commonwealth member states, particularly the four states that host nuclear weapons, all appear to be committed to joint command arrangements.

On the general purpose or the conventional forces side, you're exactly right. There appears to be very little interest by most states in retaining some sort of joint conventional forces command.

However, the Central Asian states, as I mentioned in my statement, are interested in retaining defense agreements with Russia. Russia has signed defense security bilateral treaties with most of the Central Asian states. And I think the important point is that the Central Asian states really don't have the economic wherewithal to support military forces and, therefore, will continue to rely on Russia for their own security.

SENATOR BINGAMAN. There was an article in the *Washington Post* a few days ago talking about the views of a new deputy premier, Vladimir Shumeyko. The speculation, as I understand the article, is that he is much less committed to rapid reform than Mr. Gaydar has become identified with.

Is that your perception of things, Mr. McLaughlin?

MR. MCLAUGHLIN. Yes. Generally, that's correct.

Mr. Shumeyko has now achieved a rank equal to that of Mr. Gaydar. He is an individual who, prior to being appointed to that post, was among those who spoke in favor of easing the restrictions on subsidies and support for the defense industrial complex.

So his positions up to this point have not been ones that would favor the rigorous adherence to tight budgets and monetary policy and credit policy that President Yel'tsin and Mr. Gaydar have followed until now.

So, in that sense, the *Post* article is probably correct in saying that, all things considered, it would be better if these views were not represented at that high level in the Russian Government.

Having said that, though, that's from a purely economic point of view, one of the points I underlined in my testimony has to be underlined here—that, in judging the economic performance and policies of Russia these days, we have to factor political calculations into those judgments to a higher degree than in the past.

My speculation would be that Mr. Yel'tsin, in moving a spokesman for this point of view into the upper reaches of his government, is making a political calculation, that to do so will bring that point of view into the government and, hopefully, move in the direction of co-opting

it and making it part of the process rather than having it represented as an outside opposing point of view.

My speculation would be that that's his calculation. But it is, as I think the *Post* article suggested, one that carries many risks, which is generally true of most of the choices that President Yel'tsin has to make in these difficult circumstances.

SENATOR BINGAMAN. I think you're right in pointing out the very difficult tightrope that he's walking between what's demanded of him in terms of good economics and what is required of him in terms of the political realities that he faces and the need to maintain some subsidies going, particularly of the military and defense industry and others in the economy.

Do we have a situation where the IMF may hold him to a standard that doesn't permit those political tradeoffs in the way he sees them?

Are we going to have a situation where the IMF says that they can't certify and provide the $24 billion of aid because he's taking actions that are politically expedient in his view?

MR. MCLAUGHLIN. I can give you some thoughts on that, but I think the bottom line answer to that, of course, would have to come from the IMF itself.

But, clearly, they will apply a stringent standard to Mr. Yel'tsin's performance. If you were to look at the entire range of his economic program at this point, you would have to say that he is doing reasonably well. He has freed most prices. He is following a budget policy that is, arguably, more stringent than anything we saw under the Soviet Government. The first quarter budget has shown some real restraint—the first quarter of 1992—and it's definitely moving in the right direction.

On the other hand, there has been little progress on certain other aspects of the reform program. Privatization, for example, there we see, perhaps, 1t percent of retail firms privatized so far and maybe two percent of agriculture privatized.

But, on the other hand, he has what looks like a sensible approach of aiming to privatize 50 to 70 percent of small businesses in the next year and to move into larger businesses by 1993.

And one could go on, looking at different aspects of his program. The scorecard is mixed, and this is early days. He's only been doing this since January. But so far, he's doing reasonably well. We will see him increasingly, as I indicated in my testimony, tacking back and forth between adherence to stringent policies and the need to make concessions to maintain a political consensus.

To return to your question, I cannot tell you what the IMF's judgment will be, but it is their judgment to make and not ours.

SENATOR BINGAMAN. OK. There was a lot of talk when we had our hearing a year ago, and all through last year, about the impending winter food crisis that was expected in these republics, and then in the Soviet Union.

That never materialized. I notice in this statement, you're saying that production is going to continue to decline.

When we were in Ukraine three months ago, there were reports that they were not planting as they usually would because of shortages of gas to run the tractors.

Do we have any way to look ahead toward this winter and make any kind of estimate as to whether there will be a crisis this winter in food?

MR. MCLAUGHLIN. I would reserve our detailed statements on that for a closed session. But I can say that, based on what we have done in the way of work along those lines, we would anticipate that food supplies over the next year will be tight but adequate, and the key assumption in that analysis is that weather conditions do not deteriorate markedly.

I can comment, if you wish, on the situation last winter as well.

SENATOR BINGAMAN. Go ahead.

MR. MCLAUGHLIN. Last winter was a difficult period. I might just underline that, while there was a lot of public speculation about the potential for a widespread food crisis, I think a close examination of what the intelligence community has said would show that we did not, in our assessments of the winter, foresee a food crisis of such a magnitude as to bring widespread starvation.

There were pockets of shortage last winter and these were felt most acutely in certain areas—some of the Central Asian, caucuses republics, where ethnic turmoil disrupted supply lines and elderly people and pensioners felt a shortage of food.

But a number of factors I think combined to make the winter less severe than some observers anticipated.

First, heading into the winter, we now know that there was substantial hoarding of foodstocks, and that helped people get through.

In January, as you know, President Yel'tsin liberalized prices substantially on about, 90 percent of retail goods, and this led to a rise of about 250 percent in prices. It also brought more goods onto the shelves. So, while they were more expensive, that had the ironic result of discouraging hoarding. Some people had hoarded and had stocks, and others who hadn't were able to find things on the shelves, although at higher prices.

As you know, the distribution system in what was the Soviet Union was not very efficient. President Yel'tsin made some effective moves in the course of the winter, costly but effective, to make sure that the distribution system was not as inefficient as it might otherwise have been.

There were many threats of strikes by transport workers and those did not materialize in the magnitude that most anticipated, largely because wage increases were granted. So the distribution system worked somewhat better than some people anticipated.

Add to that the fact that imports to the Commonwealth and humanitarian assistance increased somewhat over the winter. As you'll recall, I noted earlier that there was about $7 billion worth of humanitarian

assistance, including $3 billion from the United States. While the impact of this may not have been dramatic, it was very important in certain areas.

SENATOR BINGAMAN. Let me ask on Eastern Europe. In Poland, the government there engaged in this so-called shock therapy approach to their transition.

Can you draw any generalizations, based on the experience that Poland had, about that approach? Or are the circumstances in each of those countries so distinct that there's really no lesson to be drawn from the difficulties they encountered in Poland?

MR. MCLAUGHLIN. The shock therapy that Poland followed has been a model—if you will—for many of the reformers in the Commonwealth of Independent States.

President Yel'tsin's program bears some resemblance to the shock therapy that was practiced in Poland, particularly the aspect of immediate liberalization of prices and slashing of budget deficits.

But, while Poland has provided an important model, there are some major differences, though, that limit the effectiveness of what we call in Poland shock therapy, limit the effectiveness of that approach in Russia.

One thing is, of course, that Poland was burdened with nothing like the defense industrial complex that burdens Russia and Ukraine, in particular, and therefore, the problem of converting massive defense spending to civilian spending did not exist to the same degree in Poland.

The second major difference is that in Poland there was for a long time a thriving private agricultural sector that did not exist at all in the former Soviet Union.

So Poland essentially embarked on this path with many more advantages. Also the advantage, of course, of being smaller about 36 million people and the advantage of a more homogenous society, as opposed to the perhaps less cohesive society that we see in Russia.

Shock therapy also, I might add, is sometimes an overdrawn term, in that it implies a strategy for changing overnight the structure of the economy, when, in fact, as practiced in Poland and as it is now being practiced in Russia, it really, as effective as it may be, lays the basis for an ultimate restructuring of society.

Essentially, the steps we've outlined here, and that Poland has followed, stabilized the economy. One lesson for Russia is that the hard part of shock therapy lies ahead, the hard part being privatization—the creation of laws and institutions that can make a market economy work.

The criminal code in Russia, for example, is yet to be modified as completely as it must be in order to get rid of provisions that still make some forms of entrepreneurship illegal.

So that all of that lies ahead.

The other lesson for Russia, I believe, out of Poland is, as our testimony indicated, the political turmoil and fractionalization that can be generated by shock therapy.

President Yel'tsin has been on this course in Russia for just a few months now, and he is probably heading into a period where he will be buffeted by more serious political pressures than the Polish Government has been over the last two years.

SENATOR BINGAMAN. Let me ask about one other subject, and that is this black market that's developing in arms exports.

You make a reference, I think, in your statement to the gray and black market entrepreneurs appearing in the arms export business.

Could you elaborate a little bit on what we're talking about there? Who are they selling arms to? How does that develop? And is it a serious problem in that we need to concern ourselves with?

MR. MCLAUGHLIN. Well, the sale of arms and their control will clearly remain a top priority for those of us in the intelligence business.

As you look at the arms sale picture in what was the Soviet Union, clearly, arms sales are clearly dropping. The amount of hard currency that the Russian Government, and the Ukrainian Government can earn through arms sales is also dropping for a variety of reasons. Principally because most of the traditional customers for arms sales out of these economies are Third World customers who do not have adequate supplies of hard currency.

Most hard currency buyers—it is our impression—are more interested in Western systems, or are already committed to Western systems.

So there has been, in fact, a 50-percent drop in arms sales by the former Soviet Union over the last year. That said, there are some dangers here, substantial dangers in that President Yel'tsin and others in the former Soviet Union and in the new Commonwealth states have made clear their support for arms sales for a variety of reasons.

President Yel'tsin has made clear, for example, that he sees arms sales as a major source of revenue to be used in converting defense plants to civilian industries. And assurances have been given that sensitive technologies will not be sold.

But having said that, it must also be noted that control policies for managing the export of sensitive technologies, export control regimes, are new and untested. And we believe that there are some dangers here that we will have to monitor very closely.

There is certainly no shortage of interested buyers in equipment from the former Soviet Union. Commonwealth officials have made clear their willingness to sell some of the most sensitive stocks of weaponry they have, including advanced combat aircraft and surface-to-air missiles.

So, while we cannot yet document sales of weaponry like this, that would have negative consequences, there certainly are dangers there,

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and it's something that we have under very close watch, and we would be glad to elaborate on either in closed session or in answers that we would submit to you following this hearing.

SENATOR BINGAMAN. Let me ask one other question that occurred to me.

In looking at your report on Moscow defense spending cuts accelerate, you have a couple of charts, a little ways into it, estimating Soviet spending for defense activities, 1985 through 1991, and then a similar chart for 1970 through 1991.

It seemed to me, in the statement in the text, you're saying that procurement is dropping more rapidly in percentage terms than defense is overall. But the chart seems to reflect the opposite. And that was the confusion I had.

MR. MCLAUGHLIN. I may ask one of my colleagues to comment on that. But let me preface that by saying, to set the context here, our estimates in these areas—defense spending and procurement—must be bounded these days by wider bands of uncertainty than in the past.

That is why, in our testimony, for example, we indicated that the band of possibilities for defense spending, as we look at its drop from 1990 to 1991 levels, would be roughly 10 to 25 percent.

For a variety of reasons that we could elaborate on, we select a range of about 15 percent.

If you look back over several years to 1988, for example, we're reasonably confident that, in that period of time, we think Soviet defense spending fell by about 25 percent.

To give you some sense of the uncertainty as we look ahead—before I ask my colleague to relate procurement to defense—and we try to gauge why it is that we think defense spending will continue to fall, I'd like to describe some of the uncertainties we deal with.

The defense budget negotiated for 1992 among the Commonwealth states indicates that about 60 percent of that burden will be borne by Russia, the remaining 40 percent by the other Commonwealth states.

We already see signs that the other Commonwealth states will not bear that portion of the burden. The Ukraine has made that particularly clear.

So, while we can't yet put a figure on it, it's clear that the Commonwealth defense budget for 1992 will not be what it was intended to be, and the draft budget submitted to the Russian parliament for the Commonwealth was already roughly a 50 percent drop from the 1991 Soviet budget.

So we're looking at a fairly steep decline in the next year.

Also, Russian officials tell us, or tell the world, that their aim is to have defense spending ultimately be roughly 4 to 6 percent of GNP.

Now, as you'll recall, the estimates that we gave in the past for Soviet defense spending were that it accounted for roughly 15 to 17 percent of GNP. So they're aiming for a lower proportion of GNP.

But I think that you can see from that recitation of the factors surrounding the defense budgeting and spending estimates these days that we are working with a higher level of uncertainty.

Just to put a final point on that, this does not mean that we have declining confidence in our ultimately ability to say what CIS defense spending is. But we will have to, as in the past, work back from a physical assessment of what they have produced and what they have deployed to gauge their spending.

We also think—again, I can't exaggerate the uncertainty surrounding all of this, or the unpredictability in this part of the world at the moment—if one were to project present trends forward, including increasing parliamentary interest in defense budgets in Russia, it's reasonable to assume that Russian and CIS defense budgets will become somewhat more transparent in the years ahead, and that should add to our ability to monitor them.

Now, at that, let me stop and ask my colleague, Mr. Steiner, to elaborate a bit on your question about the chart.

MR. STEINER. Yes, sir. I think that what we have is a bit of an optical illusion. In point of fact, total spending does decline more in absolute terms. In 1982 prices, the total moves from about 120 billion rubles at its peak in 1988 to about 90 billion rubles in 1991. That's a 30-billion ruble decline over a 120-billion ruble base, so it's about a 25-percent decline.

Procurement, on the other hand, declines from a peak of about 50 billion rubles in 1988 to about 33 billion rubles in 1991. It's a decline of about 17 billion rubles, but the base is only 50 billion, so you get a decline of about a third in percentage terms.

You've noted the same thing that we saw when we plotted this out, and it is really no more than an optical illusion, having to do with the size of the base.

SENATOR BINGAMAN. OK.

MS. HORSTE. If I could also add to that discussion, I think an important criteria to look at is the military burden as opposed to just the numbers and estimates of spending.

Our community estimate is that spending fell by about 15 percent last year, but the economy in the former Soviet Union also shrunk by somewhere around 15 to 20 percent. So, really, the burden of defense on the economy has stayed about the same.

What they need to do is to reduce spending more than the economy is reduced, such that the burden of defense actually goes down, which is the goal of Gaydar and President Yel'tsin.

SENATOR BINGAMAN. Let me see if I'm correct, though. The states that are toward the end of this about expectations on procurement in 1992, if those expectations are borne out, then we would see a major dropoff in these charts in 1992.

We're no longer talking about a 15 percent decline. We're talking about more than 50 percent decline in procurement, substantially more than 50 percent decline, maybe 85 percent decline in procurement in a single year.

Am I reading that right?

MS. HORSTE. Yes, that's correct. Our estimates range anywhere from 60 to 85 percent cut in procurement. And the 85 percent—the high end—is assuming that the non-Russian CIS member states do not contribute to the overall budget—it's increasingly likely they will not do that.

SENATOR BINGAMAN. OK. I think this is very useful information. I appreciate the reports very much.

Thank you all for testifying.

[Whereupon, at 3:30 p.m., the Subcommittee adjourned, subject to the call of the Chair.]

CIA REPORT ON CHINA'S ECONOMY

MONDAY, JULY 27, 1992

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TECHNOLOGY AND NATIONAL SECURITY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:33 p.m., in room SD–628, Dirksen Senate Office Building, Honorable Jeff Bingaman (chairman of the Subcommittee) presiding.

Present: Senator Bingaman.

Also present: Richard F Kaufman, General Counsel.

OPENING STATEMENT OF SENATOR BINGAMAN, CHAIRMAN

SENATOR BINGMAN. We're very pleased to open this year's annual review of the economy of China. The Subcommittee on Technology and National Security has been conducting these annual reviews for many years with the intention of improving our knowledge of the economic trends in that important country.

In recent years, U.S. trade with China has increased tremendously. But there is a disparity in our respective trade policies that mars our economic relations. The United States has opened its doors to Chinese goods, and we are now that country's primary export market. But China restricts foreign access to its own markets.

The serious bilateral imbalance in our trade is in large measure the result of China's protectionist policies. China has taken some actions in response to U.S. pressures for access to its markets, but these measures have so far been too slow and too limited to correct the imbalance or to even change the trend. The U.S. trade deficit with China was $12.7 billion in 1991, and most experts expect the figure to rise to over $15 billion this year.

The latest report by the CIA, and reports from other sources, suggest that China will continue to pursue an export-led growth strategy while restricting imports.

With us this afternoon are spokesmen from the CIA to discuss their latest report and to respond to questions are Martin Petersen, Deputy Director of the Office of East Asian Analysis; and Lee Zinser, who is the Deputy Chief of the China Division of the Office of East Asian Analysis.

Gentlemen, welcome. Thank you for being here. Why don't you proceed in whatever order you would like and for as long as you would like, and then I'll have a few questions.

STATEMENT OF MARTIN PETERSEN, DEPUTY DIRECTOR, OFFICE OF EAST ASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

MR. PETERSEN. Thank you, Mr. Chairman, and good afternoon. It's a pleasure to be here and to discuss China's economy. I believe you have a copy of our paper.

I'd like to call your attention to the appendices. As usual, there is a reform chronology and a discussion of China's bilateral trade relations. This year, we've added a short discussion on China's environmental problems and a brief tutorial on the difficulties of telling what is public and what is private in China's economy.

The thrust of our report this year is that Deng Xiaoping is once again pressing forward with economic reform, but he faces significant opposition. The reform measures being discussed risk overheating the economy.

I'll cover four broad topics in my remarks. I'll start by putting the current reform drive in perspective. Then, I'll discuss the reasons why Deng is trying to revive reform. I'll follow with a review of China's economic performance last year and then with the impact that Deng's initiatives have had so far this year. Finally, I'll point out some of the risks in reform and offer some tentative conclusions about the significance in the latest reform drive.

To understand this year's reform push, it's necessary to place it in the context of China's experiments with reform-oriented policies. China began its economic effort in the late 1970s to deal with the legacy of the Cultural Revolution. Official Chinese statistics themselves indicate that labor productivity grew only 1 percent a year in the period from 1967 to 1977, and living standards fell far behind China's market-oriented East Asian neighbors.

Deng and the other leaders who took over after Mao died believed that the survival of the Communist Party depended on raising living standards. They concluded that the fastest way to speed up development was to loosen central control over the economy and to give a role to market forces.

China's reform effort is now 13 years old and is characterized by five enduring features.

First, there has never been a blueprint or comprehensive plan for economic reform. Instead, the Chinese have relied on a pragmatic trial and error approach. They try something on a limited basis and expand it if it works.

Second, the politics of reform have been highly personalized. Although all of China's top leaders have rejected the Maoist approach, there has always been a significant disagreement about how far reform should go and what the ultimate objective of reform should be. Thus, progress on reform has depended on the relative political strength of the top leaders, especially Deng Xiaoping.

Third, the implementation of reforms has varied widely from region to region. This is partly because reformers have encouraged local experimentation and partly because they've gone directly to the grassroots level to overcome entrenched bureaucratic opposition.

Fourth, Chinese leaders are intent on implementing economic reform without political reform. Deng sees economic reform as a way to restore legitimacy to the Communist Party and to preserve the current political structure.

Fifth, Chinese reformers have been unable to construct an ideological justification for reform that is consistent with Marxism. The significance of this is that it leaves them vulnerable to orthodox critics when reform-related problems with inflation or unemployment arise.

The Chinese approach to reform worked very well in agriculture, but results have been far more mixed in the urban sector. Indeed, the history of Chinese economic reform experience is one of cycles: periods of reform, followed by retrenchment or retreat.

In periods of reform, Beijing typically has reduced the role of central planning, given more authority to managers of state enterprises, and encouraged private enterprise.

Typically, this has led to rapid growth, rising inflation, widening trade deficits, followed by administrative controls and slower growth.

The last such cycle began in 1988 when excessive growth in the money supply coincided with discussions of price reform. Inflation reached 30 percent annual rates in some cities. And as we reported in our 1989 testimony, Beijing put on the brakes. It placed key price and enterprise reforms on hold and implemented retrenchment policies that caused a sharp economic slump.

The Tiananmen demonstrations in the spring of 1989 reinforced the move to a more orthodox economic policy. Orthodox leaders pointed to the demonstrations as evidence that reforms had gone too far too fast. The real cause, in our judgment, of course, had more to do with the lack of political reform than with an excess of economic reform.

There has been much popular resentment, however, about some of the side effects of reform. The man in the street was especially angry with party officials for using reform opportunities to pursue corruption and secure cushy jobs for their children.

In the wake of Tiananmen, orthodox leaders took control of economic policy; and, for the last two years, they have tried to revive economic growth by giving preferences to state enterprises and easing credit. As we discussed last year, this has revived the economy, but has compounded problems with large inefficiencies in the state sector.

China is now entering into a new cycle of reform. It kicked off in January when Deng personally intervened to expand the use of market forces in the economy. He did this by visiting Guangdong Province and praising local officials who have resisted the more orthodox policies of the last few years. Typically, Deng did not announce a comprehensive

program. Rather, he called on local officials to experiment more with local markets, and he stressed that markets are not synonymous with capitalism.

According to press reports, party guidance issued this spring has called for a new round of reform, and has even argued that markets should play the dominant role in the economy.

We believe that there are three reasons why Deng launched the new reform effort.

The first factor was the disintegration of the Soviet Union last year. Apparently, there's a sharp debate in the leadership over the reasons for the collapse of the Soviet Union. Now, surprisingly, orthodox leaders claim Soviet reforms are the cause, and they advocate even greater ideological orthodoxy and economic recentralization.

Deng reportedly is arguing that the failure to complete economic reform led to the Soviet collapse and that China must pick up the pace of reform while maintaining political control. We believe that his southern tour was an attempt to build public pressure for reform and to counter the grip of orthodox leaders on the central government and media.

The second factor is that the political stakes are rising in Beijing. The 14th Party Congress will be held in the fall. It will appoint a new central committee and politburo. And it will probably endorse a new economic policy statement. This may be the last opportunity for China's elderly leaders to put their imprints on China's future. These congresses generally are held every five years.

The third factor is that the ill health of some of the orthodox leaders may have created a window of opportunity for Deng's more pragmatic views. In the last month or so, former president Li Xiannian and Zhou Enlai's widow, Deng Yingchao, have passed away. Both supported a more orthodox approach to economic policy.

Thus, political factors rather than economic factors are behind Deng's determination to accelerate reform. Indeed, unlike the former Soviet Union, economic conditions in China are not sharply deteriorating. Indeed, in 1991, China's real GNP grew 7 percent, and its gross industrial output climbed 14 percent.

Allow me to interject a word on the reliability of official Chinese statistics. As we have noted before, there are problems in how some of these numbers are derived. Collection techniques are inexact, and local officials sometimes deliberately distort data. For example, official inflation rates must be treated with caution because they tend to understate inflation when it's rising. And official defense spending numbers may capture less than half of total defense expenditures. That said, we believe Chinese statistics generally reflect trends in the economy.

As you may recall in our 1989 Report, there is a detailed discussion of the problems involving using Chinese data. Whenever possible, we have relied on partner trade data in our discussion of China's trade

performance. Unless otherwise specified, however, all the numbers in this Report are based on official Chinese statistics.

China's economy registered strong growth in 1991 for three reasons.

First, as we reported last year, Beijing opened the credit spigots, in part to shore up large state enterprises running deficits.

Second, the sector of the economy outside of Beijing's control did well. Industrial output from locally run enterprises increased 18 percent, while that from private firms grew 26 percent and that from foreign-invested firms climbed 56 percent. This illustrates that local officials have been able to circumvent the Center's attempts to tip more resources to the state sector.

Third, rapidly growing exports helped fuel domestic growth. Exports last year grew 16 percent to $72 billion. This made China the 13th largest exporter in the world.

