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

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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SECOND SESSION

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JULY 15 AND JULY 22, 1994

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SUBMISSIONS FOR THE RECORD

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FRIDAY, JULY 15, 1994

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:00 a.m., in room SD–628, Dirksen Senate Office Building, the Honorable Jeff Bingaman (Member of the Committee) presiding.

Present: Senator Bingaman

Also present: Richard Giragosian, professional staff member.

OPENING STATEMENT OF SENATOR BINGAMAN, MEMBER

SENATOR BINGAMAN. The Joint Economic Committee will begin its regular review of the economies of the Former Soviet Union and other Communist systems. We began these reviews in 1974, and clearly the world could hardly be more different today than in fact it is.

The focus of the hearings has shifted from a perspective on the Cold War to an examination of the challenge that these republics face in reaching market reform. These economies present a new set of challenges and expectations to the United States and will most likely continue to be a priority for our future foreign policy for some time to come.

While the threats to U.S. and Western security have greatly diminished, it remains vitally important for us to continue monitoring developments in these countries.

A principal concern remains about the former Soviet Union's nuclear capabilities, the necessity for ensuring reliable control over all weapons of mass destruction. We need to be assured of the stability of the region, and we must safeguard against the global danger of proliferation of weapons of a variety of kinds.

We also are committed to a major effort to provide Russia and other reforming economies with economic assistance. Obviously, it is in our interest to encourage the continuation of these reform efforts and to understand how the U.S. and other Western aid is being utilized.

Because of the risks and uncertainties that exist, it's more important than ever that we stay abreast of the changes that are taking place in this dynamic region. To help us in this endeavor we once again have asked the CIA and the DIA to give us their assessments of recent economic performance in the countries in question and to make some projections about the future.

Testifying this morning are John McLaughlin, Director of the Office of Slavic and Eurasian Analysis; John Gannon, the Director of the Office of European Analysis, both with the Central Intelligence Agency; and William Grundmann, who is the Director of Combat Support for the Defense Intelligence Agency.

As I understand it, we're going to start with Mr. Grundmann, who will address military and economic developments in Eastern and Central Europe and in the newly independent nations of the former Soviet Union. Mr. Grundmann will be followed by Mr. McLaughlin, who will speak about the situation in Russia and other countries in the former Soviet Union. Mr. Gannon will then be our final witness, giving an overview of developments in Central and Eastern Europe.

If that's a reasonable way to proceed, we will go ahead with you, Mr. Grundmann, and thank you for being here.

[The paper presented to the Committee by the Central Intelligence Agency starts on p. 23 of Submissions for the Record:]

STATEMENT OF WILLIAM GRUNDMANN, DIRECTOR, COMBAT SUPPORT, DEFENSE INTELLIGENCE AGENCY

MR. GRUNDMANN. Thank you, Mr. Chairman, and good morning.

I am pleased to offer the perspective of the Defense Intelligence Agency on developments in Russia and Eurasia. I will focus on Russia's endeavors to reformulate its national security policy while restructuring its armed forces and reforming the defense industrial bases in the post-Cold War geopolitical environment. I will also point to some of our concerns regarding the potential for proliferation of sensitive technologies and compliance with treaties governing weapons of mass destruction.

My statement, submitted for the record, contains more detailed assessments on all of these topics.

Two years after the dissolution of the USSR, Russia's interpretation of its national interests is leading it to more assertive foreign and security policy goals. While continuing selective cooperation with the West, Moscow will insist on being treated as an equal.

Russia views the resurgence of ethnic, nationalist and religious conflicts in the former Soviet Union as threatening its stability and potentially leading to a large-scale war. Moscow has committed troops to stem many of these conflicts. In this context, Moscow considers peacekeeping a legitimate means to maintain stability.

Russia has trained elements of two divisions for peacekeeping defined very broadly by Moscow to encompass traditional missions such as cease-fire monitoring, as well as a version of peacemaking in Tajikistan that is essentially counterinsurgency combat.

Across the political spectrum in Moscow, there is agreement that a strong, viable military is necessary to defend Russia's interest and to buttress its claim to great power status. Major disagreements remains, however, over the size, shape and role of the armed forces needed in the post-Cold War world and over the levels of financial and industrial resources Russia can afford to devote to the military.

Although the military continues to confront grave problems that are unlikely to be overcome before the late 1990s, approval of a new military doctrine last November provided a firmer bases for planning future forces and operations. While recognizing regional conflicts as the most immediate threat to peace, the new doctrine lays out requirements for maintaining capabilities across the spectrum of conflict. It authorizes stationing troops beyond Russia's borders and employing forces in peacekeeping missions.

The doctrine also assigns the forces a mission to uphold internal stability. This marks a major departure from Soviet era, when this role was largely confined to internal security troops. Significantly, the doctrine dropped the longstanding pledge not to be the first to use nuclear weapons in a conflict.

The Defense Ministry has continued force withdrawals, reductions and reorganization. From about 2.8 million personnel in early 1992, authorized strengths have fallen now to slightly more than 2 million. President Yeltsin reaffirmed a 1.5 million goal for reductions last month. He apparently overrode military desires to maintain a force of around 2 million by accepting counter-arguments that a larger force is unrealistic given budgetary constraints. Actual force levels are well below authorized strength due to a number of factors covered in my statement for the record.

As they downsize, the armed forces are moving to restructure according to new mobile defense concepts. Highly ready covering forces are meant to thwart low-intensity aggression. They would be backed up by rapidly deployable mobile forces to defend against mid-intensity aggression, and strategic reserves would be mobilized in the event of large-scale conflict.