China's external finances are also healthy. China's strong export growth allowed it to absorb a 20 percent increase in imports last year and to still post an $8 billion trade surplus. Consequently, by the end of 1991, China's foreign exchange holdings reached a record of almost $43 billion, up $14 billion from 1990.

Deng and his supporters realize that this growth masks some real problems, and it cannot be sustained without answering the serious shortcoming in China's state sector.

Chinese officials acknowledge that more than a third of the state firms are losing money. Their weak performance contributed to a record budget deficit of more than $12 billion last year.

The true magnitude of the deficit is probably even greater. Beijing has used preferential loans from state banks to help some enterprises meet their tax obligations and others to remain afloat.

Some of the reforms being pushed are designed to improve the performance of the state sector. Hong Kong and Western press reports indicate that some regions are experimenting with labor reforms. These would allow enterprises to lay off unneeded workers. Besides more power over hiring decisions, Beijing is allowing some enterprise managers greater flexibility in setting production and investment schedules.

Some reforms are focused on soaking up excess liquidity. This would make it easier for the government to fund its budget deficit in a noninflationary way. For example, Beijing is trying limited experiments with local stock markets and retail channels for selling treasury bonds. This year, Shanghai began selling China's first stocks to foreigners and is preparing to open a futures market.

Other reforms allow inland provinces to open free trade zones. They can offer preferential tax, tariff, and export rights similar to those rights held by China's coastal special economic zones.

The reforms Deng is pushing are essentially a license to experiment. Deng probably hopes that local leaders will copy their successful

neighbors and that a common development model will emerge. This is what happened with the agricultural reforms of the early 1980s.

Deng is also encouraging local leaders to look beyond China for models. Earlier this year, he challenged export-oriented Guangdong Province to become Asia's fifth "little dragon" behind Hong Kong, Taiwan, Singapore, and South Korea.

Deng's reform push is encountering significant opposition from central officials and bureaucracies with a large stake in the old system. But the local reaction has been enthusiastic in some areas. For example, many cities have expressed interest in opening their own stock markets. Localities have also uniformly embraced the opportunity to attract more foreign investment. They also welcome the chance to have more control over import decisions.

We believe this locally focused reform strategy, however, carries a risk of economic and social spillovers that could damage public support for reform. The first risk is that local enthusiasm for high-growth policies will overheat the economy and boost inflation. This has happened every time Beijing has initiated a new cycle of reform, and there are indications that it's happening again. Official statistics indicate that in the first quarter of this year, investment by local governments jumped 52 percent. New construction projects doubled in the first two months of the year, compared to the same period of last year.

As a result, industrial output rose at an 18 percent annual rate in the first half of this year. The Chinese are now predicting that real GNP will grow at double digit rates this year. China's urban inflation rate has already reached double digits in the first five months of this year after rising in low single digits last year.

So far, most urban workers are being shielded from its effects. Wages rose at a 13 percent rate in the first quarter after adjusting for inflation.

A second risk is that workers will resist efforts to trim excess workers, or declare inefficient state firms bankrupt. We are already seeing press reports of isolated incidents of worker unrest in factories trying to implement labor reforms. A People's Daily Report in May appealed for worker cooperation in implementing labor reforms.

A third risk is that managers and officials will conclude that the cycle of reform will not last. If so, they may exploit reform loopholes to earn windfall profits, contributing to growing public perception of official corruption and resentment of income inequalities.

To tie all this together, market-oriented reforms are being pressed with more vigor than at any time since 1988. But the reform offensive is young and it may yet stall. Whatever exact course it takes, past experience suggests a number of things.

The first is that it's unlikely that reformers can avoid China's boom and bust cycles. Good harvests over the past few years and large foreign exchange holdings provide some buffer against inflation, and financial reforms will soak up some liquidity.

But China's inability to come to grips with the need to allow widespread state-sector bankruptcies means that factory managers will once again increase wages and investment spending excessively. That plus high local capital construction spending probably means that inflation will rise.

Our second point is that China's leadership is far from untied over this reform drive. Repeated warnings in the press about "leftism" suggests that there is substantial opposition to accelerated market reform in the party. As they have in the past, reform opponents will try to use the dislocations associated with reform to discredit the effort.

Our third point is that this kind of reform is likely to lead China further down the road toward a market economy. This will not prevent retrenchment if problems arise, such as inflation or a sharply deteriorating trade balance. But it may lead orthodox leaders to experiment with new forms of administrative control. It's clear even to them that traditional central planning strategies are not solving the problem of large state enterprises. Orthodox leaders are supporting the creation of large industrial groups of state enterprises, modeled loosely on the Japanese keiretsu system.

Another implication is that this reform drive is likely to leave localities with greater economic autonomy. During all of the reform cycles during the 1980s, Beijing found it difficult to reclaim lost ground from the localities when they tried to pull back on reform policies.

Our fourth point is that this reform drive is likely to tie China's economy more closely to the global economy. Because foreign markets are more likely to be stable than China's domestic economy, local officials are likely to take advantage of loosened trade restrictions to secure stable exports markets and stable sources of supplies.

Our fifth point is that this reform cycle may widen China's trade imbalance with some of its key partners, particularly the United States. According to U.S. statistics, in the first five months of this year, U.S. imports from China grew at a 41 percent annual rate. This was three times as fast as the growth of U.S. exports to China. We believe it likely that the U.S. trade deficit with China will exceed $15 billion this year, up from $2.7 billion in 1991.

Part of the reason China's exports are growing so rapidly is because Chinese and U.S. traders are accelerating deliveries as a hedge against China losing MFN status or being hit with sanctions under the 301 market access negotiations.

Exports are also growing rapidly for three other reasons. Reforms have shifted more sources into the production of light industrial goods where China has a comparative advantage. China has increased incentives to export. And rapidly increasing foreign investment is fueling the export surge.

Our final point is that economic reform ultimately will produce pressures for political reform. Comprehensive economic reform requires

rewriting the social contract. Workers may not be willing to accept the added unemployment and inflation risks that go with market reform without demanding greater input into the political process.

It's equally clear, however, that China cannot return to the pre-1980s policies, something not even the most orthodox leaders recommend. Clearly, the Chinese economy is evolving through these continuing cycles of reform and retrenchment. At present, a unique blend of markets and local control is on the rise. We may see, over the next few years, a mix of regional economies. Some like South China will be dominated by export-oriented, nonstate firms and foreign joint ventures. Other poorer areas will continue to depend on central subsidies and state enterprises.

That concludes my formal statement, Mr. Chairman. I'd be happy to take any questions you may have.

[The prepared statement of Mr. Petersen, together with a report presented to the Joint Economic Committee by the Central Intelligence Agency, follows:]

PREPARED STATEMENT OF MARTIN PETERSEN

Good afternoon Mr. Chairman. it's a pleasure to be here again to discuss china's economy. I believe you have a copy of our paper. I would like to call your attention to the appendices. As usual, there is a reform chronology and a discussion of china's bilateral trade relations. This year we have added a short discussion of China's environmental problems and a brief tutorial on the difficulties of telling what is public and what is private in China's economy.

The thrust of our report this year is that Deng Xiaoping is once again pressing ahead with economic reform, but he faces significant opposition and the reform measures being discussed risk overheating the economy.

- I'll cover four broad topics in my remarks:
- I'll start by putting the current reform drive in perspective.
- Then I'll discuss the reasons why Deng is trying to revive reform.
- I'll follow with a review of china's economic performance last year and the impact that Deng's initiatives have had so far this year.
- And finally, I'll point out some of the risks in reform and offer some tentative conclusions about the significance of this

latest reform drive.

I. CHINA'S REFORM EXPERIENCE IN PERSPECTIVE

To understand this year's reform push, it's necessary to place it in the context of China's experiments with market-oriented policies.

China began its economic reform effort in the late 1970s to deal with the disastrous legacy of the Cultural Revolution.

Official Chinese statistics themselves indicate that labor productivity grew only 1 percent a year from 1967-1977, and living standards fell far behind China's market-oriented east Asia neighbors.

Deng and the other leaders who took over after Mao died believed that the survival of the Communist Party depended on raising living standards. They concluded that the fastest way to speed up development was to loosen central control over the economy and to give a role to market forces.

China's reform effort is now 13 years old and is characterized by five enduring features.

First, there has never been a blueprint or comprehensive plan for economic reform. Instead, the chinese have relied on a pragmatic trial and error approach. They try something on a limited basis and then expand it if it works.

Second, the politics of reform have been highly personalized. Although all of China's top leaders have rejected the Maoist approach, there has always been significant disagreement about how far reform should go and what the ultimate objective should be. Thus, progress on reform has depended on the relative political strength of the top leaders, especially Deng Xiaoping.

Third, the implementation of reforms has varied widely from region to region. This is partly because reformers have encouraged local experimentation and partly because they have often gone directly to the grassroots level to overcome entrenched bureaucratic opposition.

Fourth, Chinese leaders are intent on implementing economic reform without political reform. Deng sees economic reform as a way to restore legitimacy to the Communist Party and preserve the current political structure.

Five, Chinese reformers have been unable to construct a ideological justification for reform that is consistent with marxism. The significance of this is that it leaves them vulnerable to orthodox critics when reform-related problems with inflation or unemployment arise.

The Chinese approach to reform worked very well in agriculture but the results have been more mixed in the urban sector. Indeed the history of the Chinese economic reform experience is one of cycles: periods of reform followed by retrenchment or retreat.

In periods of reform, Beijing typically has reduced the role of central planning, given more autonomy to managers of state enterprises, and encouraged private enterprises.

Typically, this has led to rapid growth, rising inflation, and widening trade deficits --followed by tightening of administrative controls and slower growth.

The last such cycle began in 1988 when an excessive growth in the money supply coincided with discussions of price reform. Inflation reached 30-percent annual rates in some cities. As we reported in our 1989 testimony, Beijing put on the brakes. It placed key price and enterprise reforms on hold and implemented retrenchment policies that caused a sharp economic slump.

The Tiananmen demonstrations in the spring of 1989 reinforced the move to a more orthodox economic policy. Orthodox leaders pointed to the demonstrations as evidence that reforms had gone too far, too fast. The real cause, of course, had more to do with the lack of political reform rather than an excess of economic reform.

There was much popular resentment, however, about some of the side effects of reform. The man in the street was especially angry with party officials who were using reform opportunities to pursue corruption and secure cushy jobs for their children.

In the wake of Tiananmen, orthodox leaders took control of economic policy and for the last two years have tried to revive economic growth by giving preferences to state enterprises and easing credit. As we discussed last year, this has revived the economy but has compounded problems with the large inefficiencies in the state sector.

II. PRESSURES FOR RENEWED REFORM THIS YEAR

China is now entering a new cycle of reform: it kicked off in January when Deng personally intervened to expand the use of market forces in the economy.

He did this by visiting Guangdong Province and praising local officials who have resisted the more orthodox policies of the last few years. Typically, Deng did not announce a comprehensive program. rather he:

- Called on local officials to experiment more with local markets.
- And he stressed that markets are not synonymous with capitalism.

According to press reports, party guidance issued this spring has called for a new round of reform and has even argued that markets should play the dominate role in the economy.

We believe there are three reasons why Deng launched the new reform effort.

The **first factor** was the disintegration of the soviet union last year. Apparently there is a sharp debate in the leadership over the reasons for the collapse of the Soviet Union. Not surprisingly, orthodox leaders claim Soviet reforms are the cause, and advocate even greater ideological orthodoxy and economic recentralization.

Deng reportedly is arguing that the failure to complete economic reform led to the Soviet collapse and that china must pick up the pace of reform--while maintaining political control. We believe his southern tour is an attempt to build public pressure for reform and to counter the grip of orthodox leaders on the central government and media.

The **second factor** is that the political stakes are rising in Beijing. The 14th party congress will be held in the fall. It will appoint a new central committee and politburo. And it will probably endorse a economic policy statement.

This may be the last opportunity for China's elderly leaders to put their imprints on China's future. These congresses generally are held every five years.

The **third factor** is that ill health of some of the orthodox leaders may have created a window of opportunity for Deng's more pragmatic views. In the last month or so, former president Li Xiannian and Zhou Enlai's widow, Deng Yingchao, have passed away. Both supported a more orthodox approach to economic policy.

III. PERFORMANCE IN 1991

Thus, political factors rather than economic factors are behind Deng's determination to accelerate reform. indeed, unlike the former Soviet Union, economic conditions in china are not sharply deteriorating. Indeed, in 1991 China's real GNP grew 7 percent, and its gross industrial output climbed 14 percent.

Allow me to interject a word on the reliability of official Chinese statistics. As we have noted before, there are problems in how some of the numbers are derived; collection techniques are inexact and local officials sometimes deliberately distort data.

For example, official inflation rates must be treated with caution because they tend to understate inflation when it is rising. And official defense spending numbers may capture less than half of total defense spending. That said, we believe Chinese statistics generally reflect trends in China's economy.

You may recall that our 1989 report contains a detailed discussion of the problems involved in using Chinese data. Whenever possible, we have relied on partner trade data in our discussion of China's trade performance. Unless otherwise specified, however, all the numbers in this report are official Chinese statistics.

China's economy registered strong growth in 1991 for three reasons.

First, as we reported last year, Beijing opened the credit spigots, in part to shore up large state enterprises running deficits.

Second, the sector of the economy outside of Beijing's control did well. Industrial output from locally run enterprises increased 18 percent, while that from private firms grew 25 percent and that from foreign-invested firms climbed 56 percent. This illustrates that local authorities have been able to circumvent the center's attempts to tip more resources to the state sector.

Third, rapidly growing exports helped fuel domestic growth. Exports last year grew 16 percent to 72 billion dollars. This made china the 13th largest exporter in the world.

China's external finances are also healthy. China's strong export growth allowed it to absorb a 20-percent increase in imports last year and still post an 8 billion dollar trade surplus.

Consequently, by the end of 1991, China's foreign exchange holdings reached a record total of almost 43 billion dollars, up 14 billion dollars from 1990.

Deng and his supporters realize that this growth masks some real problems and it cannot be sustained without addressing the serious shortcomings in china's state sector:

- Chinese officials acknowledge that more than one third of state firms are losing money.
- Their weak performance contributed to a record budget deficit of more than $12 billion last year.

The true magnitude of the deficit is probably even greater. Beijing has used preferential loans from state banks to help some enterprises to meet their tax obligations and others to remain afloat.

IV. THE 1992 REFORM INITIATIVES

Some of the reforms being pushed are designed to improve the performance of the state sector. Hong Kong and western press reports indicate that some regions are experimenting with labor reforms. These would allow enterprises to lay off unneeded workers. Besides more power over hiring decisions, Beijing is allowing some enterprise managers greater flexibility in setting production and investment schedules.

Some reforms are focused on soaking up excess liquidity. This would make it easier for the government to fund its budget deficit in a noninflationary way. For example, Beijing is trying limited experiments with local stock markets and retail channels for selling treasury bonds. This year Shanghai began selling China's first stocks to foreigners and is preparing to open a futures market.

Other reforms allow inland provinces to open free trade zones. They can offer preferential tax, tariff, and export rights similar to those rights held by China's coastal special economic zones.

The reforms Deng is pushing are essentially a license to experiment. Deng probably hopes that local leaders will copy their successful neighbors and that a common development model will emerge. This is what happened with the agricultural reforms of the early 1980s.

Deng is also encouraging local leaders to look beyond China for models. Earlier this year he challenged export-oriented Guangdong province to become Asia's fifth "little dragon" after Hong Kong, Taiwan, Singapore, and South Korea.

Deng's reform push is encountering significant opposition from central officials and bureaucracies with a large stake in the old system. But, the local reaction has been enthusiastic in some areas. For example, many cities have expressed interest in opening their own stock markets.

Localities have also uniformly embraced the opportunity to attract more foreign investment. They also welcome the chance to have more control over import decisions.

V. POSSIBLE PITFALLS IN THE REFORM PROCESS

We believe this locally-focused reform strategy, however, carries a risk of economic and social spillovers that could damage public support for reform.

The **first risk** is that local enthusiasm for high-growth policies will overheat the economy and boost inflation. This has happened every time Beijing has initiated a new cycle of refòrm, and there are indications it is happening again. Official statistics indicate that, in the first quarter of this year, investment by local governments jumped 52 percent. New construction projects doubled in the first two months of the year, compared to the same period last year.

As a result, industrial output rose at an 18-percent annual rate in the first half of the year. The chinese are now predicting that real GNP will grow at double digit rates this year. China's urban inflation rate has reached double digit levels in the first five months of the year, after rising in low single digits last year.

So far most urban workers are being shielded from its effects. Wages rose at a 13-percent rate in the first quarter after adjusting for inflation.

A **second risk** is that workers will resist efforts to trim excess workers or declare inefficient firms bankrupt. We are already seeing press reports of isolated incidents of worker unrest in factories trying to implement labor reforms. A people's daily report may appealed for worker cooperation in implementing labor reforms.

A **third risk** is that mangers and officials will conclude that this cycle of reform will not last long. If so, they may exploit reform loopholes to earn windfall profits, contributing to growing public perception of official corruption and resentment of income inequities.

VI. SUMMARY

To tie all this together: market-oriented reforms are being pressed with more vigor than at any time since 1988. But the reform offensive is young, and it could still stall. Whatever exact course it takes, past experience suggests a number of things:

The **first** is that it is unlikely that reformers can avoid China's boom and bust cycles. Good harvests over the past few years and large foreign exchange holdings provide some buffer against inflation. And, financial reforms will soak up some liquidity.

But China's inability to come to grips with the need to allow widespread state sector bankruptcies means that factory managers will again increase wages and investment spending excessively. That plus high local capital construction spending probably means that inflation will rise.

Our **second point** is that China's leadership is far from united over this reform drive. Repeated warnings in the press about "leftism" suggests that there is substantial opposition to accelerated market reform in the party. As they have in the past, reform opponents will try to use the dislocations associated with reform to discredit the effort.

Our **third point** is that this kind of reform is likely to leave China further down the road toward a market economy.

This will not prevent retrenchment if problems arise, such as inflation or a sharply deteriorating trade balance, but it may lead orthodox leaders to experiment with new forms of administrative controls. It is clear even to them that traditional central

planning strategies are not solving the problems of large state enterprises. Orthodox leaders are supporting the creation of large industrial groupings of state enterprises, modeled loosely on the Japanese keiretsu.

Another implication is that this reform drive is likely to leave localities with greater economic autonomy. During all of the reform cycles during the 1980s, Beijing found it difficult to reclaim lost ground from the localities when they tried to pull back on reform policies.

Our **fourth point** is that this reform drive is likely to tie China's economy more closely to the global economy. Because foreign markets are likely to be more stable than China's domestic market, local officials are likely to take advantage of loosened trade restrictions to secure stable export markets and stable sources of supplies.

Our **fifth point** is that this reform cycle may widen China's trade imbalance with some of its key partners, particularly the United States. According to us statistics, in the first five months this year, us imports from China grew at a 41-percent annual rate. This was three times as fast as the growth of us exports to China. We believe it likely that the us trade deficit with China will exceed 15 billion dollars this year, up from 12.7 billion dollars in 1991.

Part of the reason China's exports are growing so rapidly is because Chinese and us traders are accelerating deliveries as a hedge against China losing MFN status or being hit with sanctions under the section 301 market access negotiations.

Exports are also growing rapidly for three other reasons:

- Reforms have shifted more resources into the production of light industrial goods, where china has a comparative advantage.
- China has increased incentives to export.
- Rapidly increasing foreign investment is fueling the export surge.

Our **final point** is that economic reform ultimately will produce pressure for political reform. Comprehensive economic reform requires rewriting the social contract. Workers may not be willing to accept the added unemployment and inflation risks that go with a market economy, without demanding greater input to the political process.

It is equally clear, however, china cannot return to its pre-1980s policies, something not even the most orthodox leaders recommend.

Clearly the Chinese economy is evolving through the continuing cycles of reform and retrenchment. At present a unique blend of markets and local control is on the rise. We may see, over the next few years, a mix of regional economies. Some like South China will be dominated by export-oriented, nonstate firms and foreign joint ventures. Other poorer areas will continue to depend on central subsidies and state enterprises.

That concludes my formal statement, Mr. chairman. We would be happy to take any questions you may have.

Directorate of
Intelligence

The Chinese Economy in 1991 and 1992: Pressure To Revisit Reform Mounts

This paper is embargoed by the Chairman of the Technology and National Security Subcommittee of the Joint Economic Committee until 2:30 p.m. on July 27, 1992.

This paper was prepared by the Central Intelligence Agency for submission to the Subcommittee on Technology and National Security of the Joint Economic Committee, Congress of the United States.

July 1992

The Chinese Economy in 1991 and 1992: Pressure To Revisit Reform Mounts

Summary

China's economic reform process began a new cycle this year as Deng Xiaoping made a symbolic trip to China's reformist southern coast in January. His goal evidently is to speed up reform, and thus economic growth, by sanctioning more locally initiated market-oriented experiments. This strategy bypasses the central government and party bureaucrats who are resistant to change. To gain more maneuvering room for local reformers, since January the Communist Party has issued strongly worded documents that have asserted that market forces are compatible with a socialist political system. The Chinese press has also endorsed other familiar reformist themes, including the importance of the special economic zones, the necessity of opening to the global economy, and the key contribution of nonstate firms to China's development.

Deng's initiative was almost certainly launched with an eye toward the 14th Party Congress, which is due to convene this fall and select a new Central Committee and Politburo. Because party congresses are typically held every five years, this may be the last chance for the party's octogenarian leaders to put their stamp on China's future. Deng almost certainly wants the reform campaign to be in full swing when the congress convenes, not just to propel reformers into top party posts but also to persuade delegates to include in the congress document an explicit long-term commitment to continue the reform program.

Deng's desire to accelerate reform policies was also probably intensified by the collapse of the Soviet Union last fall. This almost certainly reinforced his long-held belief that rapid economic development is necessary to shore up the party's credibility--and thus preserve the current political system--by improving living standards and making China a regional economic power. Unlike perestroyka, however, Deng's reforms were clearly a response to concerns about the future of China's economy, not fears of an imminent economic slide:

- Indeed, last year real GNP grew 7 percent and industrial output rose 14 percent Nonstate enterprises led the economic expansion; production by collective enterprises grew 18 percent, output from private firms increased 24 percent, and the foreign-invested sector grew at a feverish 56-percent pace. These official statistics are useful indicators of the direction and magnitude of economic growth even though they, like other Chinese data, need to be interpreted carefully because of problems with statistical collection techniques and deliberate distortion by some local officials.

- Rapidly growing exports contributed to the domestic expansion as foreign sales jumped 16 percent to $71.9 billion. This allowed China to post an $8.1 billion trade surplus, down only slightly from 1990's record $8.7 billion surplus, despite absorbing a 19.5-percent increase in imports. Thus, China's foreign exchange reserves continued their climb, reaching a record of almost $43 billion by February 1992--the world's sixth-largest stock of hard currency and only slightly less than the United States' $44 billion reserve.

These positive trends masked some fundamental weaknesses, which Deng and his supporters were almost certainly aware of and are attempting to remedy. Last year, industrial output from state firms increased at less than half the national rate, and Chinese officials acknowledged that at least one-third of state-owned enterprises were losing money. The state sector's financial woes have slowed growth in tax receipts and worsened the state budget deficit, which increased at a 40-percent average annual rate since 1987 to reach a record $12.2 billion last year. The size of the budget deficit, moreover, probably does not reflect the true magnitude of China's fiscal problems because Beijing has granted preferential loans to money-losing state enterprises to keep them afloat, thus shifting a share of the budget burden to the banking system.