Russia is building up forces along its western borders, which were virtually undefended when it declared independence in 1991. The Moscow, North Caucuses, and Northern Military Districts are being significantly reinforced or reorganized. However, the Russian buildup in the North Caucasus in southern Russia poses potential problems in complying with the Conventional Armed

Forces in Europe or CFE Treaty. Ground force equipment limited by the treaty in the North Caucasus could exceed limits coming into effect in 1995. Moscow contends the buildup is necessary to meet vital security concerns.

When Russia finishes withdrawing units from Germany this summer, there will be no forces stationed beyond the borders of the former USSR. Moscow has also drawn down forces in other former Soviet republics, although more than 100,000 troops remain. Russia has declared that it will retain residual forces in the so-called "near abroad" to maintain stability, to keep access to key facilities and to protect resident Russians.

Along with the above-mentioned force changes, personnel, resource and infrastructure, shortfalls have degraded combat readiness. Troop field training is conducted primarily at low levels, and pilot flying hours and ship sailing days have been sharply curtailed. Morale remains a major problem.

Russia's military currently has little capability for large-scale offensive operations. Despite this dismal readiness picture, the military has preserved unit integrity, and the command and control system remains functional. Russia still retains a significant capability for local or regional operations and readiness is starting to improve.

With readiness of conventional forces at a low level, Russia increasingly views nuclear weapons as the basis for deterrence and security. Strategic nuclear forces are still capable of launching a nuclear strike in minutes. The Russians appear committed, however, to reducing force levels around START II Treaty limits in about 10 years. As a result, the strategic forces will undergo drastic changes and reductions.

The Strategic Rocket Forces Commander of Russia has stated that Moscow maintains command and control over strategic forces in Ukraine, Belarus and Kazakhstan, as well as those in Russia. We believe that strategic nuclear forces do contain sufficient and redundant safeguards to prevent unauthorized use.

Moscow has significantly cut defense spending in response to economic constraints and changing security requirements. Defense outlays in 1993 were less than 30 percent of peak Soviet levels in the late 1980s. Spending on weapons procurement and military research and development has been cut to about 20 percent of peak Soviet levels.

Because Russia's economic decline has been almost as steep as the defense reductions, the defense burden probably remains at somewhat more than 10 percent of the gross domestic product. Although the government had planned to hold the defense budget level in 1993, spending actually fell in real terms by about 20 percent.

The acrimonious debate over the 1994 defense budget reflected the severe financial pressures on the military and defense industry. The Parliament finally approved a budget in late June, which was a compromise between proponents of fiscal restraint and the advocates of fiscal relief for the military. While falling short of what Defense had asked for, the budget could boost spending on both weapons procurement and R&D.

However, tax revenues in the first six months of 1994 are down about 30 percent. Unless the government finances defense at the expense of other priorities, which it seems disinclined to do, defense spending probably will fall again in real terms.

Russia's defense-industrial complex is bearing the brunt of budget cutbacks. Defense industry continues to produce a broad array of weapons for Russia forces and for export, but at dramatically lower output levels compared to the Soviet Union in the late 1980s. Again, output fell markedly in many weapon categories since we addressed this issue before the Committee last year.

Defense factories were idle for significant periods in 1993. This shift to intermittent operations rather than closing plants was an effort to retain industrial and R&D capacities despite sharp spending cuts. However, the number of continuing military-related research and development programs is far lower than at any time during the previous 25 years. Nevertheless, it remains higher than in any other country.

Defense industrial reform has become a key element of debate. Radical reformers envision a greatly reduced, almost wholly, privatized defense industry. Centrists and conservatives seek to downsize defense industry slowly with the aim of preserving its advanced R&D, production capabilities and a skilled work force. They envision a reduced but still robust core of facilities remaining under state control.

The difficult financial situation increases the pressure to convert from defense to civilian production. Little genuine conversion has taken place, however. Progress has been hindered by, among other factors, economic dislocation, paltry government funding and bureaucratic resistance. The problems are more difficult than in the West because Russian plants provide workers social benefits such as housing, health care, day care and recreational facilities, thus tying them to plants and limiting labor mobility. Many plants are surviving by accumulating huge debts to banks and suppliers.

Many Russian arms industries are banking on weapons exports to forestall the need to convert to civilian production. Arms exports receive high-level support because officials view them as a way to avoid unemployment and generate hard currency.

Nevertheless, the declining market for arms and stiff competition from Western producers are frustrating this effort. The value of the former Soviet Union's arms exports have bottomed out at $2 to $3 billion annually, 95 percent of which are from Russia alone, after declining steadily from almost $22 billion in 1987.

The Russians regularly enlist Western marketing experts to develop professional brochures and videos for international arms fairs. They have tried to counter the view that their weapons performed poorly in the Gulf War by giving live-fire demonstrations of some of their most sophisticated systems.

They are also planning to establish training and repair bases around the world to improve after-sales support, which is an area where Western arms suppliers offer superior service. These efforts could boost exports moderately to $4 to $6 billion by the turn of the century, but they will not bring a return to Soviet-era export levels.

As noted by FBI Director Freeh's recent visit to Moscow, the growing power of organized crime groups raises concerns in the West. The potential exists for such groups to use bribes and influence over officials to funnel sophisticated weapons, especially easily concealed ones like manportable surface-to-air missiles, through gray arms markets to terrorist organizations or countries hostile to the West.

Raising even more apprehension is the possible proliferation of materials, technologies and expertise relating to weapons of mass destruction. We have no convincing evidence of significant transfers, but remain concerned that poor controls and the difficult internal situation increase their likelihood.

Russia, Balarus, Kazakhstan and Ukraine inherited the largest stockpile of nuclear, chemical and biological weapons in the world, as well as large numbers of delivery systems and an extensive scientific base. They have foresworn any intention to transfer technology related to weapons of mass destruction and are striving to prevent it. However, legal, personnel and funding problems are slowing progress toward establishing export controls.

The so-called "brain drain" of scientific expertise is a potentially worrisome avenue for technology transfer. Russia's scientific labor force has declined by about 10 percent a year since 1990 because of funding cuts that reduce many to poverty level wages. Many scientists and technicians have turned to other pursuits in the private sector, but a number have been approached and some recruited by other countries. To what extent technological know-how may have been transferred is unclear. The possibility of nuclear weapons proliferation warrants special mention. Russia, Belarus and Kazakhstan have ratified the Nuclear Non-Proliferation Treaty, and Ukraine is expected to do so later this year.

While many scientists have emigrated, very few, if any, have detailed knowledge of nuclear weapons designs. Viktor Mikhailov, head of the Russian Ministry of Atomic Energy, has stated that only two to three thousand scientists possess such knowledge, and they are closely monitored by Russian authorities.

Senator, one of the major challenges facing Russia over the next several years is to continue reshaping its military and defense industrial base into a force capable of guaranteeing national security within the context of a democratic society and a market-oriented economy.

While the West no longer faces the formidable Soviet military threat of a few years ago, Russian military forces will remain among the largest in Eurasia. Russia will retain a capability to develop and produce a wide range of weapons. The potential for local and regional conflicts and the proliferation of sensitive weapon-related technologies remains high.

The West's great challenge is to help Russia emerge as a constructive player in European and Asia security systems. A priority mission of the Defense Intelligence Community is to support Western assistance efforts while continuing to carefully assess Russia's progress towards this goal.

Senator, this concludes our testimony. Thank you.

[The prepared statement of Mr. Grundmann starts on p.39 of Submissions for the Record:]

SENATOR BINGAMAN. Thank you very much.

Mr. McLaughlin, why don't you go right ahead.

STATEMENT OF JOHN E. MCLAUGHLIN, DIRECTOR, SLAVIC AND EURASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

MR. MCLAUGHLIN. Good morning, Senator. It's a pleasure to talk to you again today about Russia and the other successor states of the former Soviet Union.

These states, as you know, have embarked on an enormously complex and difficult economic transformation, one that is more than ever bound up with the parallel political transformations underway in the region. All of these new states inherited a daunting legacy—the world's longest period of central economic planning and communist domination, and consequently a lack of experience with democracy and the rule of law. The new countries have traversed a variety of political and economic paths since getting started on their own in December 1991, and the going has not been easy anywhere.

With regard to Russia, despite the diversity of effort underway, Russia continues to strongly influence developments throughout the region because of its size, its power and its wide-ranging ties with other Eurasian countries. In many respects, Russian economic reforms have made enormous progress in the two and a half years since the breakup of the Soviet Union. Market institutions are now filling the breach left by the breakup of the old command economy, and Russian policymakers are quickly learning that tighter fiscal and monetary policies eventually lead to a healthier, more stable economy. But the goals of a thriving market economy and Western levels of material prosperity for Russian citizens remain a long way off, and the road to there will be difficult, with many twists and turns that will severely test Russia's new democratic institutions and leaders.

Russia's major achievements in economic reform including the following:

The Russian Government removed controls on the vast majority of producer and consumer prices in January of 1992 and has further liberalized the prices of oil, coal, and key foods since then. Many prices have moved closer to world market levels, although energy prices remain substantially lower.

The role of state authorities in allocating supplies among producers has fallen sharply, and roughly two-thirds of retail sales took place outside state channels last year, up from about one-third in 1991.

Government programs to privatize state property have transferred 104,000 small businesses and shares in 13,000 medium and large industrial firms to private hands since January 1992. As a result, the private sector, ranging from traditional small farm plots to large industrial enterprises part way through the privatization process, accounted for about two-fifths of gross domestic product in 1993, up from one-fifth in 1991, as you can see from the chart.

Russia's foreign trade arrangements have moved a long way from——

SENATOR BINGAMAN. Which chart is that? Is there a chart I'm supposed to look at?

MR. MCLAUGHLIN. The chart to your right. It illustrates that about 40 percent of gross domestic product today is associated with the private sector, a pretty impressive increase.

Russia's foreign trade arrangements have moved a long way from the old Soviet system that relied on extensive central controls over quantities of exports and imports, accompanied by artificial exchange rates. The present system, in contrast, is based primarily on export and import duties with exchange rates determined now by supply and demand.

And in the face of severe pressure from antireform elements during and after the December 1993 election, the Russian Government has generally stayed on course.

These achievements are substantial, but less progress has been made in some other key areas:

The financial system, for example, remains underdeveloped, with an antiquated and slow payments mechanism, and the legal system necessary to support a market economy is only beginning to emerge.

Restructuring of the Russian economy has been slow so far. Layoffs of excess workers lag far behind declines in output and investment in new, more efficient factories has been minimal.

Spending for social needs, especially for housing and child care, continues to be funded largely by state enterprises, many of which are in serious financial difficulty themselves. Also, funds for unemployment compensation and job retraining will be short of the needs when layoffs begin in earnest.

The uneven economic transition from plan to market and the simultaneous loss of empire and trading partners have had a dramatic impact on economic performance in Russia. But efforts to assess these changes are complicated by the inadequacies of Russian official data.

First and foremost, changes in prices and quantities alone fail to reflect the hard-to-measure improvements in economic welfare that movement toward a market economy has brought. Under the old system, where political leaders and bureaucrats decided what to produce and how to allocate it, large amounts of output were unwanted or wasted, and shortages were pervasive.

Second, the statistical system that Russia inherited is poorly suited to measuring small-scale economic activity in general and the private sector in particular. As a result, official statistics do not fully reflect increases in private-sector output, especially from savvy entrepreneurs who do not register with the authorities or who underreport their activities.