Central and local authorities have begun to respond to Deng's call, and reforms are being discussed with more enthusiasm than at any time since 1988. According to Chinese press, in July a spokesman for the State Commission for Restructuring the Economy said that later this year China will reform energy and raw materials prices, develop wholesale markets for farm produce, and expand capital markets. Since Deng endorsed the opening of a stock market in Shenzhen in January, numerous cities have petitioned Beijing for the right to establish their own bourses. Hong Kong press reports indicate that several regions in China have experimented this year with policies that trim excess workers from payrolls. According to Chinese-afil iated Hong Kong press, the party recently issued a document that calls for closing down enterprises that continually incur losses. In addition, Chinese press reports have called for faster social security reforms to allow greater job mobility and ease the burden of enterprise reforms on workers.

Deng and his supporters probably hope that as local authorities take advantage of the greater scope for experimentation their neighbors will adopt those measures that prove successful, raising the possibility that a national development model may eventually emerge from trial and error. Local authorities are showing more enthusiasm for reforms that increase their access to funding than to those that challenge the social contract, however, such as closing large state enterprises and laying off workers.

While it is too soon to judge whether such a model will emerge, the localities' enthusiastic response to high-growth policies suggests that the economy could overheat, causing inflation to jump again. Indeed, despite provincial differences in the share of local output accounted for by state firms, in the quality of transportation and communication facilities, and in the degree to which a region depends on the central government for investment funding, virtually all local leaders have endorsed reform proposals to decentralize foreign trade and investment authority and to expand enterprises' ability to raise funds by issuing securities. Indeed, local authorities boosted local investment spending at a 52-percent annual rate in the first quarter of 1992:

- Increased local spending has contributed to an acceleration of growth in the first five months of the year; GNP grew at an 11-percent annual rate and industrial production increased at an 18-percent rate.

- China's urban inflation rate was less than 3 percent last year but reached double-digit rates in the first five months of the year.

Three consecutive bumper grain harvests and China's large foreign exchange holdings will act to moderate inflation in the near term. And financial reforms, such as

setting up secondary markets for government bonds, will soak up excess liquidity and improve the government's ability to fund the budget deficit through noninflationary means. But the crucial test of Beijing's ability to moderate inflation over time will be its success in tackling the risky, but crucial, labor and enterprise reforms that are needed to spark rapid productivity gains and help cut the government's subsidy burden.

As the domestic economy is heating up, China's global trade surplus is shrinking. During the first half of the year it contracted by more than 6 percent, both because of an increased demand for imports and because Beijing has eased some of its import restrictions to try to make its trade regime more compatible with GATT standards and to try to mollify trade partners who have criticized the Chinese for aggressive trade practices in the last few years. For example, since the beginning of 1992 Beijing has abolished its import regulatory tax, promised to eliminate import license requirements for 16 product categories, and reduced import tariffs on 225 goods.

This narrowing of China's global trade surplus is unlikely to ease the US trade deficit with China this year, which grew 22 percent to $12.7 billion in 1991. During the first five months of this year, US imports from China grew at a 41-percent annual rate, nearly triple the pace of US exports to China. Rapid Chinese export growth is being fueled by reforms increasing the number of firms that have direct export rights and by a surge in foreign investment. In addition, some Chinese and US traders have apparently accelerated deliveries to the United States as a hedge against China's losing most-favored-nation trade status, being hit with sanctions under the ongoing Section 301 market access investigation, or coming under other possible US trade sanctions. By the end of the year, the US deficit with China will almost certainly top $15 billion.

Despite Deng's success in reigniting China's reform program, central leaders remain far from united in their vision of how market-oriented the economy should become. This suggests that, if reforms produce a significant social backlash from rising inflation, unemployment, or corruption, orthodox leaders might reassert some control over economic policy. A political swing favoring orthodox ideas would include tighter central controls over prices and local investment spending as well as reduced bank loans to the nonstate sector. Beijing also would probably tighten the administrative instruments it retains to regulate imports, such as control over access to foreign exchange, the power to arbitrarily raise certification and testing standards to make imports more costly, and the authority to rescind import licenses and thus reduce foreign firms' access to the Chinese market.

As has been evident since late 1988, such an orthodox swing would entail its own problems. Slower growth would reduce Beijing's ability to create new jobs for its growing labor force, creating the dilemma of either accepting higher unemployment or increasing subsidies to inefficient state enterprises to keep workers on payrolls. This would contribute to China's growing budget deficit. Moreover, a more orthodox program would generate strong opposition from many provincial leaders, who have significant powers to undermine central directives that are not in their interest.

The Chinese Economy in 1991 and 1992: Pressure To Revisit Reform Mounts

Deng Turns the Spotlight Back on Economic Reform

China's economic reform program entered a new phase this January when Deng Xiaoping made a symbolic trip to parts of China's southern coast that have demonstrated the success of locally engineered market-oriented experiments. During his travels to reform-oriented Guangdong Province and the Shenzhen and Zhuhai Special Economic Zones (SEZs), and later in two strongly worded central documents, Deng has tried to shift the policy debate toward greater tolerance of high-growth measures by arguing that officials should be open to any initiative that could augment economic development; Deng has also reportedly stated that market forces are compatible with a socialist political system. Deng has firmly endorsed other familiar reformist themes-such as the importance of the SEZs, the need to open to the global economy, and the key contribution of nonstate firms to China's development. Reformers believe these policies will expose China to more sophisticated managerial and marketing techniques and create incentives for growth. Furthermore, Deng has directly challenged the more orthodox leaders by warning that a major threat to China's development comes from "leftists"--ideological dogmatists who are reluctant to adopt any Western economic ideas (see appendix A for a chronology of Deng's reform drive).

Deng's efforts to accelerate China's reforms were probably sparked partly by the splintering of the Soviet Union and the inability of hardline policies in place since late 1988 to solve systemic problems in China's economy, particularly the large inefficiencies in many state enterprises. Deng and other reformers have probably attributed much of the blame for the collapse of the Soviet Union last fall to the Soviet economy's failure to maintain citizens' living standards and enhance economic development. In light of Beijing's intense interest in preserving social order after workers joined student-led demonstrations in the spring of 1989, Deng was probably especially alarmed to watch Soviet workers take to the streets to protest economic hardships. China's reformers probably recognize that their country's massive population makes a commitment to rapid-growth policies imperative; central leaders have conceded that many state enterprise workers are redundant, and demographic studies reveal that the number of women aged 20 to 30, the prime child-bearing ages in China, will peak next year. Solutions to these problems are complicated by a central bureaucracy that is too sluggish and unresponsive to deal with the country's rapidly changing and increasingly complex economy.

Deng's efforts already appear to have bolstered reform experiments, many of which were previously under way:

- Press reports indicate Tianjin and Guangzhou Municipalities arc pushing to open "stock markets" later this year, and Shenyang is laying the groundwork to have a market of its own soon.[1] Shanghai, which began selling China's first stocks for foreigners earlier this year, also opened a futures market for metals this spring.

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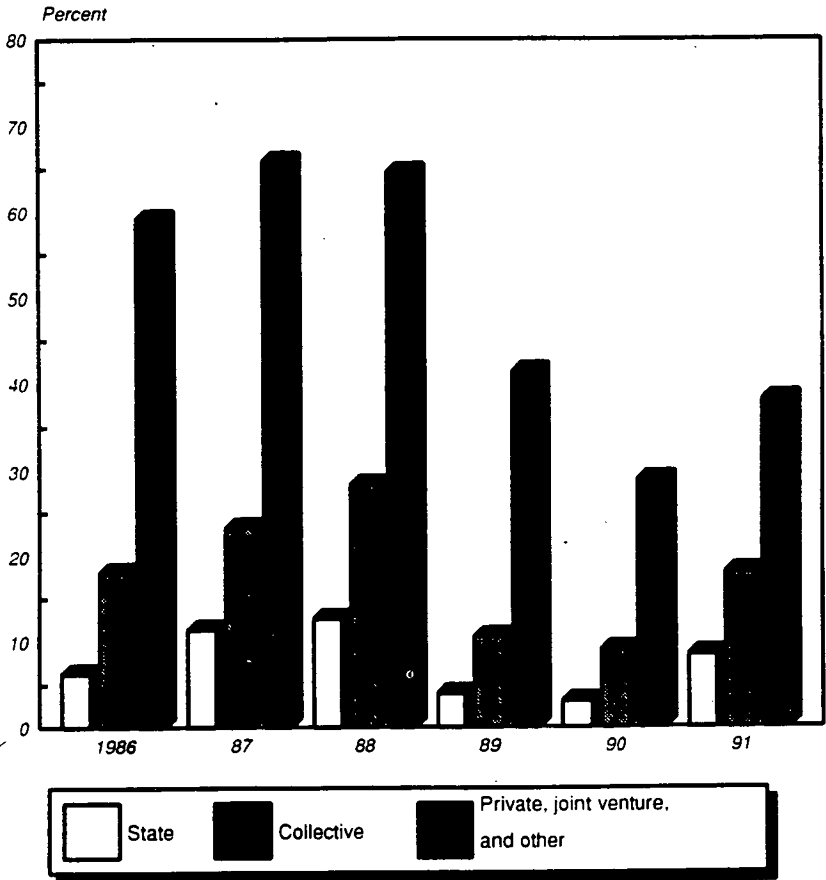
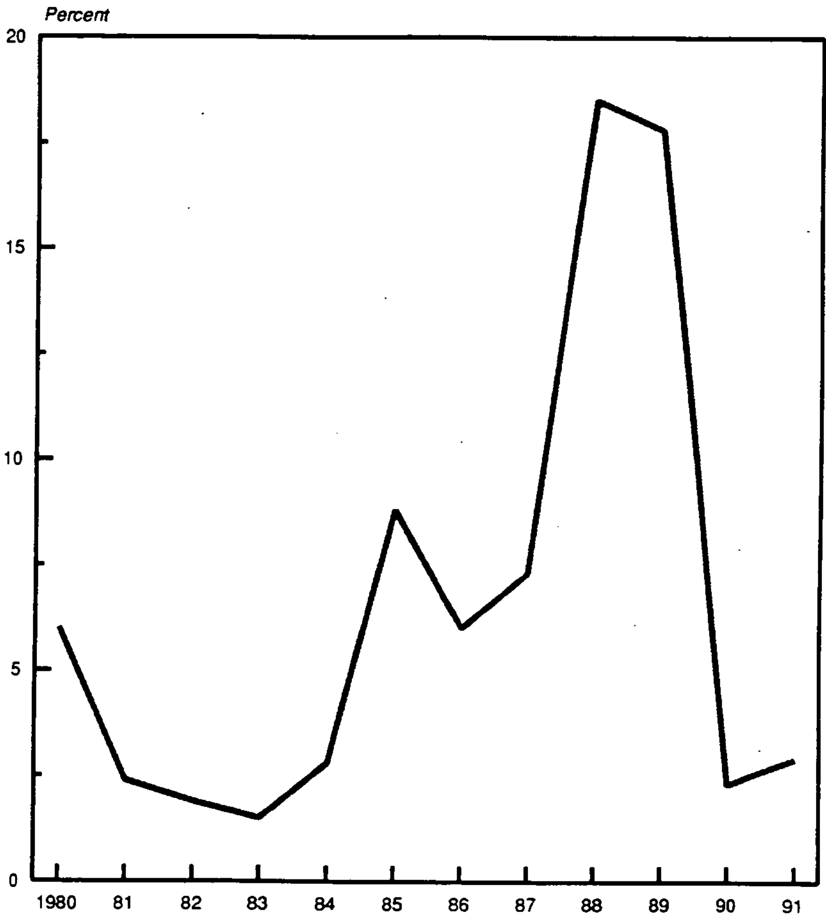
[1] "Stock market" is a misleading label for these financial institutions because firms do not issue equity and thus do not privatize ownership. The value of a firm's stock is related to the profitability of the issuing enterprise, but China's shares are similar to bonds in that they have predetermined maturation dates.

China's Industrial Output Growth by Sector, 1986-1991



Source: Official Chinese statistics. 1991 statistics are preliminary.

China's Inflation, 1980-91



Source: Official Chinese statistics

The Reliability of Chinese Statistics

Most figures cited in this paper are official Chinese statistics. They are reported because they provide useful indications of the direction and magnitude of economic performance even though collection techniques are sometimes crude--local officials have been known to deliberately distort data--and some estimation techniques are questionable. Since reform began in the late 1970s, Beijing has vastly improved the quality of its data by introducing more sophisticated sampling and estimative techniques. Moreover, the scale of its effort has grown; China's State Statistical Bureau (SSB) currently employs more than 1 million full- or part-time workers. Economic reforms themselves, however, have complicated Beijing's effort to upgrade the quality of its statistics because rapid growth of the nonstate sector--particularly rural enterprises--has increased the segment of the economy that is most difficult to measure.

The reliability of Chinese statistics varies according to the category of data. Some data series--such as unemployment--are so tainted that they are virtually unusable. In rural areas, there is a tendency to count all adults of working age as employed, a remnant of past practices of classifying all adults as working members of the commune. Moreover, the SSB does not account for the fact that many urban workers are employed, but do little or no work.

Another problem with Chinese statistics is that for many years Beijing collected data within the context of socialist doctrine, which dictates that productive labor is transformed only into material goods. Consequently, statistics did not report adequately on nonmaterial sectors such as education, passenger transport, public health, banking, and government. Although scholars have since filled these data gaps, problems remain regarding the completeness of figures on nonmaterial services where reporting systems are still relatively underdeveloped. Broad measures of macroeconomic performance such as total social product and national income are useful indicators of economic change, although some components are suspect. For example, many rural regions to not distinguish between real and nominal values of output, which inflates growth rates.

In some instances, we have sought to improve on official figures with our own estimates. For example, we adjust the data China's Finance Ministry releases on the state budget deficit to bring it more in line with Western accounting practices Beijing's method, which counts foreign borrowing and domestic sales of Chinese treasury bonds as "revenue" items, understates the central government's debt obligations. For a detailed discussion of the reliability of Chinese statistics, see "Allocation of Resources in the Soviet Union and China," Part 14, executive sessions 14 April and 7 July 1989, Subcommittee on National Security Economics, Joint Economic Committee, pp. 208-212.

- Hong Kong and Western press indicate that some regions, such as Liaoning Province and Beijing Municipality, have begun experimenting with labor reforms that allow enterprises to trim unproductive workers. In addition to greater control over hiring policies, Beijing has allowed some enterprise managers greater flexibility in setting production and investment schedules.

- According to *China Daily*, the Shenzhen SEZ has made efforts this year to increase its size sixfold and to transform regulations regarding its securities market and its special tariff zone into stronger binding laws.

- Chinese officials have also announced plans to open more free trade zones--to which Beijing will grant a variety of preferential tax, tariff, and export rights--and to ease restrictions on foreign investment in China's service industries (see appendix B for a chronology of policy initiatives).

The Domestic Rebound Continues

China's recent macroeconomic performance indicates that Deng's decision to accelerate reform was probably prompted by his desire to ensure the long-term success of his modernization strategy and not by an imminent threat to the party's credibility from slow economic growth. Beijing's loose monetary policy--the money supply grew at about a 25-percent rate in the first three quarters of last year--and greater support for state enterprise investment spending--fixed asset investments by state firms rose at a 36-percent rate m the first five months of this year--have helped the economy advance rapidly on several fronts. As a result, from January to May of this year, industrial output rose at an 18-percent annual rate, its highest rate since 1988, and real GNP grew at an 11-percent rate during the same period--nearly double the official 6-percent target growth rate. Indeed, the economic expansion has picked up since last year when industrial output and real GNP rose 14 percent and 7 percent, respectively. The nonstate sector has led this surge; last year collective enterprises including rural firms grew 18 percent, and output from private firms rose 24 percent. During the same period, broad support from central and local officials contributed to a 56-percent increase in industrial output in foreign-invested enterprises. Domestic spending increased rapidly as retail sales rose 13 percent, more than six times the rate in 1990, as households ended their two-year slowdown in consumer purchases.

Beijing's expansionary monetary policy has begun to boost inflation. The cost-of-living index for large cities climbed 2.9 percent in 1991, but has increased 11 percent in the first five months of this year compared to the same period in 1991, according to official statistics.[2] Recent agricultural price reforms that have pushed some grain prices toward market levels have also boosted inflation. Last year, grain prices rose 35 percent in urban areas largely because Beijing sharply increased retail prices for rationed wheat and edible oils on 1 May 1991. Because China produced its third consecutive bumper harvest last year of 435 million metric tons-which was the second-largest harvest ever and has kept grocery shelves full and free-market prices low-the central government on

[2] Annual estimates for retail price inflation need to be interpreted with care. They probably understate the true rate when inflation is rising and overstate the true rate when it is falling because authorities apparently average monthly inflation rates (calculated by comparing the price index in each month with the index in the corresponding month of the previous year) to derive the annual estimate. For example, official statistics probably understated the rate in 1988 and 1990 and overstated the rate in 1989.

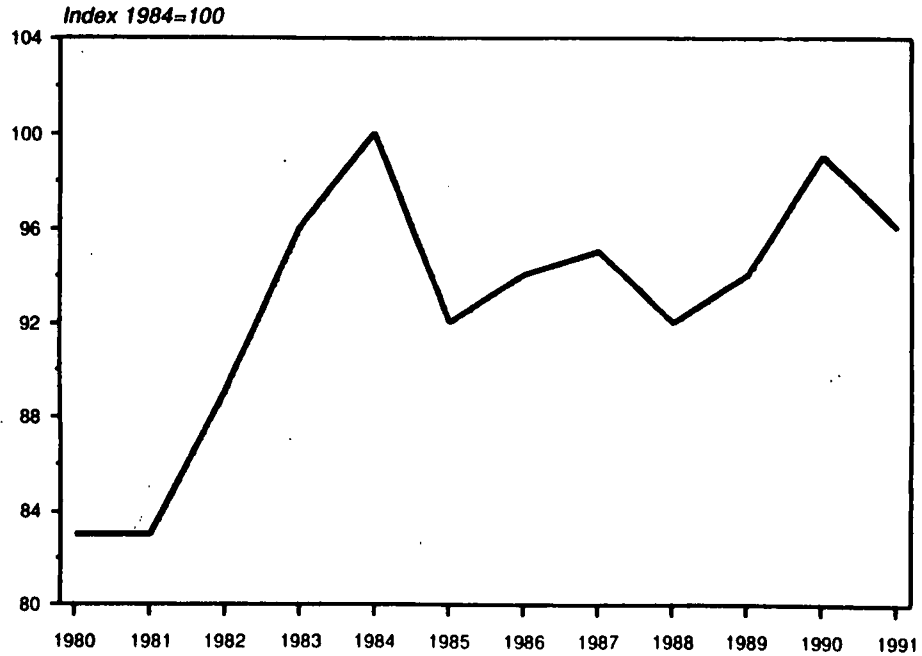
Agriculture Facing Challenges in the 1990s

Agricultural policy has not been on the front burner of China's policy debates this spring because agricultural output has been high in recent years. But it could reemerge as an issue of concern within several years. Despite recent bumper harvests, the agricultural sector will come under increasing pressure in the 1990s because production gains may have difficulty keeping pace with population increases. In 1991, China failed for the seventh consecutive year to reach the per capita grain production level farmers achieved in 1984. Reversing this trend will be difficult; virtually all arable land is already cultivated, and the area sown in grain will fall as industrial growth leads to more roads and factories. Moreover, per-unit output will improve slowly at best because China's yields are already world class and any increase would be very costly. In addition, 60 percent of China's acreage is not irrigated, and thus annual crops are strongly influenced by weather conditions. The problem is compounded by the fact that China's grain storage and transportation facilities are inadequate; China may lose as much as 10-20 million metric tons of grain each year because of spoilage.

Some reformers have argued that China's only long-run solution to its agricultural problem is to encourage production through price decontrol and private ownership of land. Price signals, they maintain, will guide farmers to generate the optimal production mix to meet consumers' needs. The reformist alternative, however, entails elements that will trouble orthodox leaders. Despite Deng Xiaoping's efforts to minimize interest in whether a policy is capitalistic or socialistic, many leaders are uncomfortable with the concept of private ownership of land. Similarly, a large number of officials remain skeptical of the market's ability to guide production. A market-oriented agricultural policy would undoubtedly shift some production away from China's traditional staples such as wheat and rice, and toward cash crops like vegetables, which would probably concern central leaders who prefer the predictability of adhering to annual production targets. Ultimately, privatization risks bankrupting some farmers, which could tarnish the reform agenda even in the eyes of some reformist policymakers.

If agricultural production falters, therefore, orthodox leaders may not be convinced by the reformist strategy and, instead, may try to increase central controls over the farm sector. Premier Li Peng has frequently stated that the central government will continue its control over grain prices to keep them high enough to maintain farmers' enthusiasm for Beijing's farm policy. In the last two years Beijing has attempted to strengthen central control over rural services, such as supplying seed, fertilizer, and pesticides, and farmers may fear that increased state regulation will undo gains farmers achieved under reforms in the early 1980s. Increasingly, peasants view the party as the landlord because party officials are becoming more closely involved in marketing, contract supervision, and land control. In addition to collectivizing services, Beijing may push to combine plots to take advantage of the gains of large-scale farming. These moves would probably be challenged by farmers whose living standards have risen sharply since reformers dismantled Mao's commune system beginning in the late 1970s. In addition, the transformation to larger farms would probably increase rural unemployment as relatively fewer workers would be needed per acre. Rural enterprises could absorb many of these workers, but some would undoubtedly drift into urban areas, straining social safety nets.

China's Per Capita Grain Production, 1980-91



Source: Official Chinese statistics

1 April 1992 was again able to raise prices for rationed grain. The large harvest occurred despite floods that damaged crops in 18 provinces and left 80 million people temporarily homeless. Grain output fell 10 percent in eastern provinces, which were the hardest hit by the flooding, but the fall harvest was favorable overall in part because of late frosts and dry conditions elsewhere.

The Trade Sector Responds to Pressures

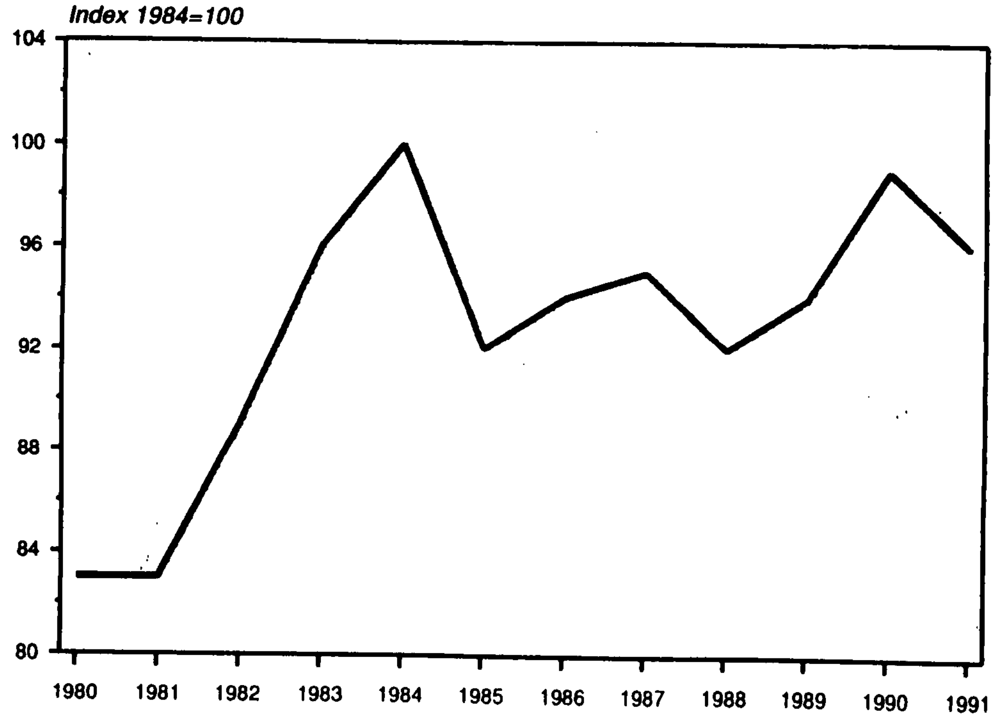
Rapidly growing foreign sales also helped spur domestic economic expansion as China's global exports increased 16 percent to $71.9 billion last year. The leadership views strong export growth as a means of accelerating economic modernization as well as a means of invigorating China's moribund state sector. China's imports began accelerating in the second half of 1991, and by yearend import growth of 19.5 percent eclipsed the expansion in exports and gave China an $8.1 billion global trade surplus, down slightly from 1990's record:l surplus of $8.7 billion.