Nevertheless, the general economic picture is clear enough. Real gross domestic product decreased by 19 percent in 1992 and 12 percent in 1993, according to Russian official statistics. The decline worsened sharply early this year, with real GDP down by 17 percent in the first half of 1994 as compared with the same period last year.

Inflation remains high, although the rate of increase in consumer prices has slowed from an average of about 20 percent per month in 1993 to under 10 percent per month since February 1994.

The recent drop in output and slowdown in inflation reflect tighter reins on both Central Bank credit and government spending. Moreover, interest rates have helped hold down demand for credit by remaining above inflation rates since late 1993. But the government's spending restraint has been achieved in large part by simply withholding budgeted outlays. In turn, this has contributed to rising debt throughout the economy, disruptions of production as disgruntled and unpaid suppliers stop deliveries, and increasing labor unrest by workers lacking pay checks. Pressure is mounting for the government to make good on its obligations that would quickly push inflation up again.

Some restructuring of the Russian economy has begun, especially in cutting back output of weapons and other goods that Soviet planners overemphasized, such as machine tools. But investment in new, more efficient factories has ground almost to a halt because of inflation, the lack of market mechanisms to better allocate funds, and enterprise owners seeking only quick profits in such a risky business climate.

Moreover, excess workers continue to draw salaries in many industries. Nonetheless, unemployment has risen to about 6 percent of the work force, according to Russian estimates that officials say are based on Western definitions.

In material terms, Russian living standards have roughly stabilized now, but they do remain substantially below 1990 levels. Indeed, consumption of many goods has begun to recover from the impact of widespread shortages in 1991 and huge price increases in 1992. And the availability, quality and variety of goods have improved greatly thanks to the liberalization of prices and of domestic and foreign trade. But the economic transition has been accompanied by rising inequality of personal incomes—an anathema to many Russians who were reared on egalitarianism. And public services, such as health care, have deteriorated sharply as local governments struggle to tighten their budgets.

As my colleague noted in commenting a moment ago about defense issues, rampant crime and corruption have emerged as key factors in Russia's attempt to reform its political and economic institutions. Criminal groups, reportedly with the assistance of some corrupt government officials, are infiltrating Russia's financial institutions, distorting the privatization process and discouraging foreign investment.

Violent crime has risen dramatically and some Russian officials have claimed that organized crime groups control some 40,000 business and a majority of Russia's 2,000 banks.

Perhaps, more importantly, the growing power of criminal groups is fueling the perception in Russia that democratic and free market institutions are inherently corrupt. Public opinion polls show, for example, that such perceptions are eroding popular support for reforms and feeding a nationalist backlash. Indeed, Russian polls show that three-fourths of those who voted for Vladimir Zhirinovskiy in last December's elections cited the breakdown in law and order as the primary motive for their choice.

Looking now to the future, Russia's economic prospects in the coming months and years will depend crucially on the ability of political players to support painful economic policies and to survive upcoming elections. The politics of economic reform remain contentious. Voters in the December election approved a new constitution that gives President Yeltsin much greater powers than he had under the old one.

But the new legislature includes large factions representing his opponents, especially the traditional Communist and Agrarian Parties and the ultranationalist Liberal Democratic Party.

To secure implementation of his decrees and avoid another dramatic confrontation with opponents, Yeltsin must increasingly seek compromise with these legislators, build issue-oriented coalitions and employ his new powers judiciously. Moreover, as power has devolved from Moscow to local and regional governments, a wide array of new economic decisionmakers has emerged, further complicating the politics of Russia's market transition.

At the same time, both the president and the legislature have been elected for the first time in Russia's post-Soviet history and must face re-elections shortly or leave office. Politicians must worry about maintaining support in the face of the growing weariness of the population with low living standards and social dislocations.

In the short term, Russia continues to face a tough choice between high inflation and rising unemployment. The present drop in output and the buildup of unpaid debt have spurred calls for action from many legislators, and most of the proposed remedies would be inflationary. The government has resisted these pressures so far and continuing to do so would bring a sharp rise in unemployment, perhaps to over 10 percent by the end of this year. If this happens, labor unrest would intensify, particularly in regions where defense industries provide the bulk of employment. But even if the pain of rising unemployment is postponed now, it cannot be put off indefinitely. Indeed, the sooner the inevitable layoffs occur, the sooner a foundation will be in place for future economic recovery.

In the longer term, much work remains to be done in developing the legal and regulatory base for a market economy. The task of restructuring Russia's aging and obsolescent industrial base also is formidable, will take years to achieve, and must be done largely by the Russians themselves.

Although foreign economic assistance can have an important impact on specific problems, Russia itself must push ahead with policies that will instill enough confidence in its future to bring back the billions of dollars of capital flight and to boost private foreign investment.

Turning to the other Eurasian states, they also are continuing to move toward market economies, but their progress varies greatly. The going has not been easy anywhere, but it has become clear that more rapid reforms are beginning to yield payoffs that slower approaches have not achieved.

Ukraine and Belarus, for example, lag behind Russia in economic reforms to date. Both countries have made limited progress in liberalizing prices, output and domestic trade, and both have proceeded slowly with the privatization of small firms. But both have also pursued very loose budget and credit policies, which have failed to prevent substantial declines in output, but did bring Ukraine the highest inflation of all Eurasian states in 1993. The statements and record of Leonid Kuchma, who was elected as the new president of Ukraine on July 10, suggest that he is likely to step up the pace of reforms somewhat.

Russia's other Eurasian neighbors have progressed toward market economies at rates that depend largely on their policies to date. At one end of the spectrum, the Caucasian states and Tajikistan remain mired in armed conflicts that have frustrated some serious reformers and brought sharp drops in output, soaring inflation and severe disruptions in external trade. At the other end, the Baltic countries, which generally have been the most consistent in pursuing economic reforms and tight financial policies, are now in the strongest economic position. Their lesson, that persistence and financial discipline pay off, is reinforced by the experience of the East European countries, which my colleague, Mr. Gannon, will now describe.