China's trade surplus and healthy service sector earnings--tourism revenues increased 28 percent to $2.8 billion in 1991--gave China a $13.3 billion current account surplus last year, according to official Chinese statistics. Consequently, China's foreign exchange reserves jumped about $14 billion in 1991, and hard currency holdings through February 1992 stood at a record $43 billion, giving Beijing the world's sixth-largest stock of foreign exchange--virtually the same amount held by the United States. The current level of reserves is sufficient to pay for more than eight months of imports--far in excess of the level generally viewed as adequate for balance-of-payments purposes.

China's export growth continues to be propelled by its comparative advantage in labor-intensive production but is benefiting from other factors as well. Foreign investment commitments surged 68 percent in 1991 to $11 billion, while funds transferred as part of existing investments climbed 14 percent to $4 billion, according to official Chinese statistics. Exports from foreign-funded firms have been the fastest growing component of overall export growth in recent years. Beijing is also supporting export growth through indirect subsidies, including favorable tax treatment, low-interest government loans, and tariff breaks on raw materials and components imported for subsequent processing and export. In addition, although Beijing announced that it was ending direct subsidies to the export sector as of 1 January 1991, direct infusions to key sectors--such as textiles and machine building--are probably still continuing. Beijing's action was probably an attempt to ease pressure on the state budget, from which direct subsidies are allocated.

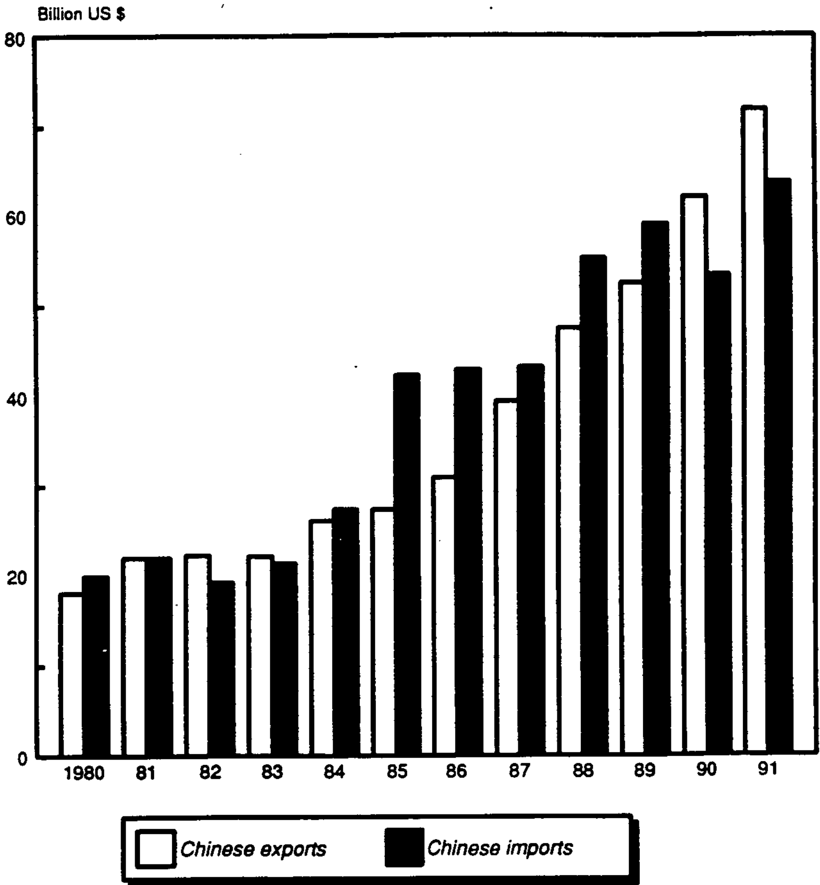
China's export success has heightened frictions with key trading partners, however, and intensified outside scrutiny of Beijing's trade practices. Many of China's trading partners have become alarmed by the sharp deterioration in their trade balances with China and have stepped up calls for improved access for their products in China (see appendix C for a discussion of how various countries are doing in penetrating the Chinese market). The US trade deficit with China, for example, expanded 22 percent to $12.7 billion last year, according to US statistics. The downturn was even more pronounced for China's primary trading partners in the European Community (EC)--Germany, France, Italy, and the United Kingdom--whose statistics indicate their bilateral trade deficits, on average, doubled in 1991. Beijing, for its part, has had to contend

China's Per Capita Grain Production, 1980-91



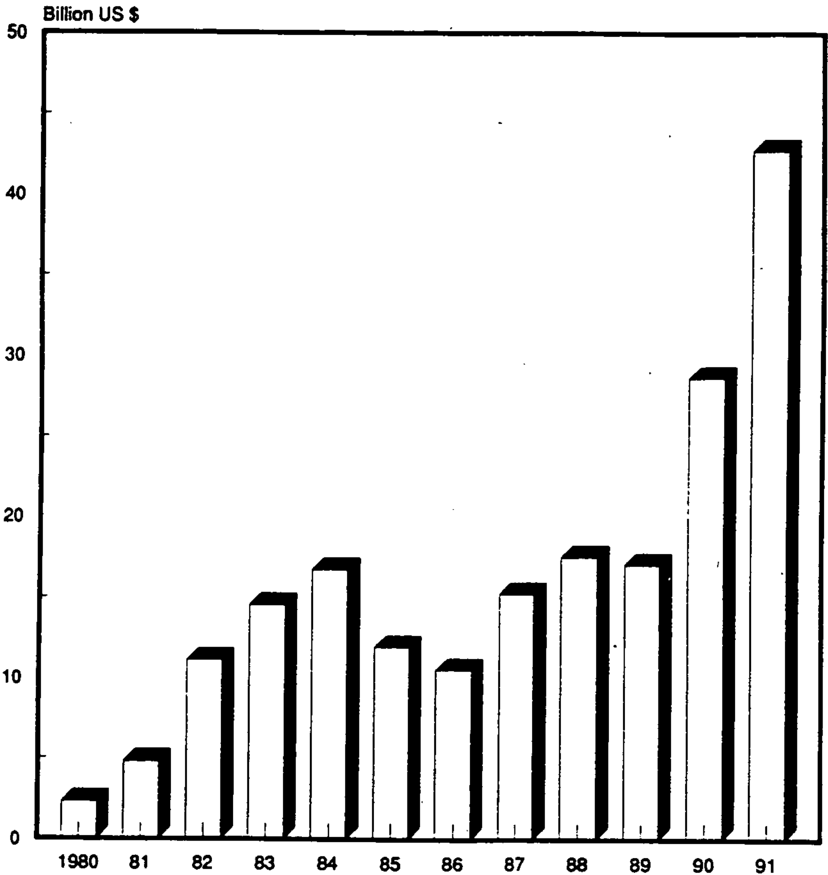
Source: Official Chinese statistics

China's Foreign Trade, 1980-91



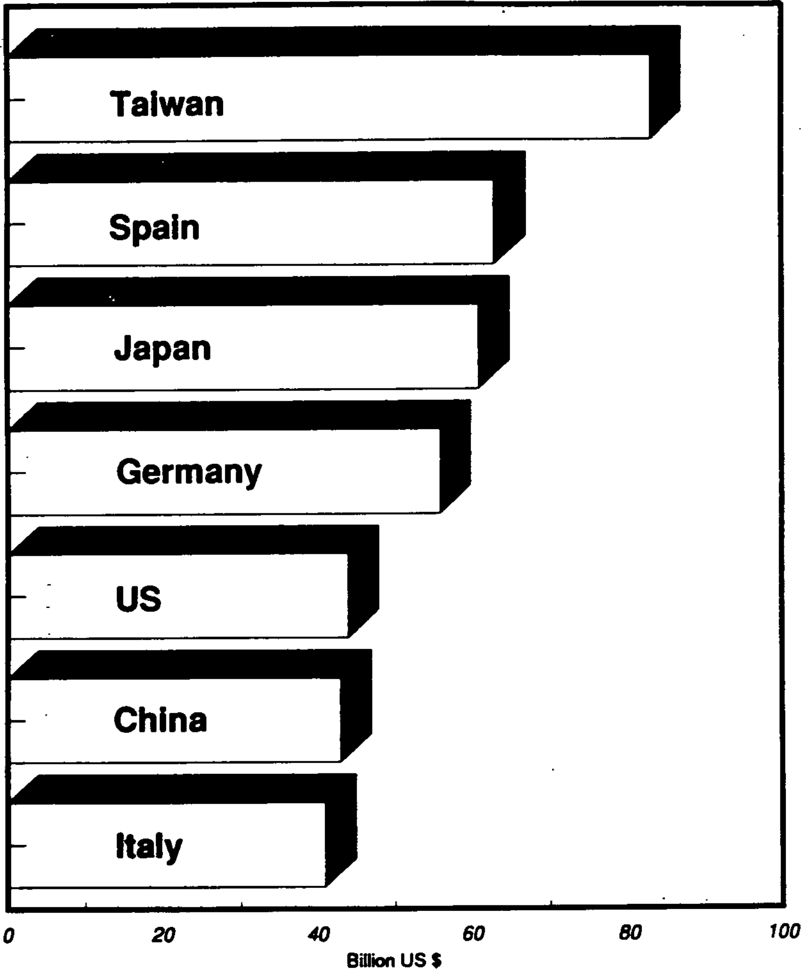
Source: Official Chinese Customs statistics

China's Foreign Exchange Reserves, 1980-91



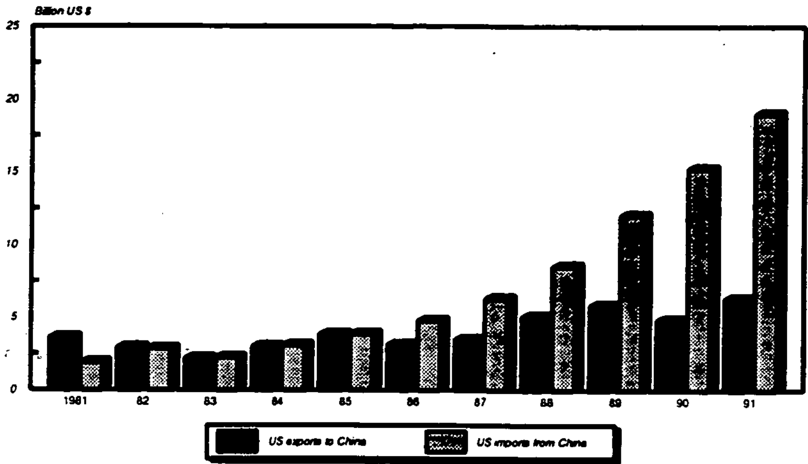
Source: IMF International Financial Statistics

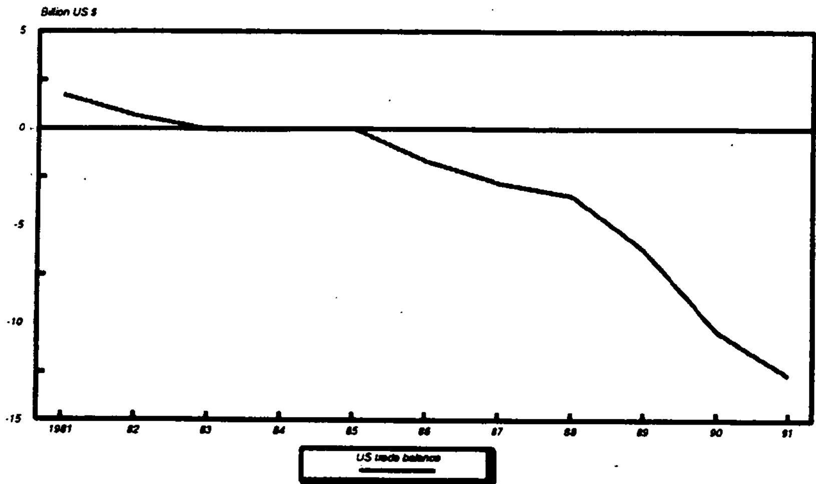
World's Leading Holders of Foreign Exchange, February 1992



Source: International Monetary Fund statistics; Taiwan data based on official Taiwan statistics.

US Trade With China, 1981-91





Source: US Commerce Department statistics. Exports on a free alongside ship (f.a.s.) basis, imports is on a customs value basis.

with a sharp escalation in the number of antidumping investigations of its products in other markets, primarily the United States and the EC. Perhaps more disturbing from Beijing's perspective are signs that markets in Asia--a region with considerable potential for expanded Chinese sales--are raising barriers to Chinese products as well:

- Earlier this year, **Japan** launched its first-ever antidumping investigation of a Chinese product in response to industry complaints that Chinese suppliers were selling silicomanganese at below-market costs.
- **South Korea**, which saw its trade deficit with China last year increase nearly 50 percent to $1.1 billion, in mid-April began imposing prohibitive tariffs on a variety of agricultural and industrial products largely supplied by China.
- **The Philippines** singled out China as the primary reason behind the implementation in late March of measures designed to reduce Manila's trade imbalances with China and four additional socialist countries.

Beijing's desire to quell outside criticism--as well as feed a growing domestic appetite for raw materials and industrial inputs--has prompted it to relax administrative restrictions that have restrained imports since austerity measures were introduced in late 1988. Since the beginning of this year, Beijing has announced a variety of measures designed to reduce central oversight of the trade sector and allow greater imports, including:

- Reducing import tariffs on 225 goods at the beginning of 1992 from an average rate of 45 percent to an average rate of 30 percent.
- Promising to eliminate import license requirements for 16 product categories--including steel products, sugar, polycarbonates, electron microscopes, audio recorders, and wristwatches--of the 53 requiring import permits. According to Chinese press, the remaining categories are to be reduced by at least two-thirds within three years.
- Abolishing in April the import regulatory tax, which applied to 18 categories of high-value goods and amounted to a 20 to 80 percent surcharge on imports of those products.

In addition, Beijing has begun publicizing previously enacted trade laws--such as regulations pertaining to China's export licensing system--and has pledged to release a broad range of future laws, regulations, decrees, and administrative guidance before these measures are implemented.

These reforms and the demands of a rapidly growing domestic economy will fuel import growth. Chinese purchases of mineral fuels, petroleum and petroleum byproducts, organic chemicals, and scrap metal all increased last year because of strong domestic demand. At the same time, imports of products such as leather and plastics--used extensively in export processing--helped fuel growth in the export sector. Beijing also attempted to salve tensions with both the United States and EC countries by sending well-publicized buying missions to these markets armed with shopping lists tailored to include purchases of big-ticket items--such as automobiles, airs and industrial machinery--in an effort to present China as an important consumer of these goods. In

many cases, however, these delegations' purchases probably merely finalized already agreed to contracts.

Beijing's import liberalization drive is also designed to burnish Beijing's credentials in an effort to speed its application to join the GATT, which it submitted in 1986. The Chinese leadership has taken a greater interest in acceding to the GATT since Taiwan began pushing for the formation of a working party to consider its own application, submitted in January 1990. Beyond the political motivations behind Beijing's renewed push lie some economic factors that it views as increasingly vital. China's leaders almost certainly believe that GATT membership will help insulate them from the commercial pressure they currently face and protect them from unfair adjudication of trade disputes. In addition, the general trend toward the formation of regional trading groups has heightened the sense of urgency among the leadership to secure a place in this international body, where Beijing hopes to shape international trade policies and protect its access to other member countries' markets.

Despite these trade reforms, however, Beijing maintains a variety of levers that allow it to administratively control imports. One key mechanism is the leadership's control over foreign exchange expenditures. China's State Administration for Exchange Control (SAEC) allocates foreign exchange to importers under an annual economic plan that encapsulates the center's import priorities. For imports outside of the annual plan, entities with retained foreign exchange-which is held on deposit either in hard currency accounts in the Bank of China or in domestic currency accounts that entitle holders to a foreign exchange quota--must petition for approval to use these funds. SAEC officials also control access to China's roughly 100 foreign exchange "swap" centers and block the purchase of foreign exchange intended for the importation of consumer goods, clothing, or electronic products. Excessively stringent certification and testing standards as well as arbitrary customs valuation procedures are other means used to increase the cost of imported goods, thus reducing their competitiveness. In addition to foreign exchange controls, Beijing uses import licensing as a means to deny foreign firms access to the Chinese market, even when the foreign goods are of higher quality and lower price than domestic substitutes. In most cases, the ministry that oversees the manufacture of a product in China is involved in the import approval process as well. Beijing also frequently uses excessive tariff rates--currently ranging as high as 100 percent for some goods--to discourage reports.

The Old Economic System's Foundation Erodes

Reforms Leave State Enterprises Behind ... The recent reform drive has been spurred in part by the state sector's slow pace in adopting market-based measures and its consequent problems with waste and inefficiency. Some state firms have failed to invest adequately in modernizing their production equipment because low profit retention rates discourage factory managers from adopting the latest technology. Many state enterprises also operate with a financial handicap because the central government still requires them to provide workers with cradle-to-grave social welfare protection that includes housing, medical services, retirement benefits, and education for employees' children. These expenses have undermined the ability of state firms to compete with collective, private, and foreign-funded enterprises. To compensate the enterprises for their additional expenses, Beijing gives the firms easy credit and state budget subsidies.

Beijing's unconditional financial support, however, has eroded the incentive for managers to use resources efficiently. As a result, last year industrial output in state firms rose 8.9 percent, while national output grew twice as fast and foreign-invested firms increased production six times as rapidly. Chinese officials acknowledged that one-third of state firms are losing money (see appendix D for a further discussion of the status of state enterprises).

In the absence of strong market pressures, many state-owned enterprises have adhered to production targets at the expense of improving product quality and efficiently using resources, causing firms to produce unmarketable goods. During a survey of shops in 10 major cities conducted by the Ministry of Commerce last year, 40 percent of goods tested failed to meet government standards. In their haste to increase output without regard to product quality, state firms caused stockpiles of raw materials to drop 10 percent and inventories of unsold consumer goods to rise $3 billion during the first quarter of this year, according to Western press reports. In addition, losses by state enterprises increased 14 percent in the first two months of this year. A year ago, the State Council ordered firms to stop producing items that do not sell, but failed to propose effective restraints, suggesting the call will have little impact on economic performance (see appendix E for a detailed discussion of the environmental costs associated with state enterprise production).

Rising inventories in turn have contributed to the chain of unpaid debt that is tying up production at many state enterprises.[3] China's efforts to clear up interenterprise debt last year included launching a nationwide campaign that allocated the equivalent of $5.6 billion in loans to debt-ridden firms. In November, an official at the State Council office in charge of debt claimed the campaign had reduced the volume of outstanding financial obligations by one-third, but Chinese press reports suggest that new debt is accumulating faster than old debt is retired. An article in Shanghai's *Liberation Daily* last fall stated that, after similar efforts in the spring of 1991 had cleared $30 billion in debt, new defaults of billion had emerged. Recently, press reports indicate that the State Council has begun another experiment to cut enterprise debt. According to the arrangement, Beijing will allow certain creditor factories operating within the state plan who have not been paid by their in-plan consumers to sell their goods to any buyer, whether or not the purchaser operates within the plan. Although the strategy may help break the debt chain, if applied broadly, the arrangement could disrupt central planning by giving state firms an excuse to ignore annual economic plans.

... And Strain the State Budget. The weak performance of many state firms and measures that have hampered revenue collections have added to government budget problems. The budget deficit--which has grown at 40-percent average annual rate since 1987 to reach a record $12.2 billion last year--continues to worsen, in part because Beijing relies on the inefficient state-sector to provide roughly two-thirds of all tax revenues. In addition to state sector woes, reforms in the 1980s that decentralized revenue collection authority have added to the fiscal problem by increasing the ability of local officials who collect tax receipts to avoid meeting their revenue obligations to the

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[3] The debt-chain problem has developed because state enterprises are unable to meet their financial obligations to other firms when mounting unsold inventories cut revenues. The other firms, in turn, are unable to honor their bank loans, creating a "chain" of debt.

central government. In his address to the National People's Congress in March 1992, China's Finance Minister accused local governments of evading taxes and falsifying records to reduce payments to Beijing. He said that the State Council this year would draft a law that would centralize authority to approve tax reductions and increase the punishment for tax evasion. In addition, local tax collectors face formidable obstacles which have further undermined the country's fiscal system; according to a *China Daily* report, last year more than 3,000 tax collectors were attacked and five were killed while performing their duties.

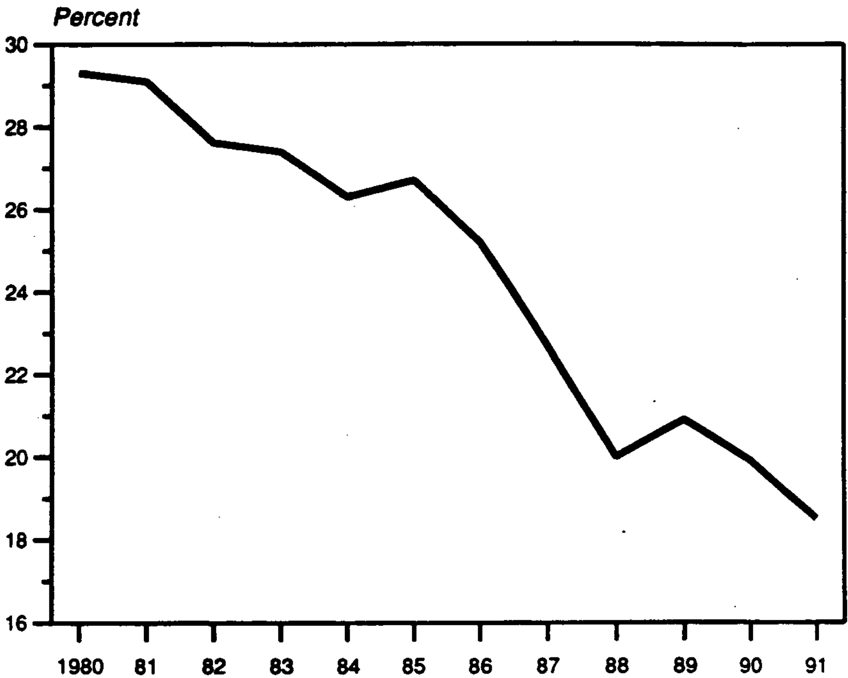
Beijing's efforts to cushion the impact of state-controlled grain price increases has also contributed to the budget problem. Despite attempts to cut subsidies, overall spending rose 8 percent last year in part because price subsidies exceeded their budgeted amount by 12 percent. The Finance Minister also blamed the growing deficit on subsidies for relief efforts during the flooding last summer and the cost of policies aimed at invigorating state enterprises. He had particular scorn for government bodies whose spending habits caused administrative expenditures to exceed their budgeted target by nearly 10 percent. To correct this pattern, he called for Beijing to prevent administrative departments and government institutions from purchasing new equipment this year.

The size of China's budget deficit, however, probably does not reflect the true magnitude of the country's fiscal problems because the central government has been able to reduce subsidies to deficit state enterprises by giving them increased preferential loans. Numerous Hong Kong press reports suggest that the People's Bank of China has increased its allocations of credit to cover the loss of direct budgetary subsidies and to help break the debt chain--in effect shifting the burden to the banking system. Despite Beijing's efforts to cut export subsidies, for example, a *China Daily* report from earlier this year indicates that the Bank of China will give priority financial assistance to money-losing export firms.

China's tight state budget is complicating the leadership's efforts to modernize the military. When adjusted for inflation, budgeted defense spending--which may account for only half of the country's military spending--fell 21 percent from 1984 to 1988, when the leadership faced no pressing security needs, but has risen 22 percent since 1988.[4] A substantial portion of the recent increase is being spent to improve soldiers' living standards and morale--which had declined after several years of high inflation, flat defense spending, and the 1989 Tiananmen Square demonstrations. Moreover, the budget is becoming an increasingly important source of revenue for the military because funds available from nonbudget channels for new weapons have declined. Profits from arms sales--on which China relied heavily over the past decade to purchase foreign technology--have fallen by 80 percent since the end of the Iran-Iraq war. This decline is likely to be exacerbated by the poor showing of Chinese weapons in the Gulf

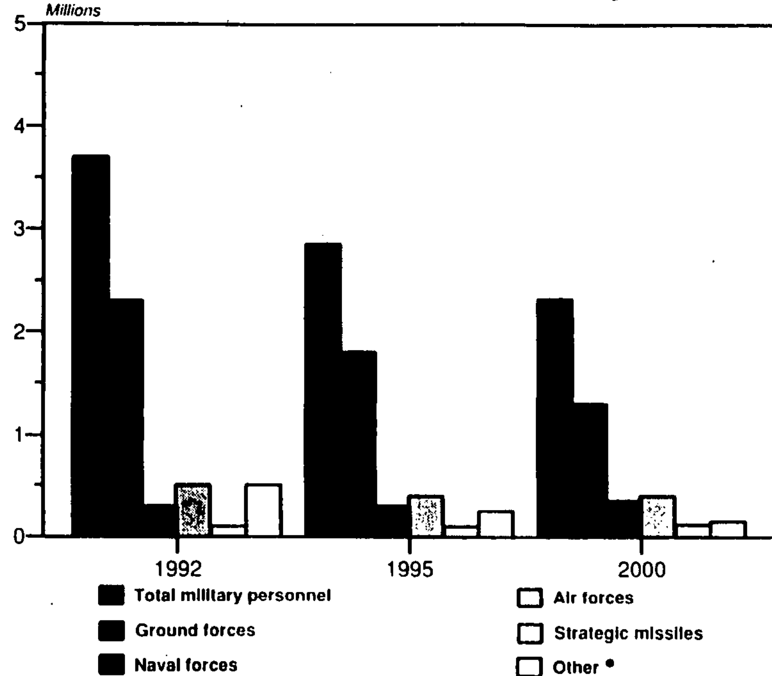
[4] Defense spending figures from the state budget do not include many important military expenditures, such as: most of China's research and development spending (funded through the National Defense Science Technology & Industrial Commission and the industrial ministries), modernization of defense-industrial plant and equipment, subsidies paid by localities and commercial enterprises to supplement the incomes of workers conscripted by the Peoples' Liberation Army, and the cost of conscripting recruits and integrating demobilized serviceman back int the civilian economy.

China's Budget Revenues as a Share of GNP, 1980-91



Source: Official Chinese statistics

Current and Projected Chinese Military Personnel



• Includes headquarters staffs for General Staff, General Logistics, and General Political Departments, Air Force and Navy headquarters staffs, seven military region headquarters staffs, 28 provincial/municipal military district commands, and miscellaneous PLA academies, technical institutes, production, agricultural, support, and entertainment units,

Source: CIA estimates

war, as well as a glut of more advanced Western and Soviet hardware on the world's arms market.

To arrest the budget's decline, Beijing has begun implementing a series of fiscal modifications. The Finance Minister announced at the National People's Congress in March that this year China will adopt a budgeting system that separates construction revenues and expenditures from other funds, which he claimed will increase the central government's control over cash flows. Although the revamped fiscal structure will more clearly account for revenue movements, it apparently contains no penalties for exceeding Beijing's expenditure targets. Consequently, the new system will probably have a limited impact on the spending patterns of local governments, which frequently surpass the centrally set spending limits. In a related effort to reform the state budget, another official from the Ministry of Finance announced in June 1992 that this year the Ministry will begin experimenting with a proportional tax system designed to ensure that certain revenues go directly to state coffers. The official, however, has already admitted that provincial authorities will be able to compromise the new system by giving preferential treatment to industries that pay taxes to local officials. If China maintains its reform momentum, Beijing may transform more elements of its central bureaucracy--including some ministries--into commercial entities to cut administrative expenses and to increase the role of market forces. In June 1991, for example, the central government created Chinatron--which combines nearly 100 electronics plants into a national electronics sector conglomerate--to take over some of the functions of the Ministry of Machine Building and Electronics Industry. Beijing has formed other national conglomerates in the energy and petrochemical sectors.

Implications of Accelerated Reform

Because of these state-sector problems, much reform rhetoric has recently focused on remedies for ailing state enterprises. According to Chinese Government-affiliated Hong Kong press, the Chinese Communist Party Central Committee recently issued a document, probably written under the auspices of Deng Xiaoping, that calls for closing down enterprises that have continually incurred losses and for expanding the nascent shareholding system. Reformers are also advocating labor reforms as a method for trimming excess workers from factory payrolls. According to Chinese press reports in February 1992, early this year there was a campaign to scrap the "Iron Rice Bowl"--Beijing's guarantee of lifetime employment for workers. The bulk of reformist literature continues to strongly advocate opening the economy to the outside world by, among other things: developing regions along the Chang Jiang (Yangtze River) near Shanghai to make them more attractive to foreign investors; opening border cities to facilitate trade, especially in the north; expanding financial links to Hong Kong, Macao, and Taiwan; further developing the special economic zones; and increasing the economic integration between coastal and inland provinces.

The Potential for a Provincial Model. Beijing's emphasis on decentralizing economic decision making authority during the 1980s has decreased the center's ability to guide economic development and will force the leadership to rely more heavily on locally conceived programs to facilitate growth. As provincial leaders respond to Deng's renewed stress on the importance of local control over economic policy, they will probably analyze closely the outcomes of their neighbors' reform experiments, raising

China's Stock Markets: The Growing Pains of Reform

Chinese officials are accelerating financial reforms following Deng Xiaoping's call in January for localities to experiment with bolder economic policies, but China's nascent stock markets are suffering growing pains because Beijing has no securities laws and local officials are uncertain what measures are needed to stabilize their developing markets. Prices at the Shanghai stock market--one of China's two such bourses--have recently swung wildly; in May, after authorities removed limits on daily price fluctuations for the market's 15 traded shares, some prices rose by as much as 192 to 470 percent the first day. Stock officials responded quickly by outlawing trading by investment syndicates--which they blamed for pooling funds to drive up prices and "fry stocks"--pushing the market down 19 percent as investors reacted to fears that additional restrictions were in the offing. On the Shenzhen market, prices of stocks sold to foreigners recently jumped 45 percent in one week.

Despite these problems, the Chinese will undoubtedly try to further expand the market in an effort to tap the country's deepening reservoir of potential investment funds; the national savings rate is over 30 percent. Although many central leaders hope stock markets will reduce the burden of supporting state enterprises, some orthodox leaders probably associate recent market behavior with the speculation and corruption that characterized China's economy before 1949 and will criticize Deng's policies for reviving such practices. Indeed, some central government press reports have already used the recent suicide of a distraught investor in Shanghai to suggest that stock market reform is proceeding too quickly.

the possibility that a national economic paradigm will arise that most regions will attempt to emulate. According to Chinese press, officials in many provincial-level entities, such as Shanghai, have spoken publicly about following the model of Guangdong Province, which has combined export-oriented development with the southern Chinese entrepreneurial spirit to create a hybrid economic region that is among the world's fastest growing economies. This year, Deng himself challenged Guangdong to become Asia's fifth "Little Dragon" after Hong Kong, Singapore, Taiwan, and South Korea, suggesting he would like the province to chart an economic course that other regions can follow.

Because local development strategies will be shaped by resource endowments such as the share of provincial output accounted for by state firms, the quality of transportation and communication facilities, and the degree to which a region depends on the central government for investment funding, several "models" for provincial development are likely to evolve. Provinces with relatively developed economies will be able to take advantage of their high savings rates, access to hard currency, and superior infrastructure to attract foreign investment. Provinces dominated by relatively slow-growing state firms, however, will have more difficulty creating jobs and thus will be forced to weigh more carefully the intermediate impact on employment levels of efficiency-enhancing reforms.

The Threat of Overheating. Although specific agendas will differ, provincial leaders will tend to support high-growth policies that have the greatest potential to create jobs, suggesting that the economy will continue to be inclined to overheat. Beijing has repeatedly chastised local officials for pressuring branch banks into expanding credit issuances which have raised investment spending excessively. Deng's campaign could make the economy even more likely to overheat because his call to speed reform comes at a time when industrial production is already showing signs of accelerating growth. Official statistics indicate that in the first quarter of this year wages adjusted for inflation rose 13 percent overall--59 percent in foreign-invested firms--while investment by local governments vaulted 52 percent. According to an official at the State Statistical Bureau, new construction projects, fueled by a spate of competing development plans, doubled in the first two months of 1992 compared to the same period last year. These trends, combined with an expansionary monetary policy and expectations of additional state price adjustments, could push up inflation as competition among investors raises raw material prices and consumers bid up prices for final goods and services, igniting another round of overheating. In fact, according to a Western press report, a senior economist at the Chinese Academy of Social Sciences warned this May that rapid industrial growth could soon cause shortages of energy, raw materials, and transportation facilities.

For the near term, at least, regional growth will remain rapid, but uneven--intensifying interprovincial per capita income differences. Local economies with relatively developed domestic financial markets, direct access to Hong Kong investment funds, and established links to world markets will be able to tap more quickly their domestic savings and foreign currency deposits to reduce transportation, telecommu- nications, and energy bottlenecks and attract foreign investment. Southern coastal provinces, in particular, will probably view China's increased emphasis on reforming and opening to the outside as an official endorsement of policies the region has

Relative Shares of Total Exports, 1989[a]

[a] By province, autonomous region, or municipality

Percent of total exports

Province	Percent	Province	Percent
Guangdong	20.12	Hunan	1.61
Shanghai	12.41	Guangxi	1.50
Liaoning	10.91	Anhui	1.28
Shandong	7.49	Jiangxi	0.96
Jiangsu	5.99	Shanxi	0.96
Zhejiang	4.60	Yunnan	0.96
Tianjin	4.17	Shaanxi	0.96
Hebei	4.07	Nei Mongol	0.86
Fujian	4.07	Hainan	0.86
Beijing	2.89	Xinjiang	0.86
Heilongjiang	2.57	Gansu	0.43
Hubei	2.57	Guizhou	0.32
Sichuan	2.35	Ningxia	0.11
Henan	2.03	Xizang	-
Jilin	1.71	Qinghai	.

Unclassified

championed for years. Immediately following Deng's visit in January, a Communist Party newspaper in Guangdong Province published a long theoretical essay that essentially redefined socialism to encompass any policy that improves living standards. Deng's recent call for Guangdong to become the fifth "Little Dragon" and Vice Premier Zou Jiahua's recent endorsement of Guangdong's rapid reform program suggest that a broad range of central leaders support the province's economic strategy.

As the economy continues to heat up, import liberalization policies that Beijing has recently adopted will combine with strong domestic demand to shrink China's trade surplus. This has already happened in the first half of 1992 when imports grew at a 23-percent clip and exports increased at a 17-percent rate, causing China's global trade surplus to fall 6.4 percent compared with the same period last year. Reform-oriented and orthodox central leaders alike recall, however, that in 1984 and 1988 relaxed controls over the purchase of foreign goods led to sharp surges in imports when consumers rushed to buy luxury goods and enterprises purchased higher quality production inputs. In both cases, Beijing reimposed trade restrictions to arrest the slide in the trade account. If consumers and factory managers believe that this year their window to foreign markets will be open wide only briefly, they may tush again to place import orders.

If the trade surplus contracts sharply, depleting China's hard currency reserves, central leaders could postpone further trade liberalization or even reassert some import controls. These measures could be accompanied by a leadership decision to devalue the official rate of the Chinese currency to encourage exports and make imports more dear. Because the value of the renminbi in the swap centers is below that set by the official rate, policymakers could defend the devaluation as an attempt to bring the price of the domestic currency closer to its market-determined level.

Although economic expansion will increase the number of jobs, officials may have trouble implementing reforms that allow inefficient firms to trim excess workers or declare bankruptcy. Authorities may already be slowing some labor reforms because many workers, who have long counted on Beijing's promise of cradle-to-grave social welfare protection, have been angered by the prospect of losing their jobs. According to a Hong Kong press report, workers in Liaoning Province responded to recent attempts to reduce bloated labor forces by smashing factory windows and doors and, in one case, stabbing a manager. Recently, when almost half of the 4,000 employees at the state-owned Seagull Watch factory in Tianjin were fired, disgruntled workers destroyed equipment and fought with police, according to Hong Kong press. Even if these are isolated incidents, Beijing is undoubtedly concerned over the potential impact of moving too quickly with labor reforms. Although China does not permit the establishment of unions outside the Communist Party-dominated All China Federation of Trade unions, press reports indicate that earlier this year workers began trying to establish autonomous trade unions--some of which are patterned after Poland's Solidarity trade union--as platforms for voicing workers' grievances.

The leadership has taken some steps to put the best gloss on labor reforms and prepare workers for more changes. In late May, *People's Daily* appealed for worker cooperation and improved welfare programs for those about to lose their jobs. The article called on factory managers to prepare workers for coming changes by explaining to them how labor reforms are ultimately beneficial for all involved.

Beijing's Uncertain View of the Future

Although the rapid growth of nonstate firms combined with continued economic reforms seems certain to change the structure of China's economy, policymakers lack a unified vision as to what the future economy should look like. Deng's campaign this year has patched together at least a working consensus to press ahead. But the unwillingness of some party elders to clearly back Deng's program suggests significant ideological divisions remain, which could undermine attempts to implement policy coherently.

Even within the reformist camp, there may be only nominal agreement over which policies the central government should pursue. According to Chinese press, some policymakers are calling for Beijing to bolster macroeconomic levers before proceeding with other reforms, while economists are stressing the importance of first freeing prices and privatizing state-owned firms. The reformers' unifying procedural principle appears to be that local initiative--not a centrally mandated agenda--should drive China's economy, suggesting they see a limit to Beijing's role in directing economic development. Consequently, reformist policymakers have been willing to devolve power to provincial officials and to encourage them to experiment with policies suited to local conditions. Reformers have typically stressed high-growth measures, supported the maturation of collective and private enterprises, and tried to integrate China into the world economy by increasing exports and tolerating larger foreign investment. But reformers within the leadership have had trouble clarifying the center's role in setting economic policy in part because senior reform leaders have not clearly articulated how far China should progress with efficiency-enhancing measures. Even Deng virtually never in detail about his reform program, instead encouraging local leaders to tinker with whatever measures they believe will improve development--an extension of Deng's emphasis on pragmatism.

Continuing ideological divisions within the leadership will encumber efforts to forge a policy consensus if macroeconomic problems intensify. Lack of leadership consensus over how far reforms should go--as well as the inherent difficulty of managing a socialist economy in transition--imparted a stop-and-go quality to China's reform program in the 1980s. The current reform drive has just gotten under way and it is too soon to judge how much recent financial reforms will affect Beijing's ability to keep inflation within politically acceptable bounds, but a continuation of the stop-and-go process is likely.

In the face of mounting economic tensions, central leaders would probably resort to familiar stabilization policies such as administrative credit and investment controls. The growth of capital markets, however, will complicate the use of traditional socialist economic restraints. One possibility is that Beijing may default to a "managed marketization" course in which the central government decreases its day-to-day involvement in economic decision making but maintains a degree of control over most of the economy --thus allowing Beijing to guide economic activity. The leadership's decision to upgrade the State Council's Production Office into a new Economic and Trade Office (ETO), announced in late June, may have been a step in this direction. According to Hong Kong press, during the transition the ETO has increased its staff and mandate and will be responsible for overseeing state enterprises, communications, finance, and trade

Role of Reform in Easing Inflation

Beijing may hope that the modest capital market reforms local officials have implemented, and the country's progress toward a market system, will mitigate the economy's tendency to overheat. Financial reforms--such as stock markets, retail channels for selling treasury bonds, and the development of secondary bond markets--are giving some investors options for protecting their wealth other than hoarding consumer goods. These forms of savings are less liquid than bank deposits and thus may be somewhat less likely to contribute to an inflationary spiral. Moreover, the development of market-based debt instruments provides private firms with the option of financing their investments without increasing the money supply. The growth of the nonstate sector, which now accounts for half of total output, suggests China's economy would increase supply in response to price increases; inflation would be softened because increases would be in products in greatest demand.

Recent financial reforms will also tend to mitigate the inflationary impact of the budget deficit. Last year China created an investment syndicate, composed of nearly 60 financial institutions that used their retail outlets to market one-fifth of the central government's domestic debt. Total treasury bond sales were almost 50 percent above their targeted level and helped absorb excess consumer demand, develop national bond markets, and--unlike past forced bond sales--build investor confidence in the value of debt instruments.

China's Political Swings		
Reformist		Hardline
China sets economic modernization as its top party goal, opening way for pragmatic economic experimentation.	December 1978	
	April-July 1981	Civilian and Army ideologues attack reformist policies toward intellectuals.
The 12th Party Congress confirms reform policies and begins a campaign to clean up the party.	September 1982	
	September 1983-February 1984	Hardliners attack reform policies and intellectuals in the "Spiritual Pollution" campaign.
The party announces plans for urban industrial reform.	October 1984	
Personnel changes to the Politburo and Central Committee sharply reduce military influence.	September 1985	
	November 1986-January 1987	Student demonstrations that call for more democracy contribute to ouster of General Secretary Hu Yaobang, once Deng's designated heir. An "Anti-Bourgeois Liberalization" campaign persists through the spring.
13th Party Congress establishes reformer Zhao Ziyang as General Secretary.	October 1987	
	August 1988	Hardliners force Zhao to back off from ambitious reform plans and to accept the more cautious approach favored by Premier Li Peng.
	April-June 1989	Student demonstrations lead to a military crackdown in Tiananmen Square, and Zhao is ousted. Jiang Zemin is named General Secretary.
Deng Xiaoping visits the Shenzhen and Zhuhai Special Economic Zones and reiterates his support for southern China's freewheeling economic policies.	January 1992	
The party announces a series of measures to speed reform by extending preferential economic policies to inland areas, expanding China's service sector, and encouraging the development of private enterprise.	May-June 1992	

The Orthodox Economic Prescription

Although Deng Xiaoping's reformist ideas now dominate China's economic agenda, orthodox leaders could regain at least some control over economic policy if reforms produce a significant social backlash from rising inflation, unemployment, or corruption. A political swing favoring orthodox ideas would probably lead Beijing to:

-- Slow or halt the pace of reforms--such as stock ownership systems, price reforms, and labor reforms to trim surplus workers--that could be economically destabilizing or that could fuel social unrest.

-- Attempt to reassert central control over some local economic decisions; for example, by limiting local investment in industrial projects or in "nonproductive" undertakings such as hotels.

-- Tighten credit to reduce inflationary pressures, while relying on bureaucratic directives to ensure that the favored state sector receives needed loans regardless of profitability--rather than letting market forces determine allocation.

-- Increase the proportion of goods allocated through state distribution channels, while clamping down on private enterprises and private traders to limit profiteering and to cap entrepreneurial incomes.

-- Emphasize basic industries and agriculture--as opposed to consumer goods production--to restore what orthodox officials see as more "balanced" economic growth.

-- Tighten central controls over imports to ensure that imported commodities are geared towards industrial policy objectives and to limit competition with domestically produced goods.

An orthodox policy mix would generate pressures for renewed reform but, depending on the balance of power in the leadership, could remain in force for several years. By slowing growth, orthodox leaders would make it more difficult to create enough new jobs for its growing labor force. Thus, Beijing could face the dilemma of either accepting higher levels of unemployment or continuing to grant massive subsidies to inefficient, overstaffed firms to keep workers on payrolls. This would contribute to China's widening budget deficit. In addition, under the orthodox approach, living standards probably would grow more slowly than workers have come to expect. The orthodox program would also encounter strong resistance from many provincial leaders, who have significant powers to undermine central directives that are not in their interest. Thus, over time social and political pressures would grow to turn back to reform.

Orthodox policies also could create a backlash from China's trading partners. Like reformers, orthodox leaders endorse the idea of promoting rapid export growth to speed development, but their turn to tighter import restrictions could cause China's global trade surplus to balloon, as it did in 1990.

affairs. A Chinese-affilated Hong Kong newspaper, however, recently referred to the ETO as an interim office, suggesting that Beijing plans to further empower the ETO, perhaps by granting it commission status, which would give it the authority to coordinate the activities of various ministries.

Central leaders could also fall back on other administrative mechanisms. Last year Beijing unveiled a plan to establish 100 large-scale industrial conglomerates that will pull together into enterprise groups state-owned factories, research institutes, banks, and other firms that are now isolated by regional and bureaucratic boundaries. Proponents intend these groups to achieve greater economies of scale, boost industrial integration, and improve the transmission of production technology. They may also expect these groups to help Beijing establish greater central control over state enterprises. Last year the leadership published a list of 55 groups that will be incorporated as enterprise groups, according to Chinese press reports, and Premier Li Peng indicated in a speech last fall that the leadership will add additional groups after evaluating the results from this first batch.

Ultimately, Deng is probably not as concerned with crafting a detailed policy program as he is with ensuring that reform has sufficient momentum to survive his death. To this end, he no doubt wants China's reform program to be in full swing when the 14th Party Congress convenes this fall to chart the party's course for the next five years. The success of Deng's efforts will be evident in the extent to which the party congress document endorses market-based measures and provides an ideological justification for continuing with reforms in the face of shortrun dislocations. Another indicator of the prospects for continued reform will be the philosophical orientation of the leaders the congress promotes. if further economic overheating is avoided in the runup to the congress, it is likely that reformist policymakers will be promoted, which will strengthen reformers in the leadership and brighten the long-term outlook for economic reform.

Appendix A: Self Chronology of Deng's Reform Push

15-18 January	General Secretary Jiang Zemin visits Shanghai and calls for further "liberation of thought" and "faster steps in economic reform and opening to the outside"--phrases identified with Deng Xiaoping.
18 January	Deng stops over at the Wuhan railway station on his way to Guangdong and meets with Hubei Party Secretary Guan Guangfu and other Hubei officials, according to Hong Kong press. Deng emphasizes that economic reform should continue for 100 years and criticizes party cadres' penchant for "formalism"--preoccupying their time with long meetings and formalities rather than concrete policies that would benefit the economy. Deng reportedly asks Guan to convey these statements to Jiang Zemin and Premier Li Peng.
Mid-late January	Deng, accompanied by President Yang Shangkun, visits reformist Guangdong Province in southern China--his first public appearance in almost a year--and praises the Shenzhen and Zhuhai Special Economic ones there for adapting ideas from capitalism. Reports in Beijing-controlled Hong Kong media depict a healthy Deng touring the SEZs, reiterating support for their freewheeling experimentation, urging local leaders to be bolder in taking risks, and calling for any leaders opposed to reform to resign their posts. Deng's statements are carried widely in southern provincial press and Chinese-controlled Hong Kong newspapers, but the hardline-dominated central propaganda apparatus remained silent until late March.
Late January	An enlarged party Military Affairs Commission meeting is held in Zhuhai apparently to reaffirm People's Liberation Army (PLA) allegiance to Deng and his reform program, according to Hong Kong press reports.
25 January	Li Ruihuan tells a national meeting of propaganda department heads in Beijing that they must make economic constructio --and implicitly not the struggle against peaceful evolution--the focus of their work. Li tells them to encourage people to further "emancipate their minds" and carry on "seeking truth from facts"--two Deng slogans.
3-20 February	Deng, again accompanied by Yang Shangkun, visits Shanghai and meets with local officials.
12 February	An expanded Politburo meeting is held, according to Hong Kong press reports, at which Jiang Zemin relays Deng's instructions on reform dissemination among party cadres.
20 February	*Shenzhen Tequ Bao,* the official newspaper of the Shenzhen SEZ, publishes the first of an eight-part series of commentaries on Deng's recent talks.