[The prepared statement of Mr. McLaughlin starts on p. 53 of Submissions for the Record:]

SENATOR BINGAMAN. Go right ahead, Mr. Gannon.

STATEMENT OF JOHN GANNON, DIRECTOR, THE OFFICE OF EUROPEAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

MR. GANNON. Thank you, Senator. I also appreciate the opportunity to be here this morning.

Let me summarize the points that we make more fully in our written report to you. As Eastern Europe approaches the five-year mark in its political and economic transformation, the economic picture is steadily improving across the region, even while electorates in several countries are showing dissatisfaction with the pace of results of the changes to date. Leftist parties have made inroads at the expense of market reformers by campaigning to slow the pace of reforms, but Eastern Europe is generally staying on the reform course that it has been on since 1990.

The past year has seen further progress in the implementation of economic reforms. In no country and on no important issue has there been a retreat from the path toward a market economy. Reforms have become largely irreversible throughout the region as market forces have attained a momentum of their own.

With private sectors accounting for such a large share of production—now over half in Poland, Hungary and the Czech Republic—and most prices freed from regulation, market forces have replaced central government direction of economic activity. Increasingly, East European governments rely on the same economic policy tools—monetary and fiscal policies—used by Western counterparts.

A review of 1993 shows that structural reforms and stabilization policies finally began to pay dividends in performance after several years of depressing economic news and hardship. Economic growth—spurred by a booming private sector—that is now large enough to offset state sector decline has spread to nearly all countries in the region.

Poland's economy grew nearly 4 percent last year and is in its third year of expansion. Output elsewhere either stagnated or fell somewhat, but was on the rise by the end of last year. Growth would have been stronger had it not been for the recession in key West European export markets and a poor crop caused by dry weather.

The positive trends, however, indicate movement along the road rather than completion of the journey. Despite the favorable shift in the direction of many economic indicators, their levels remain generally disappointing. Output, as measured by GDP, is still far below prereform levels and does not approach the Western-style prosperity promised by early reformers. Unemployment rates that, in many cases, are in the mid-teens are high by any standard, and inflation remains in the double digits.

Indeed, many East European citizens believe that better is not good enough. The brightening economic picture has coincided with growing signs of popular impatience with the reforms. In 1990, people who were willing to endure short-term hardships for the opportunity of a better life in the long run feel that the payoff from reforms has been too little and too late.

Several years of falling output accompanied by high unemployment have generated a reform fatigue that an uptick in economic indicators has not yet alleviated. Politicians have tapped into popular disenchantment with reforms by campaigning to expand the social safety net and to slow the pace of reforms.

Leftists triumphed in elections in two of the region's strongest reform countries, in Poland last September and in Hungary this May, and they remain dominant in Bulgaria and Romania. Generally, the left has been careful to advocate continued reforms, privatization, financial stabilization and coming to terms with the IMF, while calling for adjustments in implementation. Budget constraints have frustrated attempts to increase social support.

Economic performance is likely to show continued steady improvement in 1994, in our judgment. Data for the first half of the year indicate that the region is on track to fulfill the brighter 1994 forecasts issued by these governments. Output has continued to pick up in nearly all countries and farm production should contribute to growth in GDP. Unemployment appears to have peaked and has begun to turn around in most countries.

After losing ground in the fight against inflation in 1993, most countries have brought down price increases in the early months of 1994. All countries but Hungary have reached agreement on terms for loans from the IMF. Poland and Bulgaria have completed long-running debt rescheduling agreements.

Although the East Europeans have made remarkable progress in a rather short time, much work remains on the road to a market economy. Many state-owned enterprises need to be privatized, restructured or closed. Fear of a surge in unemployment from these actions is the greatest drag on the structural reforms. Governments believe, with good reason, that many state enterprises could not survive exposure to market forces. The weak financial condition of many of these firms continues to complicate banking reform.

Substantial differences in economic progress remain across the region. The Czech Republic, with its successful mass privatization program, low inflation and unemployment rates and balanced budget, is on track to complete the essential tasks of economic transformation within the next few years.

Despite their earlier starts, Poland and Hungary recently have moved more slowly than the Czech Republic and still face important hurdles, such as privatizing state enterprises and reforming banking systems, that will take several years.

Despite significant progress in recent months, Slovakia, Bulgaria and Romania have much further to go in financial stabilization and in restructuring their economies.

SENATOR BINGAMAN. Thank you very much.

Let me ask a few questions. I understand that we'll also have a closed session to ask any additional questions, but let me ask any of the witnesses, I guess primarily Mr. Grundmann and Mr. McLaughlin, about the situation in Ukraine.

First of all, the relationship between Ukraine and Russia on the issue of nuclear weapons, what is the status there? I know there were a series of agreements, I thought, to return those weapons to Russia, and now I'm just not sure what the status is on the location and control and decommissioning of those weapons.

MR. MCLAUGHLIN. Senator, I can give you a general answer and elaborate on it in more detail in a closed session.

Generally, the story of nuclear weapons outside of Russia—and when I say this, I include Ukraine—is a good story in terms of developments since the breakup of the Soviet Union. Nuclear warheads that were left outside of Russia, are returning to Russia for destruction, and that includes those that were left in Ukraine.

As you know, the United States was instrumental in negotiating an agreement between Russia and Ukraine for the return of the SS-19 and SS-24 warheads that were left in Ukraine, their return to Russia for destruction, and that agreement—without going into a lot of detail here—is generally on track in terms of fulfilling the requirements of the agreement. So this is a generally positive story that we can tell.

With the election of a new president in Ukraine, we naturally must pause to consider whether there could be any change in that picture. So far, the new president, President Kuchma, has indicated that he intends to fulfill Ukraine's international agreements, but at the same time, he has also said a number of times publicly that he is concerned that Ukraine has not been sufficiently compensated for its readiness to surrender the nuclear weapons that were left on its territory. So one could see his public statements as having put down a marker that, in the future, he may want to look at some of these agreements.

So, to sum up, it's basically a good picture. The agreement is negotiated, is holding and is working. The new president of Ukraine is saying that he will maintain that agreement, although I think we have to take somewhat of a wait and see posture based on some of his public statements.

SENATOR BINGAMAN. This is the agreement for the return of the weapons to Russia.

MR. MCLAUGHLIN. For destruction.

SENATOR BINGAMAN. For destruction. Can you tell me anything about the progress on actual destruction of weapons?

MR. MCLAUGHLIN. I could go into that in the closed session. I can't elaborate here on what we know about that, other than to say that, in general, we think this agreement is working.

SENATOR BINGAMAN. Mr. Grundmann, did you want to add anything to any of that?

MR. GRUNDMANN. Certainly, Senator, I reinforce what Mr. McLaughlin said about the progress ongoing in the removal of weapons, and we can elaborate more in the closed session. But certainly the longstanding tension over the custody and the eventual disposition of those weapons, which began with the independence of Ukraine and during the period leading up to the culmination of the START Agreement, has been eased somewhat by the January 1994 trilateral statement, trilateral Russia, Ukraine and American statement, and this appears to be a process that is now on track.

One issue that remains unsettled, of course, is the accession of Ukraine to the Nuclear Non-Proliferation Treaty, which is one of the conditions set down in the Lisbon Protocol to the START Treaty.

Another area of tension is the status of the Black Sea Fleet. That has been an ongoing dispute between Russia and Ukraine. Of course, the Black Sea Fleet is largely based in the Crimea. The primary issue appears now to be not so much the division of the ships in the fleet, but rather ownership and control of the bases and fleet infrastructure. So that's another area that we will monitor closely, and hopefully as things develop in the new government of Ukraine that situation will stabilize.

SENATOR BINGAMAN. One thing that is in your statement, Mr. Grundmann, is this reference to the fact that Moscow will seek to retain military facilities in Georgia, Armenia, Azerbaijan, Moldova and Tajikistan. What is the long-term plan on that? I would think that at some stage that would no longer be tenable.

If either of you have comments on that arrangement, I would be anxious to hear as to where that leads and for what period of time they can continue to maintain Russian troops in those other republics.

MR. GRUNDMANN. I can speak, Senator, to the forces that are currently abroad in terms of levels and the trends that we see, and I'll defer to my colleague to speak more on the policy end of that.

Clearly, as I stated, there are more than 100,000 troops that remain in the area of the former Soviet Union outside Russia, and some of these are there by invitation or by some agreement. For example, in the Baltics, Russia and Latvia signed an agreement for the withdrawal of approximately 9,000 remaining Russian troops by the end of August this year. Only about 3,000 Russian troops remain in Estonia. Of course, that has been highlighted in recent events. However, the residency status of Russian military retirees remains an unresolved issue that appears to be impeding the agreement on troop withdrawals. Then, of course, Russia has completely withdrawn from Lithuania, as it has from Azerbaijan.

SENATOR BINGAMAN. Mr. McLaughlin, did you have anything about the future of this arrangement, as you see it?

MR. MCLAUGHLIN. Yes. Senator, I think the presence of Russian forces in those neighboring states reflects Russia's assessment of its own interests as it looks out to the future in this post-Soviet period. I believe Russia sees its interests varying somewhat around the periphery of its country and out toward the borders of the former Soviet Union.

There is one general interest that I think is motivating this desire to maintain a troop presence, though, and it is a Russian concern about who maintains border controls along what was the external border of the former Soviet Union. Many of these stretches of border are now long and poorly patrolled, and they are in regions of instability or regions where Russia worries about what could come across the border, either extremism of one sort of another—Islamic extremism, or narcotics, or other things that normally would be prevented.

So, in areas like Tajikistan in Central Asia, or for that matter along the entire border of that part of the former Soviet Union or in the borderland that say Azerbaijan shares with Iran, there is a Russian concern that someone needs to be manning those borders, and these new states are small and ill-equipped to do so. So they are negotiating arrangements with the new states that are now in those regions—Georgia, Armenia, Azerbaijan, Tajikistan and so forth—to jointly man those borders and protect against influences that they would not want crossing over.

So that's a general interest they share around the area. They are also concerned to deal with ethnic fighting and instability in these regions, and a great emphasis, as you know, in Russian security policy now is on the need for peacekeeping forces in some of these areas. So they are also trying to maintain troops for that purpose as well.

SENATOR BINGAMAN. You see the continued maintenance of these troops, though, as not being a major source of tension between the Former Republics and Russia?

MR. MCLAUGHLIN. Well, in some cases, it is a source of tension and dispute. Russia has made clear that it regards this part of the former Soviet Union as a vital sphere of influence. President Yeltsin has said in public statements that he considers Russia as first among equals in what we would call the Newly Independent States.

So there is some disagreement with a number of these countries about the extent and level of Russian influence that there should be. But in some cases, the countries along the perimeter of Russia have agreed to become members of the Commonwealth of Independent States, or to join the Security Pact that is associated with that. So Russia is working through negotiations to establish the presence of its forces there, but it would be an exaggeration to say that all of these countries are completely happy with that circumstance.