23 February	*People's Daily* publishes a pro-Deng editorial, "Opening Up to the Outside World and MakIng Use of Capitalism," written by a Beijing People's University economics professor. The article argues that China should adopt whatever is useful from capitalism for its development strategy.
Late February	Excerpts from Deng Xiaoping's speeches during his tour of southern China are issued as Central party Document Number Two, but the document's transmission is hindered by hardliners in the Propaganda Department and several government organs.
9-10 March	Jiang Zemin chairs a Politburo meeting that takes the unusual step, in a front-page article in the 12 *March People Daily*, of publicly endorsing Deng's call for accelerated economic reform and echoing Deng's warning that the main threat to the party comes from the "left" According to Hong Kong press reports, Jiang, Song Ping, Li Ximing, and Yao Yilin make self-criticisms at the meeting.
14-15 March	*Reform* magazine and the Society for Research on Enterprise Reform and Development cosponsor a seminar on economic reform in Beijing. In attendance are several liberal economists associated with former General Secretary Zhao Ziyang, including Du Runsheng, Gong Yuzhi, and Wu Mingyu--who notes that a new "whateverist faction" has emerged over the past two years, formed by theoreticians who always ask whether something is socialist or capitalist in nature.
16-17 March	Wang Renzhong, Executive Vice Chairman of the Chinese People's Political Consultative Conference (CPPCC)--a nominal advisory body composed of sectorial representatives and headed by hardline party elder Li Xiannian--who in recent years has presided in place of the ailing Li Xiannian, dies on 16 March. The unusual public announcement the next day that Li is too ill to preside apparently offers reformers a unique opportunity to orchestrate discussion at the annual CPPCC meeting to be held 18-28 March.
17 March	A signed article in the official *Economic Daily* says that officials who block economic reform should be fired: "We must resolutely dismiss from their leading positions those officials who lack the spirit of blazing new trails, who are incompetent and mediocre and cannot make new developments."
20 March-3 April	The fifth session of the Seventh National People's Congress (NPC) is held in Beijing. On 20 March Li Peng delivers his annual government work report, which pays only lipservice to Deng's reform ideas. Provincial delegates criticize the report in the most open debate in any NPC session since the 1989 Tiananmen crackdown. At the closing session on 3 April, delegates vote to revise the work report by including more reformist language--including Deng's warning against "leftism" and a refutation of the orthodox idea that discussion of planned

	and market mechanisms reflects a distinction between socialist and capitalist systems.
Late March	Delegates to the 18-28 March annual session of the CPPCC similarly criticize Li Peng's annual government work report.
23 March	Yang Baibing, director of the PLA Political Department, announces that the PLA will serve as a "protector and escort" for reform and support the party's call to promote economic reform for 100 years.
25 March	*People's Daily* publishes an article supporting Deng entitled "The Basic Line Must Be Implemented for 100 Years."
27 March	The PLA's *Liberation Army Daily* says that China can adopt "advanced" elements of capitalism but should shun multiparty systems, bourgeois ideology, and decadent lifestyles.
30-31 March	*People's Daily* and Beijing Central Television finally acknowledge Deng's January trip to Guangdong Province with extensive coverage of his activities there. The *People's Daily* article is essentially a reprint of one that first appeared in the 26 March *Shenzhen Tequ Bao* entitled "The East Wind Brings Spring all Around: An On-the-Spot-Report on Comrade Deng Xiaoping in Shenzhen." The article, which subsequently appears in several major dailies in a central propaganda media blitz on Deng's trip, combines excerpts from Central Party Document Number Two with journalistic descriptions of Deng's visit, but makes no reference to Deng's comments on opposing leftism. Yang Shangkun is portrayed as Deng's closest comrade in arms.
Early April	Party "investigative" work groups are reportedly sent on Deng's behalf to various central organizations--including the party Propaganda Department, the Ministry of Culture, the State Education Commission, the Central Party School, and *People's Daily*--to root out leftists and hardline resistance.
4 April	Hardline party elder Peng Zhen meets with NPC delegates from his home province of Shanxi--his first public appearance in more than a year--and gives lipservice to Deng's reform campaign.
5 April	CPPCC Chairman Li Xiannian sends a message to officials in his home province of Hubei, telling them to support the Three Gorges Dam project--just approved in the NPC session--but apparently refusing to give his views on Deng's reform push.
13 April	The Central Party School sponsors a forum for theoretical workers in Beijing to study Deng's recent remarks. Former Propaganda Department Deputy Director Gong Yuzhi gives a strong pro-Deng talk--subsequently published in Shanghai's *Wen Hui Bao*--criticizing those who would "liken the market economy to capitalism." According to Hong Kong press reports,

participants at the forum support an annual growth rate of at least 10 percent.

14 April — The Beijing-controlled Hong Kong *Wen Wei Po* reports on three recent visits to Shenzhen by groups of army leaders, organized by the PLA's General Political Department. Among the participants are 38 lieutenant generals and 26 major generals, drawn from the commanders and deputy commanders of the various services and the seven military regions.

17 April — The major Guangdong newspapers give front-page coverage to a *Zhuhai SEZ News* article on Deng's January visit entitled "Spring Tide in the South Sea: Notes on Deng Xiaoping's Visit to Zhuhai." The article is also reprinted in the Beijing-controlled Hong Kong press.

17 April — Hardline elder Vice President Wang Zhen pays lipservice to Deng's reform initiative in a written memorial to a deceased colleague.

20-26 April — The party's Military Affairs Commission holds an enlarged meeting in Beijing which endorses Deng's reform push and sets out the military's responsibilities in implementing Deng's remarks as articulated in Central Party Document Number Two. The meeting also apparently discusses a restructuring of the PLA.

25 April — Vice Premier Tian Jiyun, in an address to a class at the Central Party School in Beijing, says that China's opening-up policy should be extended to the poorer interior areas and criticizes "leftists" in the leadership, according to Beijing-controlled Hong Kong press.

28 April — *People's Daily* publishes a proreform editorial entitled "Reach a Higher Level in a Down-to-Earth Way," noting that Deng's speeches in southern China are a source of great encouragement for China's economic development and implicitly suggesting that China should have a higher growth rate than the 6 percent given in Li Peng's annual work report.

29 April — *People's Daily* publishes a commentary entitled "Persist in Doing Two Types of Work Simultaneously" that states China must "carry out reform and opening up on the one hand, and crackdown on all kinds of criminal activities on the other; seize the building of material civilization on the one hand, and the building of spiritual civilization on the other." The "two types of work" formulation continues to be manipulated in May and June by both reformers and hardliners to influence the pace and scope of economic reform in the propaganda apparatus.

1 May — Beijing Central Television shows a frail Chen Yun meeting with Shanghai party and government officials sometime in late April. Chen endorses development of Shanghai's Pudong District and

tells local leaders to emancipate their minds, take bold steps, and do down-to-earth work--all Deng exhortations--but falls to mention Deng by name or specifically endorse the reform drive. The television coverage also shows Yang Shangkun visiting Chen in Shanghai in early February.

8 May — *People's Daily* publishes a proreform editorial that criticizes the hesitancy of some officials to implement reform measures.

12 May — The official *Legal Daily* publishes an article on the need to accompany economic reform with tough suppression of social disorder. The article says if crime and other "negative phenomena" are allowed to continue unchecked opponents of reform will use them as a pretext to slow or halt reform. The article credits Deng with underscoring the need to build both "material and spiritual civilizations."

15 May — A *People's Daily* commentary, the eighth in a reform-oriented series-apparently on hold since late 1991--on Deng's dictum of "building socialism with Chinese characteristics," supports Deng's economic reform drive by arguing that bag "spiritual civilization" is an integral part of China's economic construction. The article underscores Deng's oft-repeated declaration that Marxism, as China's guiding ideology, must continue to adapt and develop to China's changing needs.

19 May — The Beijing-controlled Hong Kong *Ta Kong Pao* cites "a top party leader" as urging all localities to maintain and even increase the momentum of reform, and particularly to "step up the effort to change the operational mechanism of state-owned enterprises" by pushing them into the market.

20 May — Jiang Zemin, in a speech to recent college graduates in Beijing, supports Deng's reform line and urges the adoption of anything useful to China from capitalist and Western countries.

22 May — Deng, his wife, and daughters Deng Nan and Deng Rong inspect Beijing's Capital Iron and Steel Company, according to Hong Kong press. Deng confirms the company's boldness in reform and says that the reform of large and medium state-owned enterprises is a matter of emancipating the mind.

22 May — The PLA's *Liberation Army Daily* carries an article defending the SEZs against charges that they are capitalist and harmful to socialism. The author says the SEZs are fundamentally socialist because public ownership predominates and they raise productivity and living standards.

25 May — Central TV begins a four-part documentary series on Deng's reforms that praises his contributions to China's modernization and depicts Deng as the logical and rightful successor to Mao Zedong and you Zhou Enlai. *Guangming Ribao* and *Xinhua's Ban Yue Tan* magazine cosponsor the production.

Late May	*People's Daily* publishes a series of reform articles specifically targeting state enterprises--following Deng's reported visit to the Beijing Capital Iron and Steel Company--that seem designed to prepare the public, and workers in particular, for the aces and inevitable dislocations that will result from accelerated reforms in state enterprises.
Late May	Central Party Document Number Four is issued, reversing China's primary reliance on central planning in favor of market regulation, according to Hong Kong press. The document also urges an overall opening up of China's economy, including the extension of the special policies of the SEZs to China's interior provinces. Beijing-controlled Hong Kong press says the document elaborates on specific policies to implement the spirit of Deng's speeches during his January inspection tour of Guangdong, and was approved by a 15 May Politburo meeting. The document also announces the upgrade of the State Council Production Office to a new Economic and Trade Office headed by Vice Premier Zhu Rongji.
1 June	Former Hong Kong New China News Agency Director Xu Jiatun, who defected to the West in 1990, publishes an article in the Hong Kong *South China Morning Post* in which he defends the 1989 Tiananmen protests and supports Deng's economic reform, but calls for political reform as well.
3 June	The State Council officially designates Chongqing, in Sichuan Province, as the first "open" city in China's interior-a status designed to promote more rapid economic development by attracting foreign trade, investment, technology, and management techniques already existing in the SEZs and some coastal cities.
6 June	Chi Haotian, the Chief of the PLA's General Staff, leads the fourth--and highest level--PLA inspection tour of the Shenzhen and Zhuhai SEZs since Deng launched his reform drive in January, according to Hong Kong press.
9 June	Jiang Zemin gives a speech to the Central Party School on accelerating reform and stresses the need to guard against leftism. Unlike Tian Jiyun's April address, Xinhua later publishes the text of Jiang's speech and notes that all PLA units are required to study the speech.
11 June	Beijing announces that the State Council Production Office has been upgraded to the State Council Economic and Trade Office. Reformist Vice Premier Zhu Rongji continues as director of the new agency.
15 June	The State Council announces that seven more southwestern cities and counties--including the capitals of remote Yunnan and Guangxi Provinces--will be granted some of the prefferential policies practiced in the coastal areas.

21 June — Hardline party elder Li Xiannian, Chairman of the People's Political Consultative Conference, dies after an extended illness. Li was one of Deng Xiaoping's top rivals and a key patron of hardliners in the central planning bureaucracy.

24-27 June — The State Council holds a meeting on accelerating economic reform in areas along the Yangtze River, with Shanghai spearheading the development of the region.

29 June — Beijing announces a recent joint decision of the party and government to accelerate the development of China's service industries. Hong Kong press reports say the decision is circulating among top party officials as Central Party Document Number Five of 1992.

29 June — Vice Premier Tian Jiyun delivers a speech at a national agricultural conference in Guangdong Province in which he calls for more market mechanisms to regulate the production, marketing, and distribution of agricultural products.

1 July — *People's Daily* marks the 71st anniversary of the founding of the Chinese Communist Party with a harsh editorial warning hardliners to stop resisting Deng's reform drive, underscoring that economic modernization is the party's most important objective.

Appendix B: A Chronology of Central and Economic Reforms, January 1991 to June 1992

1991:

January

China abolishes most direct export subsidies.

February

Shanghai officials announce plans to offer 10 square kilometers of the Pudong Development Zone for lease to foreign and domestic investors.

April

Central leaders establish a financial syndicate of 58 institutions responsible for allocating one-quarter of China's treasury bond sales for the year. Syndicate members sell the debt instruments through their retail channels in an effort to make state treasury bonds more attractive.

Guanghan County in Sichuan Province experiments with agricultural reforms by freeing prices for grain, edible oils, and farm inputs. Although provincial leaders have since modified their efforts, the reform experiment has cut Guanghan's subsidy burden in half. In fact, local officials, pleased with the results, have expanded the experiment to 40 additional counties.

May

Tianjin municipality establishes a free trade zone. Within a month, local customs authorities declared all export firms in the zone bonded enterprises, effectively creating a bonded zone.[5] Within a year, the zone contains 50 foreign-invested firms and domestic enterprises with a total investment of $200 million.

Zhejiang Province opens its first foreign currency exchange market. The market has 40 member seats and 11 monetary organizations that deal with foreign currency affairs.

China raises consumer prices for rice, wheat flour, cornstarch, edible oil, and several other staples sold in state stores.

July

China implements a law that was passed in April by the National People's Congress clarifying income tax obligations for foreign-invested enterprises.

Shenzhen establishes two bonded industrial parks--the Futian Bonded Industrial Park and the Shatoujiao Bonded Industrial Park. According to a Xinhua report, local officials intend the parks to exploit their proximity to

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[5] A bonded zone is the most market-based environment for investors in China. In a bonded zone investors are exempt from import and export duties, and production taxes and industrial consolidated taxes if their products are sold outside Chinese territory. Investors are permitted to set up trade firms, commodity warehouses, and export production enterprises within the area separated by partition facilities.

Hong Kong to import funds and advanced technology to boost Shenzhen's export-oriented economy.

Beijing municipality officials begin to allow private entrepreneurs who operate commercial and industrial businesses in the city to hire employees from labor markets operated by the local government. The move not only speeds the development of legal labor markets, but also requires employers and workers to sign legal contracts that define conditions of employment.

September

The central government declares that foreign-invested firms do not have to obtain advance permission to borrow internationally as long as they register at the exchange administration departments alter signing any loan agreements.

October

Hunan Province--one of China's grain production bases--opens its first grain wholesale market. The market, which the Ministry of Commerce ratified, handles exchanges for grain, edible oil, and forage on a national basis.

November

The People's Bank of China grants the Shanghai Securities Exchange permission to begin issuing China's first renminbi-based stocks that can be sold to foreign investors. The issuance of the stock--known as B-shares--is handled by six foreign and domestic brokers and actually occurs in January.

The State Administration for Exchange Control allows Sichuan Province to open its first foreign exchange market. The market is allowed to sell hard currency earned by domestic and foreign-invested enterprises.

1992:

January

The State Council's Customs Tariff Commission lowers tariffs on 225 items from an average most-favored-nation (MFN) rate of 45 percent to an average rate of 30 percent and cuts non-MFN tariffs on those items by about one-third to an average rate of 41 percent.

February

Trade Vice Minister Tong Zhiguang tells GATT delegates that this year China will eliminate its import substitution list--which the country has used to discourage consumers from purchasing items on the world market that are similar to goods produced in China.

March

Shanghai municipality opens the Waigaoqiao bonded zone and officials announce they have already approved 15 projects for the zone with a combined committed investment of $170 million.

The Industrial and Commercial Bank of China opens its first foreign branch in Singapore.

The Zhengzhou grain wholesale market in Henan Province issues China's first grain futures contracts.

April

China eliminates its import regulatory tax, which policymakers selectively apply to discourage imports of luxury goods such as automobiles.

In an attempt to solve its housing problem, Qingdao in Shandong Province begins allowing foreigners to invest in real estate. According to a press report, the city government will remove its offices from the downtown area to make room for the development of tourism and commerce.

Officials in Haikou, the capital of Hainan Province, announce investment incentives that they claim will make the city "more flexible, more open, and more favorable" to foreign investors than any area in China These measures include: allowing leased land to be freely transferred, released, mortgaged, inherited or used as material investment; allowing foreign banks to establish branches; allowing foreign-invested firms to transfer their capital, including profits, out of China; and allowing local businesses to issue bonds and shares both at home and abroad and to borrow funds using their estate as mortgage.

China significantly raises state-controlled consumer grain prices, and Guangdong Province abolishes grain rations entirely.

May

The Shantou Special Economic Zone (SEZ) leases land in the zone for the first time--a move widely regarded as a step toward reforming land-use rights. The SEZ conducts the bidding for the land in accordance with regulations the Shantou City government drafted earlier in the year.

The Ministry of Commerce allows Shanghai to open its first meat products wholesale market.

The State Council approves establishing a free trade zone in Dalian Municipality, in Liaoning Province. According to press reports, construction has begun and the zone will probably open in early 1993.

June

Gansu Province begins allowing all state-owned, collective, and private enterprises to engage directly in foreign trade. In addition, the province signs an agreement with Mongolia to open a port in the Mazong Mountains to facilitate border trade.

Chinese Government-controlled Hong Kong press reports that the State Council recently granted Beijing Municipality permission to implement policies--similar to those enjoyed by SEZs--to attract foreign trade and investment.

A Ministry of Foreign Economic Relations and Trade official announces that China will abolish import and export licenses for numerous commodities currently subject to central oversight, and that 122 internal management documents will be abolished. These documents include control of export

volume to Hong Kong and Macao, management of export revenues, and related rules of importation of selected agricultural commodities.

Appendix C: China's Shifting Trade Patterns

US Links Hold Steady...

The United States remains China's primary export market despite Beijing's well-publicized export diversification drive announced in July 1991 in the wake of US Congressional review of China's most-favored-nation (MFN) trade status.[6] China's exports to the United States increased at a nearly 25-percent clip in 1991, according to US statistics, and continue to account for over one-quarter of China's global sales.[7] China expanded its share of the US market in labor-intensive products such as garments, pottery, and footwear--US imports of Chinese footwear climbed 71 percent last year and now account for nearly one-third of total US shoe imports. Chinese exports also captured an increased share of the US market in more technologically sophisticated product lines, including data-processing machinery and parts, telecommunications equipment, and optical equipment. Indeed, virtually the only categories where China's share of the US import market declined last year were in product lines needed to fuel increased domestic production, such as textile fibers and fabric, primary form plastics, and power-generating equipment.

US exports to China in 1991 climbed nearly 31 percent--about 50 percent faster than the growth in China's global imports. Beijing's relaxation of import controls aided US suppliers in defending their overall share of the Chinese market. US export growth was strongest in products required to stoke China's expanding domestic output, such as fertilizers, organic chemicals, and plastics. Big ticket sales--most notably a 45-percent increase in US aircraft exports--contributed to the US export gains as well. Purchases of US grain fell, however, probably as a result of China's bumper wheat harvest last year.

Despite the improved performance of US exports, US statistics indicate that the trade deficit with China widened 22 percent to $12.7 billlon in 1991.[8] Early trends suggest China will probably run another record surplus on bilateral trade this year; US imports from China grew at a 41-percent annual rate in the first five months of 1992, nearly three times faster than the growth in China's sales to the world. The early surge in Chinese exports is almost certainly being fueled by concerns that China's access to the US market might be reduced later this year--either as a result of sanctions stemming from the current Section 301 investigation of China's market access barriers to trade or because of conditions placed on the renewal of China's MFN status in 1993. Although the current export expansion is likely to slow in the second half of 1992, Beijing's bilateral trade surplus will probably exceed $15 billion this year.

... While Ties to Asian Neighbors Deepen

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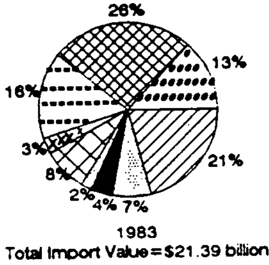
[6] China's export diversification strategy is designed to reduce its dependence on the US and EC markets by boosting exports to developing countries in the former Soviet Union, Eastern Europe, Latin America, Africa, the Middle East, and Asia.

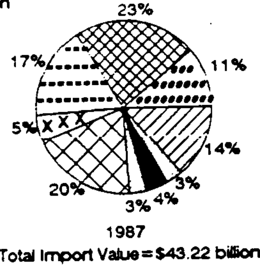
[7] Because of the growing discrepancies between Chinese trade statistics and those of its partners, wherever possible we have used partner-country statistics.

[8] The US bilateral trade deficit with China in 1991 accounted for 19 percent of its $66 billion global deficit.

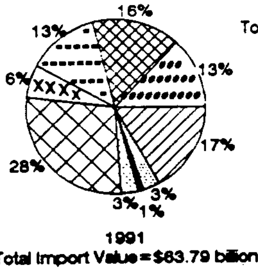
Sources of Chinese Imports



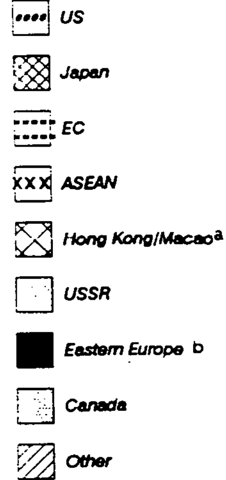
1983
Total Import Value=$21.39 billion



1987
Total Import Value=$43.22 billion



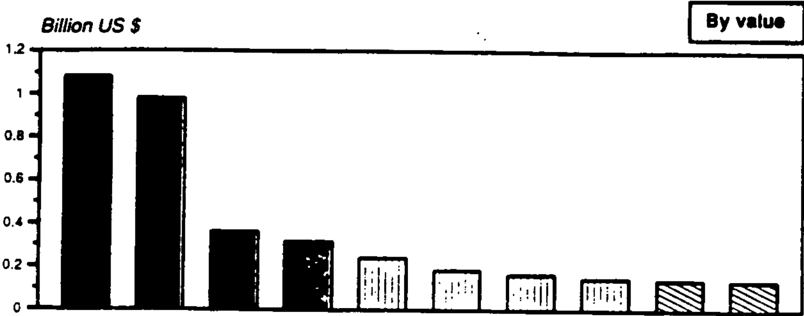
1991
Total Import Value=$63.79 billion

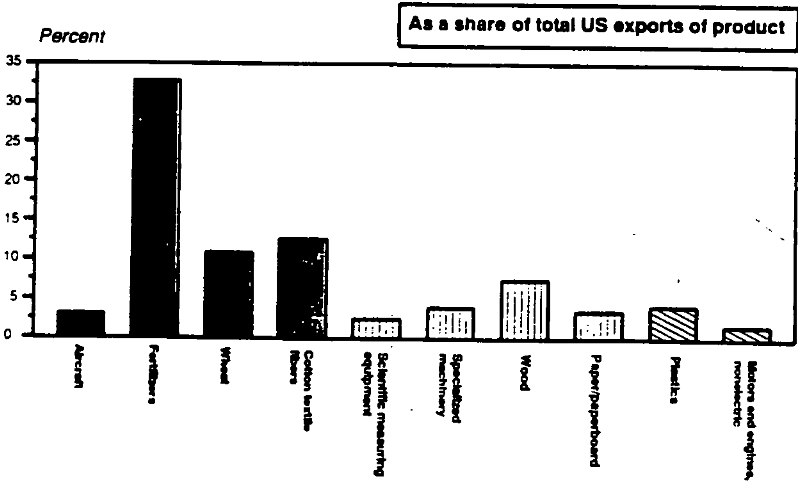


[a]*Hong Kong/Macao statistics probably include goods from Taiwan.*
[b]*Includes Bulgaria, Czechoslovakia, East Germany (1983 and 1987 only), Hungary, Poland, Romania, and Yugoslavia.*

Source: Chinese Customs statistics

Top 10 US Exports to China, 1991

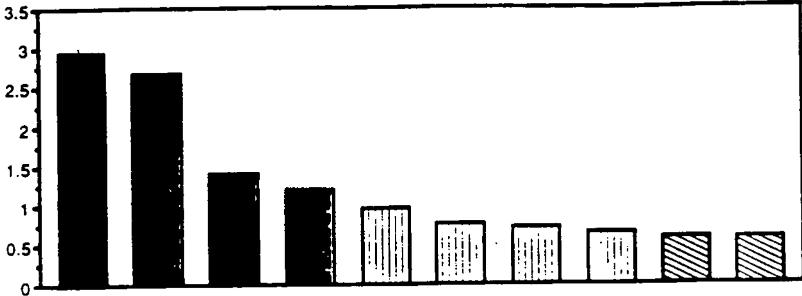




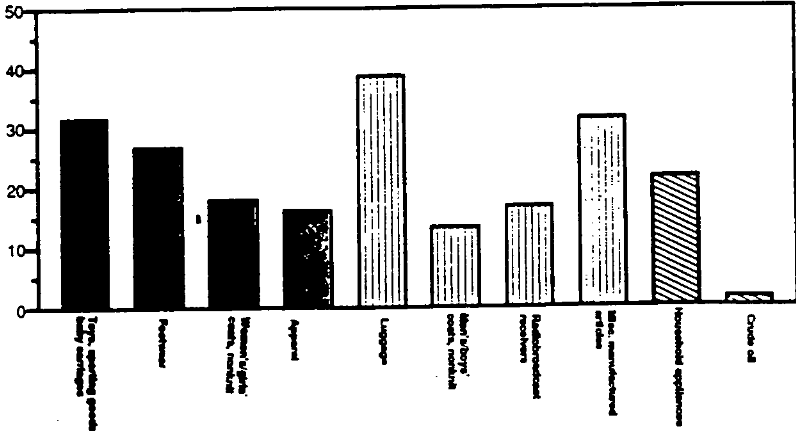
Source: US Commerce Department statistics. Exports on free alongside ship (f.a.s.) basis.

Top 10 US Imports From China, 1991

By value



As a share of total US imports of product



Source: US Commerce Department statistics. Imports on cost, insurance, and freight (c.i.f.) basis.

Beijing turned its attention to nurturing trade ties in its own backyard in 1991, solidifying links to established trade partners and cultivating contacts with emerging markets in the region. The shift in China's focus probably reflects not only the leadership's recognition that considerable opportunities exist for expanded trade within Asia but also the belief that solid economic relations with its neighbors may be the best counterweight to an integrated European Community (EC) or an alliance resulting from a North American Free Trade Agreement.[9]

Japan was perhaps the key beneficiary of Beijing's renewed interest in the region. After a five-year slide, Japanese suppliers increased their share of the Chinese import market--often at the expense of US and EC exporters in specific product lines. According to Japanese statistics, Japan's exports to China climbed 40 percent last year--faster than the 31-percent increase in US sales to China-while purchases of Chinese goods increased just over 18 percent. As a result, Japan's trade deficit with China actually nudged down slightly, falling 5 percent to $5.6 billion. Although Japanese commercial loans and aid probably paved the way for increased sales to China last year, the inroads also probably reflect a political decision on Beijing's part to reward Tokyo for the important role it played in supporting an early return to normal economic relations with China following the Tiananmen crackdown; concessional lending alone did little to improve Japan's share of the Chinese market during the late 1980s.

ASEAN's share of the Chinese market also increased slightly in 1991 to nearly 6 percent. Statistics from ASEAN countries indicate that all members successfully boosted their sales to China last year, and, in most cases, the growth in exports to China outpaced any increase in Chinese sales to their markets. **Thailand** and **Indonesia**, for example, improved their overall trade balances with China by paring imports of Chinese products.

Dramatic gains-albeit from relatively small bases--characterized China's trade with emerging trade partners in the region last year:

- Trade with **Taiwan** increased 64 percent to $4.2 billion, with Taiwan enjoying a surplus of over $3 billion.[10] Although Chinese statistics do not provide a commodity breakdown of cross-strait trade, Taiwan's exports to the mainland are dominated by sales of components and semifinished goods used to produce finished goods for subsequent export China's sales to Taiwan are composed primarily of agricultural products, although Taipei began allowing indirect imports of semiprocessed goods as well last year.

- The opening of representational trade offices in early 1991 smoothed the way for expanded trade with **South Korea** last year. China's exports to South Korea, dominated by sales of low-priced agricultural products, soared 73 percent, according to Chinese statistics. Despite a 56-percent the in imports from South Korea, China recorded a surplus of $1.1 billion.

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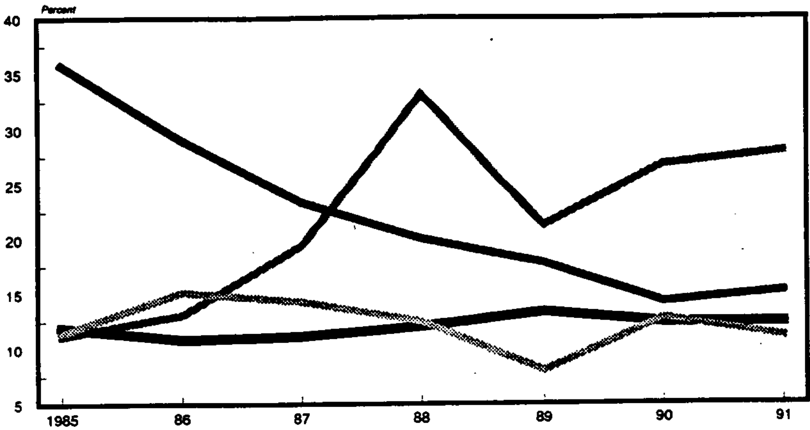
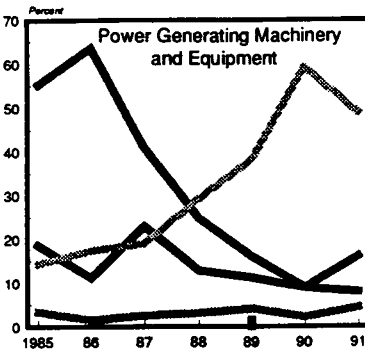
[9] For its part, Beijing remains cautious about formal participation in Asian economic groupings. Although China--along with Taiwan and Hong Kong--joined the Asia Pacific Economic Cooperation arrangement last year, Chinese officials have been hesitant to sign on to other associations that either carry political overtones or that might be viewed as exclusionary. For example, Beijing has indicated only lukewarm interest in Malaysia's proposal for an East Asian Economic Caucus and Japanese proposals for a Northeast Asian economic sphere.

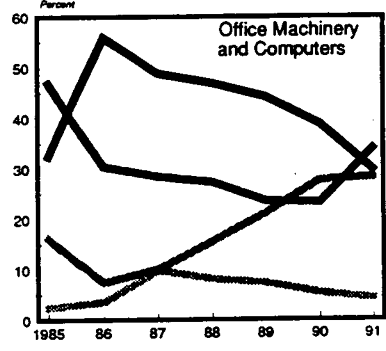
[10] Because of Taipei's ban on direct trade and investment links to China, trade continues to be routed through third-country entrepots--usually Hong Kong.

Japan Increases Its Share of the Chinese Market in 1991...



...Edging Out EC and US Suppliers in Key Sectors





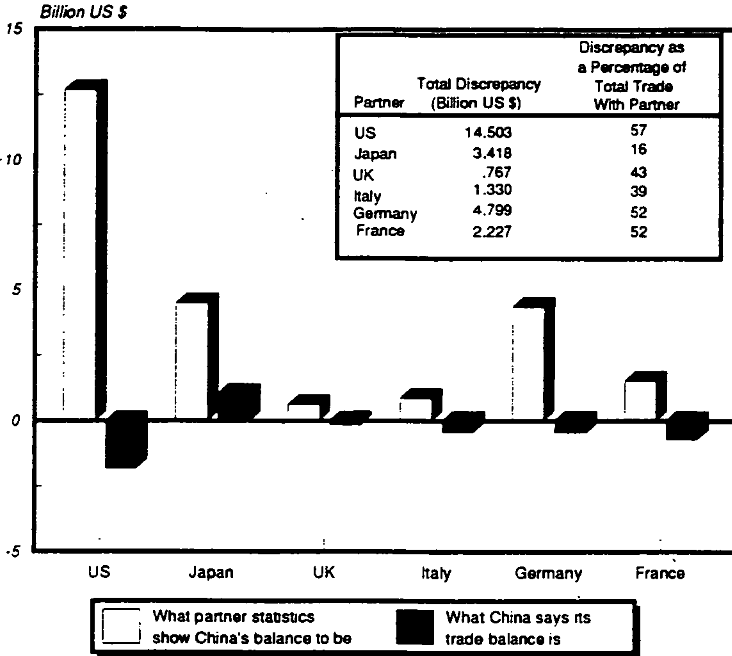
US Japan Hong Kong EC4*

Source: Chinese Customs statistics.

*The EC4 includes China's primary trade partners in the European Community (EC)--Germany, France, Italy, and the United Kingdom-- which together accounted for 78 percent of China's trade with the EC in 1991.

Note scale change.

China: Statistical Discrepancies With Key Trading Partners, 1991*



Partner	Total Discrepancy (Billion US $)	Discrepancy as a Percentage of Total Trade With Partner
US	14.503	57
Japan	3.418	16
UK	.767	43
Italy	1.330	39
Germany	4.799	52
France	2.227	52

* In order to eliminate the distortions caused by including insurance and freight costs in import statistics, data have been adjusted to a balance of payments basis.

- Trade with **Vietnam** more than quadrupled last year, according to Chinese statistics, although it still accounts for less than 1 percent of China's trade with Asia. Chinese traders in border regions adjacent to Vietnam--which have largely been left out of the economic gains enjoyed by China's coastal provinces--have been at the forefront of these expanded ties.

EC Losing Ground

The EC member countries fared considerably worse than their Asian competitors in the Chinese market in 1991, according to member-country statistics. China's primary trade partners in the EC--Germany, France, Italy, and the United Kingdom--all experienced a deterioration in their trade balances with China last year. The slide was most pronounced for the **United Kingdom**, which saw its bilateral deficit with China nearly triple to almost $675 million following a one-third drop in sales to the Chinese market. Both **France** and **Germany** faced nearly a doubling in their trade deficits with China.[11] **Italy** alone increased its exports to China in 1991, posting strong gains in exports of textile fibers and yarns, organic chemicals, metalworking machinery, telecommunications equipment, and road vehicles. Low-interest commercial loans and government-backed credits from Italian sources almost certainly played a role in Italy's increased sales.

The EC countries will probably see their position in the Chinese market improve modestly this year. Bonn's decision in late June to remove restrictions on government-backed credits to China, at least through the remainder of 1992, will almost result in some big-ticket German sales. In addition, a high-powered Chinese trade mission--the largest such effort ever launched by Beijing--visited 14 countries during a month-long buying swing through Europe beginning in late June, ringing up an estimated $2 billion in purchases. Even before the results of the buying mission were in, Chinese statistics for the first three months of 1992 showed Chinese exports to the region down, while Chinese imports from the EC ticked up slightly.

Trade With Eastern Europe Continues Decline

China's trade with East European countries continued its downward spiral last year, plummeting 50 percent from 1990 levels to $879 million, according to Chinese statistics.[12] The move to central trade on a hard currency basis is almost copy at the root of the decline, but trade has been slowed as well by the need to clear imbalances in annual barter arrangements that have emerged in recent years. China's exports to Czechoslovakia, for example, fell 92 percent in 1991 as Beijing waited for Prague to deliver goods to cover a shortfall that had emerged in 1990. Ties to Yugoslavia fared the best last year--down just 1 percent--but are likely to suffer this year as a result of the ongoing unrest in Yugoslavia.

Beijing Hoping for Increased CIS Dealings

China's trade with the former Soviet Union suffered from the dissolution of established trading ties as the Soviet Union fell apart, dropping 11 percent in 1991 to $3.9

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[11] The disparity in EC and Chinese statistics as a percentage of overall trade has approached that between US and Chinese statistics.

[12] Eastern Europe is defined here as comprising Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia.

billion, according to Chinese statistics. Chinese imports of iron, steel, and timber all declined--probably as a result of production problems across the border. Chinese exports of foodstuffs, not surprisingly, increased last year, but Chinese exports overall fell nearly 19 percent.

Trade with the former Soviet republics is likely to recover this year as Beijing spearheads efforts to spur growth in the border regions. China's State Council in early 1992 designated four border cities--Heihe and Suifenhe in Heilongjiang Province, Hunchun in Jilin Province, and Manzhouli in Inner Mongolia--as "open cities," endowing them with the same status as China's 14 coastal open cities. This new status opens these regions to foreign investment, even in the service sector. Local enterprises in these border cities are being offered incentives--such as tax holidays--to establish joint ventures with the former Soviet republics, and China's specialized banks are increasing lending to the region. The attention already appears to be bearing fruit--Chinese statistics indicate that the volume of barter trade during the first four months of 1992 more than tripled over the level set during the corresponding period the previous year. Although official Chinese statistics for the first quarter of 1992 show nearly 90 percent of China's CIS trade continues to be conducted with Russia, the decentralization of trade in both China and the CIS will almost certainly result in more diversified dealings this year.

Appendix D: What Is a State-Owned Enterprise in China?

China generally categorizes industrial firms as "state-owned enterprises," "collective enterprises," and "private enterprises."[13] According to Chinese statistics, there are now over 75,000 state-owned industrial enterprises, including nearly 13,000 that are designated as "large and medium-sized" firms. Under reform, however, the distinction between many of these state-owned enterprises and other types of firms has become increasingly blurred.

"State-owned enterprise" is a short-hand term for the Chinese designator "enterprise under the ownership of all the people." Before 1980, state-owned industrial enterprises were generally:

- Established and maintained with central government investment.
- Overseen by central government authorities, such as industrial ministries.
- Included in central government plans that specified allocations of funds and materials that the firm would receive from government sources and set output targets for goods to be delivered to the state.

Virtually all other industrial firms before 1980 were "collectives" with ownership theoretically vested in the firm's workers rather than in "all the people." The Chinese consider collectives-which are generally smaller than state firms-to be another form of public ownership. In addition:

- They usually used funds raised by local authorities, such as at the commune or urban district level, or pooled by individual investors.
- They were not included in central government plans. Most collective industrial firms, however, were probably listed in local plans, receiving production and tax targets from municipal or commune industrial bureaus.

The reform decade of the 1980s brought significant changes to this scheme. Beijing decentralized the supervision and planning control over most state enterprises to provincial or municipal authorities. Local officials subsequently contracted the operation of many smaller state firms to leaseholders or worker groups, changing these firms to collective or individual management even if they remained "state-owned." Authorities also gave most state firms the authority to withhold a portion of their products from the state's allocation network for sale through market channels.

Beijing also allowed limited private-sector activity and opened the door to foreign-funded joint ventures. There are now millions of family-run enterprises, primarily engaged in retail and service trades. In addition, China has 100,000 registered private firms, in some cases employing hundreds and even thousands of workers.[14] As of the end of 1991, there were some 17,000 foreign-funded joint ventures and wholly owned foreign firms operating in China.

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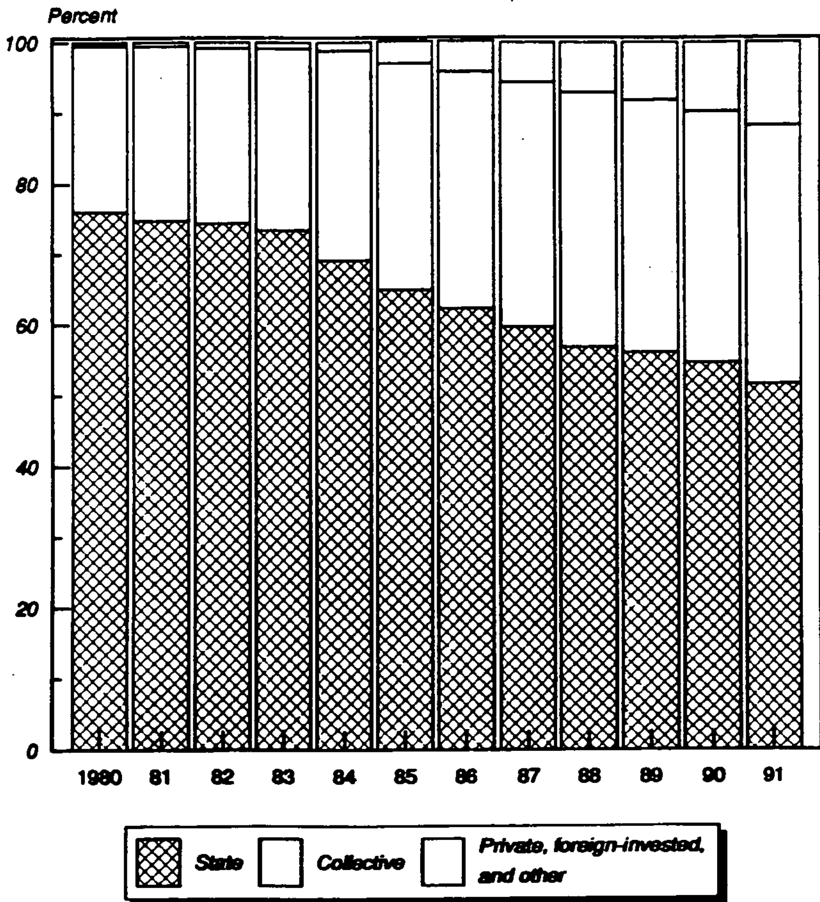
[13] In Chinese, "enterprise" refers to any business-related endeavor, including factories, mines, service outlets, distribution organizations and retail shops, financial establishments, and foreign trade organizations. This appendix focuses on industrial enterprises except where specified.

[14] China defines "private enterprises"--as distinguished from individual and family-run firms--as those having more than seven hired employees.



Source: Official Chinese statistics

The proportion of China's industrial goods produced by state enterprises has fallen to less than 55 percent, whereas collective and family-run enterprises now account for more than one-third. Private enterprise and joint-venture industrial output is rising rapidly, but remains under 10 percent of total output.

Aside from some key commodities such as petroleum and other heavy industrial products, it is now hard to distinguish between goods produced in state, collective, and private enterprises. For example, state firms may produce goods in joint ventures formed with foreign partners, using materials processed by collective and family-run rural enterprises, and funded through sales of shares to domestic and foreign investors.

The deliberate misuse of ownership labels also complicates efforts to distinguish between enterprise types. Private entrepreneurs, with the compliance of local officials, often register their firms as either collective or state-owned as a hedge against shifts in the political wind. Local officials also use false-front overseas companies-particularly in Hong Kong--to invest in local firms, creating "false foreign devil" joint ventures to gain preferential tax rates and other benefits.

Despite these complications, there are hundreds of key firms that remain under the supervision of the central government and retain other attributes of the classic state-owned enterprise. These firms include virtually all of China's oilfields, major steel mills, most large power generation stations, the railroad system and other key transportation and communications enterprises, and many defense-industrial plants.

A growing number of central economic ministries are also organizing corporations to oversee "enterprise groups" that may include state firms, joint ventures, and financial institutions. The regime recently released a list of 55 centrally authorized groups that will receive enhanced powers--including the authority to conduct foreign trade--and others are almost certainly under consideration. These enterprise groups--which are probably intended to mimic the success of Japan's keiretsu--may help Beijing recentralize some control over the state-enterprise sector and also boost the sector's commercial prospects. The lines of authority in these emerging corporations are often blurred, however, by competing vested bureaucratic interests.

Appendix E: China and Environmental Degradation

China is slowly recognizing that environmental degradation is a threat to long-run economic development. Deng Nan, Vice Minister of the State Science and Technology Commission and daughter of Deng Xiaoping, in May 1992 indicated that China's direct and indirect economic losses to environmental degradation are valued at more than 100 billion yuan annually or approximately 5 percent of the country's 1,958 billion yuan GNP. She also questioned the country's ability to sustain rapid economic growth into the next century in the face of worsening air and water pollution, soil erosion, and acid rain:

- A recent study by the World Health Organization places four Chinese cities--Shenyang, Xian, Beijing, and Guangzhou--among the world's 10 worst for air pollution. Such pollution doubled the incidence of lung cancer in northern China during the 1980s, according to China's Ministry of Public Health MPH).

- According to Chinese estimates, the drinking water of more than 60 percent of the country's population, or roughly 700 million people, fails to meet Beijing's standards--the lowest accepted by the World Health Organization--and is contaminated with industrial wastes, such as lead and mercury, as well as human and agricultural wastes. Although medical data is sketchy, MPH officials believe contaminated water is raising the incidence of stomach, liver, and intestinal cancers in many Chinese cities.

- Acid rain affects roughly 520,000 square miles of territory--much of it prime agricultural land--according to Chinese press reports. In addition to lowering crop and fishery yields, acid rain damages vehicles and industrial and agricultural equipment by accelerating metal oxidation or rusting.

- According to official estimates, China lost more than 1 million acres of arable land to soil erosion over the past 40 years. Most of this soil washed into rivers, lakes, and seas, clogging hydroelectric plants and poisoning fisheries with residual pesticides and fertilizers.

China's attention to domestic environmental issues expanded over the past decade. Beijing adopted more than 15 environmental protection laws and boosted spending on the environment on average by 22 percent annually to roughly $2 billion in 1991. In turn, China's pollution control effort has a strong local component; press reports indicate that the majority of antipollution projects are funded by municipal or provincial governments, and some local-level officials in coastal provinces--which are experiencing rapid economic growth largely as a result of foreign investment--are opposing further development of heavily polluting industries, such as petrochemicals.

In addition, Beijing last year announced a new economic philosophy that placed economic growth and environmental protection on an equal footing. China plans to spend $15 billion on the environment during the Eighth Five Year Plan (1991-95) and is becoming increasingly active in international environmental forums. Chinese economists and scientists are joining international efforts to devise methods of accounting for environmental factors when measuring economic growth and to develop affordable cleanup technologies. In June, some 70 Chinese companies participated in a "green" tech-

nologies and products exhibit during the United Nations Conference on Environment and Development.

Beijing, however, will probably continue sacrificing the environment to its shortrun economic development goals. Central leaders show little interest in addressing environmental concerns. Without support at the top, China's pollution control effort will probably remain minimal. China's spending on the environment remains below that of comparable developing nations, and National Environmental Protection Administration (NEPA) chief Qu Geping estimates that over the next decade China needs to spend at least $4 billion annually to control pollution and nearly $38 billion to clean up earlier damage. Moreover, China's pollution control regime is weak. Legislation calls for heavily polluting factories to be moved to cities' our instead of being forced to close. NEPA's regional offices are funded by local officials, who--despite the movement against foreign polluters--also run the domestic factories that are generally the worst environmental offenders. NEPA collected only $3 million in fines polluting factories during the 1980s.

In addition, expanding the country's inadequate energy supplies to fuel continuing fast-paced economic growth is a priority during the 1990s, leaving little room for attention to ecological and environmental concerns; in 1990, Beijing set its sights on increasing energy production by more than 35 percent by the year 2000. Approximately 75 percent of China's energy supply is generated by burning coal, which, according to press reports, releases some 14 million tons of smoke, 16 million tons of sulphur dioxide, and 3.5 billion tons of carbon dioxide into the atmosphere each year.

It is difficult to calculate the impact of environmental degradation on China's economy given the country's lack of accurate pollution statistics; Beijing only began sporadic environmental monitoring in the early 1980s. Nevertheless, in our view, the costs could be high:

- Pollution-related health problems--cancers, respiratory and bone diseases--will almost certainly lower worker productivity rates and may stress China's health care system, which averages only one doctor per 680 people.

- Air and water pollution and deforestation are threatening to diminish China's attractiveness to travelers; tourism last year generated $2.8 billion in foreign exchange.