SENATOR BINGAMAN. I was in Russia and Ukraine a couple of years ago with Senators Nunn, Warner and Lugar and there was a very strong concern by people in our Embassy in Moscow that U.S. aid and assistance was not getting through to Russia. What level of aid have we provided and in what form, can you tell me anything about that?

MR. MCLAUGHLIN. I can give you a general picture. My policy counterparts would be able to break it down; those responsible for implementing the aid program would be able to break it down in finer detail. But over the last year, I believe that U.S. assistance has amounted to about $1.1 or $1.3 billion, and it has taken the form largely of credits for commodities, humanitarian assistance, food assistance and assistance for medical supplies. That's what we have done bilaterally. There is another aspect of aid that, of course, is the U.S. role in multilateral aid. But in terms of U.S. aid, that has been the thrust over the last year.

If you went back historically to the period, say, between 1990 and 1993, in that period when something like $120 billion was pledged to the former Soviet Union and roughly half of that was delivered, the United States would be the second largest donor in that period after Germany, I believe. So those are the magnitudes and in general the scope of the U.S. role.

Now, as to whether this assistance is getting through, I think the picture has been reasonably good in the last year. As I said in my testimony, assistance particularly at these levels is not going to be the thing that turns the tide in Russia. It's something that must be targeted and that must be targeted on certain sectors where it can make an important difference.

When you just look at the magnitude and consider that Germany is pumping a hundred billion dollars a year or so into the eastern part of its country to bring it up to standard, you get some sense of the magnitude of aid that would be required in Russia to make a huge difference.

But to turn to your question of whether it makes a difference and whether it's getting through, I believe enough of it is to make a difference, and I just can't document for you where it may or may not be getting through. What we do know is that when you look at things like Russia's imports of food in many years, for example, in 1992, U.S. assistance accounted for a sizable portion of the food that Russia imported. I think it was up around 50 percent of its food imports in that year, and in 1993 I'm certain it was also a sizable amount.

So the general picture is one of the assistance generally getting through and generally making a difference, but the caveat I would put on that is that we're talking about relatively low levels of assistance in a society that would, in the best of circumstances, require massive levels.

Senator Bingaman. On conversion of the defense sector to civilian production, I gather, Mr. Grundmann, you say here that little genuine conversion has taken place. I guess what I'm wondering, is this is a very substantial part of the industrial capability or infrastructure in both Russia and in Ukraine that is devoted or committed to defense production? You're saying that they haven't been able to convert, and I gather from some of the other statements in here that they are no longer producing weapons in large quantities. What are the doing?

Mr. Grundmann. The outputs of many plants have in fact dwindled to very low levels. The plants are being maintained as much to provide employment in some cases. Some of the enterprise heads are hedging against conversion to civilian production in the hopes that defense production demands will increase.

There have been some areas in which they have attempted to convert with very dismal results. For example, Russia's aviation sector attempted at one point early on to move into the food processing industry with what we would term disastrous results.

SENATOR BINGAMAN. What are the disastrous results that you're referring to?

MR. GRUNDMANN. There is simply not a successful outcome in terms of the market and in terms of an ability to create any economy of scale in that regard. But we would add that not all defense industrialists are waiting for government direction and funding, particularly those in high-technology areas.

For example, in part of the aerospace industry, there has been some very active search to market space hardware, launch services and joint ventures have been established with a number of Western firms, including U.S. companies. An example is the Khrunichev State Scientific Production Center which established a joint venture with the Deutsche Aerospace concern in May to provide launch services in a reusable space capsule named Express, and in addition missile designers are marketing ballistic missiles as space launch vehicles. We have a table in our statement.

SENATOR BINGAMAN. But you're citing a few specific examples where there has been some progress, but your basic statement is that little genuine conversion has taken place?

MR. GRUNDMANN. That's correct, Senator.

SENATOR BINGAMAN. Do you have any comment on that, Mr. McLaughlin?

MR. MCLAUGHLIN. The only thing I would add is that you asked what are they doing. An important aspect of what's going on is that about 25 to 30 percent of the work force in defense industries have gradually simply left the industries and moved on to other employment. So while no major defense industries have closed, there is a kind of hollowing out of the work force which is in some respects good because it is helping Russia to reorient its production.

SENATOR BINGAMAN. On the issue of organized crime, I would like to ask about your chart that showed, I think, that 40 percent of the Russian economy is now in the private sector. Is that what that chart shows?

MR. MCLAUGHLIN. Roughly, that's what it means, yes.

SENATOR BINGAMAN. How much of the Russian economy is under the control of organized crime, because I've heard various folks comment that it was somewhere in that same range. Is everything that is not part of the government organized crime?

MR. MCLAUGHLIN. I wouldn't go that far, and I would say that of course it's difficult to estimate, and most of what we know about this is from Russians who themselves are concerned about the problem, are investigating it and pursuing it vigorously.

The Russians who speak on this say that as many as 40,000 Russian businesses are heavily influenced by organized crime, and many of those would be in the private sector. Russians also tell us that Russia's 2,000 banks are also heavily influenced by organized crime. In fact, the two major objectives of organized crime are probably to gain control or influence in the financial sector and to gain control over exports of precious resources. So it's fair to say that in the private sector organized crime is probably gaining an important foothold, and this is a major concern.

SENATOR BINGAMAN. Let me ask Mr. Gannon something about Hungary. One of the charts that you have in your report shows a tremendous lack of support for the move from communism to the free market. As I understand it, in Hungary it's particularly noticeable. Most Europeans say that their economic situation is worse now than under communism, and the figures in Hungary seem to be a little more pronounced than they are anywhere else. So you have a tremendous public sentiment that things were better before the change.

What explains that, as you see it, and what are the implications of that?

MR. GANNON. It is true that within Hungary the disenchantment is much higher with what has happened since 1990. However, I would very quickly add that within the former Communist Party of Hungary, we had really the bedrock of reform. It was reformed communists, in fact, who brought down the former regime and had already gone well on the way towards reform before that regime collapsed.