- Worsening erosion and leaching will further reduce soil fertility, necessitating greater use of chemical fertilizers--China already consumes more than 110 million tons of fertilizer annually to replace lost nutrients. Some Chinese agricultural experts believe that stagnating grain output may force China to become the world's largest importer within 10 to 15 years.

- Pollution and overpumping of ground water will almost certainly worsen China's water shortage--many cities fall short of demand by 35 percent during peak-use periods--hindering production in many industries, such as mining, steel, and electronics, which require clean and plentiful water supplies.

SENATOR BINGAMAN. Thank you very much. Mr. Zinser, did you wish to make any statements before I ask questions?

MR. ZINSER. In Mr. Petersen's statement, I'm sure he meant to say $12.7 billion was the U.S. trade deficit with China last year, rather than $2.7 billion.

MR. PETERSEN. That's correct.

SENATOR BINGMAN. Let me ask a few questions about this trade relationship. Your Appendix C in the Report summarizes the main point that you wish to make about the trade relationship. I guess I'm struck by the fact that as our imbalance with China continues to grow, the imbalance with some countries, at least, is improving; for example, Japan. You talk about how Japan's trade deficit with China nudged down slightly, falling 5 percent. Could you elaborate a little bit on the reasons that lessening of the trade imbalance between China and Japan, while ours is continuing to worsen?

MR. ZINSER. I think there are several reasons. First, I should point out that one of our other graphics shows that the share of China's market that goes to Japanese exports has fallen substantially from the mid-1980s until last year. It was only in last year that it started picking up again.

SENATOR BINGMAN. This is exports from China to Japan?

MR. ZINSER. No, from——

SENATOR BINGMAN. Japan to China.

MR. ZINSER. That's right. To say it another way, the share of China's imports coming from Japan fell substantially overall during the 1980s, and that's starting to turn around.

SENATOR BINGMAN. Let me just interrupt a second to refer to the charts that are in your Report. This is U.S. trade imbalance with China, which, according to what I understand these charts to say, is continuing to worsen, and has worsened, very substantially in the last three or four years. So, that's the backdrop that leads me to the question about why Japan seems to be doing better.

MR. ZINSER. Well, let me answer from the U.S. standpoint, if you prefer. On the export side, our imbalance is worsening because China is continuing to shift a number of resources into labor-intensive industries that produce products that are in strong demand in the United States.

There's also been a substantial shift of foreign investment, particularly from Hong Kong and Taiwan firms, into Southern China, and that's adding to the rapid export growth.

On the other side of the ledger, Chinese imports from the United States fell sharply in 1990 as a result of a deliberate policy to restrict and cut down imports across-the-board, though it's tended to fall disproportionately on U.S. firms because the U.S. products were concentrated in a few product categories that China tightened import controls over substantially.

SENATOR BINGMAN. What are those product categories?

MR. ZINSER. We have a chart in our Report that shows some of those categories: fertilizer, wood products, paper products and plastics were all sectors that were particularly hard hit by the Chinese import restrictions in 1989 and 1990.

SENATOR BINGMAN. If those restrictions that particularly affected our exports to China in 1990, how does that explain what's continuing to happen even this year?

MR. ZINSER. Well, many of those have not been loosened. As you mentioned in your opening statement, there have been some steps toward import liberalization in China, but it still remains a very strongly administered trade system.

SENATOR BINGMAN. Okay. You're saying that that separates us from Japan in what particulars now? I understand that, maybe, the things that they are exporting are not particularly restricted like the things we're exporting. But what's the rest of that explanation?

I guess the one thing that I'd really like to get your reaction to is the statement that you made on page 34, that the inroads that the Japanese have made probably reflect a political decision on Beijing's part to reward Tokyo for the important role that it played in supporting an early return to normal economic relations with China following the Tiananmen crackdown.

MR. ZINSER. Yes, that's exactly right. And as I was mentioning a minute ago, during the mid-1980s to 1990, there was a substantial reduction in China's imports from Japan. And that was, in part, a deliberate decision to reduce China's dependence on Japanese products. That's turned around as a result of some of the strong steps that the Japanese took in pushing for a quicker return to normal economic relations after Tiananmen.

SENATOR BINGMAN. I guess what suggests itself to me is that if a political decision on Beijing's part was the explanation for China's improved trade relationship, or for Japan's trade relationship, then, perhaps, a political decision on Beijing's part is an explanation for our worsened trade relationship, in that, as you indicated, the items that were singled out for particularly adverse treatment are those that we were exporting to China in 1990. Is that your view?

MR. ZINSER. Well, I don't believe it was deliberately targeted against the U.S. products. I think that it just happened to fall against some of the products that are important export items for us.

MR. PETERSEN. Excuse me, Mr. Chairman. There's a couple of other things here too. Chinese imports from the United States are up as well. They were up about 31 percent last year. It's just that their exports are up far more. That, in part, accounts for this growth. I think, if you look at the base, you get a 25 percent growth in exports to the United States last year. Imports were up 31 percent. But you're still talking about a $12.7 billion deficit.

There are a couple of reasons for that. One, China is trying to increase its exports because they're pursuing an export-led development strategy.

The second thing, they're frontloading their exports to the United States this year because they're concerned about loss of MFN, and they're concerned about the possible 301 sanctions, as well.

We are their most important market. About a quarter of their global sales come to the United States. Our market is also far more open than Japan's market. There are a lot of things at work here.

SENATOR BINGMAN. I particularly noticed the statistic that you have here on page 32, that U.S. imports of Chinese footwear climbed 71 percent last year. That's a fairly substantial increase.

MR. PETERSEN. Yes it is.

SENATOR BINGMAN. Is that displacing other imports, or is that displacing domestic jobs? Or, are we just wearing more shoes?

MR. PETERSEN. I can't answer the domestic jobs point-of-view, Senator. But what we're seeing is very heavy investment in South China, particularly from Hong Kong and Taiwan. A lot of this is low technology, labor-intensive goods, like footwear. I think, in the last six years, we've had something like $13 billion worth of investment go into Guangdong and Fujian Provinces; about $10 billion from Hong Kong, and about $3 billion of it from Taiwan, if I remember correctly.

So, what we're seeing is the development of a very vigorous export sector in South China. And with the loosening of the controls on the trade sector, one of the things we're getting is this increase in exports.

SENATOR BINGMAN. I think one of the things we established last year in the hearing was that—and I don't want to misquote anybody, so, correct me if this is wrong—China's policies reflected a willingness to encourage foreign investment as long as it was foreign investment for purposes of export.

MR. PETERSEN. That's correct.

SENATOR BINGMAN. They were not encouraging foreign investment for purposes of sales to their domestic market.

MR. PETERSEN. That's correct, and that's what you're seeing in this investment in South China. These are basically export-oriented industries.

MR. ZINSER. If I could give an example of what Mr. Petersen's talking about, this very substantial investment from Hong Kong and Taiwan businesses has shifted the shares of Taiwan and Hong Kong and Chinese firms into the U.S. import market.

If I could cite a couple of examples, the category of trunks and suitcases, for example. In 1986, Hong Kong accounted for 34 percent of U.S. imports of trunks and suitcases. China accounted for 12 percent. Last year, that relationship had been reversed. Hong Kong accounted for only 16 percent of U.S. imports of trunks and suitcases. China accounted for 39 percent.

So, those numbers reflect the shift that Mr. Petersen is talking about, As Hong Kong businesses have moved into southern China and set up

export processing factories there, what we're seeing in U.S. trade statistics is a shift in the source of origin of those goods.

SENATOR BINGMAN. Let me ask a few questions about the extent of the efforts that are being made by China to correct this imbalance. You list three things that they have supposedly done—this is on page 7 of your report—they reduced import tariffs on 225 goods at the beginning of 1992 from an average rate of 45 percent to an average rate of 40 percent.

Could you describe that a little more? Is that a significant step? I mean, what are those 225 goods? That still seems like a pretty hefty tariff.

MR. ZINSER. Well, it's a step in the right direction. The tariffs cover a wide range of products from agricultural related products to industrial chemicals, machine tools, some types of handmade items, curtains, and some types of minerals. So, it's a very broad swath that's being cut there.

Now, the second part of your question, the significance of that, that's still a very high tariff rate. And there are still other administrative restrictions, including import licenses and quotas that the Chinese Government can use to restrict imports on particular product lines.

SENATOR BINGMAN. So, while tariffs have dropped, the import licensing requirements and the import quotas remain on those 225 items.

MR. ZINSER. Well, there's been some reduction on import licenses on 16 product categories that's accompanied——

SENATOR BINGMAN. Well, I wasn't sure. You say in that sentence that they're promising to eliminate import licensing for 16 product categories. That doesn't sound very conclusive. We promise a lot around here that we never deliver on.

MR. ZINSER. Well, our best expectation is that those will be implemented. But we don't have the——

SENATOR BINGMAN. There's no concrete action that's been taken yet. It's just——

MR. PETERSEN. It's still a promise at this stage. But I can tell you, Mr. Chairman, we monitor their promises quite closely. And one of our principal functions is to follow-through on the implementation of any number of agreements or promises that the Chinese do make. So, what we have here is a promise. We'll have to see what they do with the promise.

SENATOR BINGMAN. Now, the third item you list is that they abolished the Import Regulatory Tax in April.

MR. ZINSER. That's right.

SENATOR BINGMAN. That applied to 18 categories of high value goods, and amounted to a 20 to 80 percent surcharge on imports. I guess, it's way too soon to know whether that has any effect.

MR. ZINSER. Again, that's a step in the right direction. The average surcharge rate was about 50 percent. Some of the 18 products that were covered under that are items that U.S. firms are competitive in; microcomputers and cosmetics, for instance.

On two of those 18 items, however, it appears that the Chinese have raised the tariff rate to compensate for the reduction in the regulatory tax. Those items are automobiles and video cameras. So, in that case, it's probably a wash.

In the other two that I mentioned and in some of the others under the 18, the U.S. firms ought to be able to increase their sales because of this reduction or elimination in the Import Regulatory Tax.

SENATOR BINGMAN. You also have some reference in here—I think the wording is significant here ,because I don't want to put words into your mouth—but you say:

> Beijing also attempted to salve tensions with both the United States and the EC countries by sending well-publicized buying missions to these markets, armed with shopping lists, tailored to include purchases of big ticket items, such as automobiles, aircraft and industrial machinery, in an effort to present China as an important consumer of these goods. In many cases, however, these delegations' purchases probably merely finalized already agreed to contracts.

MR. PETERSEN. That is correct. That is my judgment.

SENATOR BINGMAN. Is that generally the case with the so-called trade missions that have come to the United States? Is it your view that rather than actually increasing the amount of exports to China that they have essentially had the effect of finalizing already agreed to contracts?

MR. PETERSEN. Yes, that's our general assessment.

SENATOR BINGMAN. Okay. What is the status of negotiations now? You indicate that the threatened sanctions under 301 are a factor in the mind of the Chinese? What is the status of those——

MR. PETERSEN. I think, probably, the U.S.T.R. is better able to answer than we are. Those negotiations are ongoing.

SENATOR BINGMAN. Okay. When did that start? When did we announce that, do you recall?

MR. ZINSER. That was last fall in October, I believe.

SENATOR BINGMAN. Let me ask you—this is a general question—are there actions or policies that some of China's other trading partners have engaged in, which have proven effective in dealing with this export strategy that China has developed, that we ought to consider?

MR. PETERSEN. Most of the EC countries are pursuing the same sorts of remedies that we are—market access talks, talks about intellectual property rights, for instance. They have not been terribly successful.

Indeed, if you look at most of the EC countries, I think their trade balance is like ours, with the possible exception of Italy—I think they may have improved theirs a bit. The Japanese have this patient approach in their case. Among the Asians, I think that the South Koreans have recently imposed some tariffs on Chinese products in retaliation for their concerns about their access to the China market and their import policies.

I don't see anything out there that's magic that seems to be working. The Chinese are sensitive to this as a political issue, not only here but elsewhere. They are concerned about accession to GATT. I think one of the reasons why they undertook some of the liberalization measures that we were talking about a moment ago is to improve their chances for accession to GATT.

So, clearly the exports and the money they earn from exports are very important to them, but they realize it's creating problems too.

SENATOR BINGMAN. What is the overall trade balance that China has with the rest of its trading partners, with all of its trading partners combined?

MR. PETERSEN. They ran a surplus last year of $8.1 billion globally. In the first half of this year, it's down about another 36.4 percent. Their trade surplus last year was a little bit less than it was the year before. If I remember correctly, it was about 8.7 percent the year before. So, it's slowly going down.

SENATOR BINGMAN. It's going down as it relates to the world generally; it's going up as it relates to us.

MR. PETERSEN. That's correct.

SENATOR BINGMAN. And ours is going to be over $15 billion this year. That's your estimate.

MR. PETERSEN. If you were to project the first six months of this year through the total year, it could even be in the neighborhood of $19 billion or $20 billion.

There's some reasons to believe that there'll be some adjustments in the second half of the year. For one thing, in the first six months of this year, they seem to be speeding up exports out of concern over MFN and the 301 negotiations.

In other words, quotas are going to be filled before too long on some of these products. And the orders have already been placed, so they'll fill the old orders. It will be somewhere in that neighborhood, but it's going to be over $15 billion.

SENATOR BINGMAN. With the fifth point of your conclusion, it leds me to believe that you see this trend continuing in the future years. You say that you believe it's likely that the U.S. trade deficit with China—you talk about 1993 or 1992—do you have any reason to believe that the growing imbalance in our trade relations would be corrected in 1993?

MR. ZINSER. One of the uncertainties in making such a prediction is that, as Mr. Petersen said, the 301 market access talks are underway. Were they to be concluded successfully with a reduction in the next few years of the sorts of restrictions that have impeded U.S. sales to China, then that plus a very strong domestic demand in China for imports could cause U.S. exports to China to grow fairly rapidly.

That said, I don't think we have seen anywhere near the peak of the Chinese export potential. And it's very likely that Chinese exports to the United States over the rest of the decade will grow fairly rapidly.

SENATOR BINGMAN. I guess we do have a situation where the longer we continue to negotiate under this 301 the greater the impetus for aggressive exports in anticipation of the conclusion of those negotiations.

MR. ZINSER. Those negotiations are set to conclude no later than the 10th of October of this year. So, they're actually coming down to the wire.

SENATOR BINGMAN. One other issue that you point to is this enormous foreign exchange holding that they have developed. To what extent has China been able to acquire foreign exchange by sales of weapons to the Third World or in the international market? That's an issue which we've discussed a lot up here in Congress, the extent of the weapons sales and the United State's concern about that. What can you tell me about the extent of that as an issue?

MR. PETERSEN. It's very difficult for me to talk very much about that subject at an unclassified level. What I can tell you is that those arms sales peaked in 1988 at the height of the Iran-Iraq war, and they've been falling fairly significantly since then, down about 80 percent. They had about $700 million in conventional arms deliveries last year. They have about $251 million so far this year.

In terms of importance to China's overall economy, it's not a very significant number. But it is important to certain political constituencies . China. It's important to the defense factories that make these goods. It's important to certain forces within the PLA that retain a percentage of the profits from these sales. To some extent, it furthers certain Chinese foreign policy interests. So, it's not solely an economic issue.

SENATOR BINGAMAN. To what extent has China participated in the acquisition of some of this military technology that the Soviets, or former Soviets, the Russians now——

MR. PETERSEN. I stumble over that all the time, too.

SENATOR BINGMAN. And, I guess, the Ukrainians as well.

MR. PETERSEN. Yes.

SENATOR BINGMAN. But the Russians, in particular, have made known their willingness to sell much of their military hardware and technology in the world market. To what extent has China involved itself in that?

MR. PETERSEN. I'm sure you're aware of the purchase of the SU-27 aircraft. There are, perhaps, two dozen of those. It's also a matter of public record that the CIS chief of staff, when he visited China in the February-March period, stated that Russia and China were going to look at areas for cooperation in this area.

I would expect additional Chinese purchases of Soviet military goods in the future. I'd be surprised if they did not. They're interested in it. It's very difficult for me to say much more than that at this level.

SENATOR BINGMAN. Can you say anything about the general trends in China toward increasing the size of the military or the level of weaponry that they have, and whether that holds some threats out for some type of a regional arms race.

MR. PETERSEN. Actually, the trend in the physical size of the People's Liberation Army is just shrinking. Beijing would very much like to cut its ground forces by about 1.4 billion men by the year 2000—billions and millions get mixed up easily when you're talking about China. What they're concentrating on is really a more mobile, more flexible, more efficient military. We're seeing some effort to upgrade the air force. The SU-27 deal is a good example of that. We're seeing some effort to increase naval capabilities as well.

In terms of a regional arms race, I think there's a couple of things that need to be said about that. Number one, everybody in Asia watches everybody else's defense budget. Number two, I would say that China's defense budget is probably of greatest concern to Taiwan and Vietnam.

And the third point that I would like to make is that almost everyone in Asia sees the U.S. presence in Asia and the U.S. military presence in Asia as a force for stability in that region, and they welcome that presence, including the Chinese.

SENATOR BINGMAN. What is the Chinese reaction to what is clearly the growth of this Japan-led trade bloc in Asia?

MR. PETERSEN. I think the Chinese are wary of any trade bloc. And I think they would be particularly worried about one that puts Japan in the driver's seat.

At the same time, they're also concerned about EC92. They're also concerned about the possibility of a North America Free Trade Association. Therefore, they're interested in exploring their options in terms of these trade groupings.

That said, sir, I don't think this is an area where the Chinese have really reached a decision yet. We're seeing some discussion in journals and some discussion in Chinese think tanks. But they're not terribly clear in their own mind what all this means for them and where they ought to go. I think one reason why they're eager to get into GATT is that they figure it will provide them some protection against regional trade associations that may limit their access to either the U.S. market or the European market.

MR. ZINSER. If I could just add to that too. Because the United States is their largest export market, an East Asia regional grouping would cause problems for them in the sense of leaving their biggest market out of it. So, the Chinese have a very strong incentive to support the multilateral trading system. As Mr. Petersen said, that's one of the reasons that they are interested in getting in GATT.

SENATOR BINGMAN. What percent of China's exports come to the United States?

MR. ZINSER. Twenty-six percent.

SENATOR BINGMAN. Twenty-six percent, and that's growing?

MR. ZINSER. That's right.

SENATOR BINGMAN. So, if there was some kind of an Asian trade bloc, the theory would be that the United State's ability to sell back to China would be impeded by that——

MR. ZINSER. And the Chinese would be very concerned that their ability to sell in the United States might be impeded by some reaction from the U.S. Government to the development of an Asian trade bloc.

SENATOR BINGMAN. It's hard to conceive of what protectionist policies an East Asian trade group could put in place that China hasn't already put in place itself. But I can see that there might be some political reaction here.

MR. ZINSER. On the other hand, there are many different scenarios, and we haven't really scoped any of them out. But one possibility is that the formation of a regional trading bloc would force the Chinese to lower some of their import barriers, certainly with the region, and the external barriers might come down to some average for the trade bloc.

There are a number of possibilities there, but the important thing is that the Chinese have a very strong incentive to being part of a multilateral rather than a regional trading system.

SENATOR BINGMAN. All right. Let me ask a fairly general question to conclude things. The reforms that are going forward now, it's not clear to me whether they are leading toward something of a liberalization of their system. The aspects of their system that seem to control their trade relationships seem very much to still command. I mean, there does not seem to be any embracing of a free-market system as it relates to their trade relationships with the rest of the world. Would you comment on whether you think these reforms ultimately will get us to that, or whether we're talking about a situation here for the rest of the 1990s where this export-focused strategy is going to continue?

MR. PETERSEN. I'm going to try to respond to that, and then I'm going to ask Mr. Zinser to follow up.

I think one thing to keep in mind, Mr. Chairman, is that the Chinese reforms are evolving. They're evolving to something. No one is quite sure what that is, least of all the Chinese themselves. They know they can't follow the old policies. So, what they are trying to do, I think, is to follow a version of the so-called Asian economic development scenario where you basically have export-led growth, a vigorous government direction in certain sectors of the economy, and a fairly vigorous private sector, or less public sector of the economy, in China's case.

I think what you will see, if they follow through on the reform initiatives that we were talking about in our Report, is an expanded ability of some of these local enterprises to both import and export.

So, I think we will have some greater import opportunities . China. But I think your key point is a correct one, that this is a system that they turn on and off. And if it gets out of control, if their balance of trade deteriorates significantly, then we will see them put on the breaks again as they have in the past.

MR. ZINSER. Yes, I'd like to go back to Mr. Petersen's opening statement. The cyclical nature of reform overall has been paralleled by a cyclical relaxation of import controls. That said, the trend over time has been for reduced government restrictions on imports. We saw a trend away from that in 1989 and 1990 because there were concerns about their widening trade deficit. Since the end of 1990 and early 1991, there has been movement towards the more liberal import cycle.

As you began with today, Japanese exports to China last year increased 40 percent, which represents a very rapid growth. And it shows that the barriers aren't stopping imports; they are just restricting certain types of imports.

If I could follow up on that just very briefly, I don't want to leave the impression that there's simply a political decision involved in importing more from Japan. There's concessionary financing; there's government aid; and there's a very different mix of exports that the Japanese sell to the Chinese, much more oriented towards machinery, heavy equipment, things like that.

We have some of that in our very strong aircraft sales with China. But we also have much more of a raw materials component in our exports to China. So, the import restrictions in 1989 and 1990, as they tightened up, hurt our sales of those sorts of raw materials. But as China's domestic recovery picks up, our exports in those product lines are also going to pick up as they allow more raw materials in to feed the rapid growth.

SENATOR BINGMAN. I guess what I take from your answers is that although there are signs of loosening of restrictions on imports, those are possible because exports are growing so rapidly. The figure you have in here is that U.S. imports from China grew to a 41 percent annual rate the first five months of this year.

MR. ZINSER. That's correct.

SENATOR BINGMAN. If those exports from China to the United States were not growing at that enormous rate, then it would be your estimate that the Chinese Government could once again tighten down on imports from the United States to China so as to maintain the very beneficial surplus situation that they find themselves with.

MR. PETERSEN. That is correct. And, indeed, the history of the reform process supports that conclusion.

SENATOR BINGMAN. So, the strategy they're pursuing has them directed toward maintaining a very large trade surplus with us.

MR. PETERSEN. With everybody, if possible.

SENATOR BINGMAN. With everybody if possible. But their trade surplus with everybody is decreasing, at least to some extent.

MR. PETERSEN. That's correct.

SENATOR BINGMAN. With us, it's increasing. And they can allow it to decrease with others as long as it keeps increasing with us.

I think that's very useful. I may have some follow-up questions that I would ask you about in the future. I think this is a useful report. Thank you very much.

MR. PETERSEN. Thank you. I welcome the opportunity to be here.

SENATOR BINGMAN. Let me go through a very short closing statement before we conclude the hearing. I think now that the Cold War has receded, we have finished the national security justification for assisting the Chinese economy with special trade and technology transfer policies. Our present trade policies are extremely advantageous to China. Our markets are wide open to Chinese goods. And it's clear from the testimony here and from the findings in your Report that Chinese restrictions on U.S. access to China's market are very substantial.

Beijing's trade policies are a major contributor to our enormous bilateral trade deficit. It's now second only to our trade deficit with Japan. China is a poor country. We welcome its efforts to improve itself and achieve economic reform. But China's efforts should not be at the expense of the American taxpayer and American business firms and workers. The present policy amounts to that type of assistance.

We may be also indirectly facilitating a new Chinese military buildup by providing the foreign reserves which are necessary to buy many of those arms. Clearly, we have a lopsided relationship. It's something that I very much hope we can see some progress on before we have a similar hearing next year.

Again, thank you both for being here.

[Whereupon, at 3:34 p.m., the Subcommittee adjourned, subject to the call of the Chair.]

60-381 (216)