So what we have seen in the election in May is that some of those former communists have come back, and it is essentially the socialists who will run the new government. But Mr. Horn and his economic minister, in what they have said and what they have done so far, indicate a continued commitment to economic reform that does not cause us to believe that there will be any marked departure with the policies of the previous government.

The debate there as elsewhere in Eastern Europe is over the pace of reform and the degree to which resources should be committed to a social safety net. Hungary is the only country that has not yet made a firm agreement with the IMF. However, we remain guardedly optimistic, even though the reforms in Hungary have slowed somewhat in the past year or year and a half, that the basic commitment to reform will remain.

SENATOR BINGAMAN. To what extent is our own government providing assistance to Hungary in this transition?

MR. GANNON. The U.S. Government has pledged about $800 million to Hungary. The State Department could provide additional details on our assistance effort. More important than aid, however, has been the foreign investment in Hungary. Hungary receives 55 percent of all foreign investment. It has a very high rating for investors.

SENATOR BINGAMAN. Fifty five percent of——

MR. GANNON. ——of the foreign investment in all of Eastern Europe since 1990 has gone into Hungary.

SENATOR BINGAMAN. That's all foreign investment and not just U.S. investment?

MR. GANNON. That's correct.

SENATOR BINGAMAN. How much U.S. investment is there?

MR. GANNON. I would have to get the figures for the United States. I can give you the aggregate for the region. I do not have Hungary available. I can get that for you, sir.

SENATOR BINGAMAN. Maybe, this is a question for the other panelists. Is there significant foreign investment in Ukraine?

MR. MCLAUGHLIN. It's very low. I don't have the exact figure for you, but to put it in some perspective, the new foreign investment moving into Russia last year was just above a billion dollars, and in Ukraine it's much, much lower. I would estimate somewhere in the range of two, three or four hundred million, and to put that in perspective, that figure for Russia is well below the absolute figure for foreign investment in Hungary, which is of course a country of only 10 million people.

So foreign investment in Russia and in the other states of the former Soviet Union is lagging serious, although you can see some bright spots. I'm willing to elaborate on them, if you want me to. There is some indication in the last year that we see a slight upturn, but it's lagging seriously in Ukraine because Ukraine has not taken the steps necessary to attract foreign investment in terms of adopting laws on property and other things that foreign investors require.

SENATOR BINGAMAN. Do we anticipate that the new leadership in Ukraine will take those steps?

MR. MCLAUGHLIN. Well, I think from what we know of Mr. Kuchma's statements and his public record in his previous period as Prime Minister under the former president, there is, I would say, a fair chance that he will move in a more reformist direction than the previous president. What I know of President Kuchma is that he is above all a pragmatist. He is a person who is of course trained in the old system, in that he headed the largest missile production plant in the former Soviet Union, but he is an individual whose record indicates that he knows when something isn't working. His record also indicates that he is a person who is inclined to seek advice from experts and to try things that make sense to him.

So I would conclude from that that we're probably entering a period in Ukraine where he will try some things that will move the country in a more reformist direction. Now, in doing so, I have to add immediately that he will be dealing with a new Parliament that was also elected recently in which, from what we know about it, the sympathy for economic reform is not at all high.

It is a Parliament dominated primarily by people of communist or socialist background, who have made clear both in their statements and in the election of their leader of the Parliament that they favor older methods and not the new methods that Ukraine needs to adopt. So this will be a touch and go kind of struggle in Ukraine.

MR. GANNON. Senator, in answer to your earlier question about U.S. investment in Hungary, since 1990 it is $3.1 billion, and that is about two-thirds of all investment by U.S. companies in Eastern Europe.

SENATOR BINGAMAN. So it's $3.1 billion over a three-year period, is that what that reflects?

MR. GANNON. Roughly three years, yes.

SENATOR BINGAMAN. And the $1 billion figure for Russia is a one-year figure?

MR. MCLAUGHLIN. Yes. When I said that there is a bright spot in this, even though that's far below Russia's needs, I think the figure for the previous seven years was something in the range of one to two billion dollars. So, within one year, they have had comparatively a good growth in their investment. But, as I continue to emphasize, it falls well short of needs.

SENATOR BINGAMAN. There are a lot of other questions. I think we should adjourn to a closed session and go ahead with a few additional questions and any other comments you have at that time.

Thank you all very much. I appreciate the reports.

[Whereupon, at 10:08 a.m., the Committee adjourned, subject to the call of the Chair, and reconvened thereafter in a closed session.]

SUBMISSIONS FOR THE RECORD

ROUGH ROAD TO MARKETS IN RUSSIA AND EURASIA

15 JULY 1994

Paper prepared by the Central Intelligence Agency for Submission to the Joint Economic Committee, Congress of the United States

Since the dissolution of the Soviet Union in December 1991, the 15 successor states have traversed a variety of political and economic paths as they proceed toward market-oriented economies—which all of the new countries proclaim as their long-term goal. It has not been easy anywhere, but it has become clear that more rapid economic reforms are beginning to yield payoffs that slower approaches have not achieved. This is illustrated clearly by events in the two largest countries. Whereas Russia's reforms have begun to improve responsiveness to consumer needs, Ukraine's efforts to retain more vestiges of the old system have failed to prevent a severe economic decline.

This paper focuses primarily on Russia, which continues to influence developments throughout the region because of its size, power, and wide-ranging ties with the other Eurasian states. The progress of Russian economic reforms to date is reviewed first, followed by a survey of economic performance and a brief discussion of the short-term outlook. Finally, the status of economic reform s in the other countries is summarized.

Russia

President Yeltsin took advantage of his popularity following the August 1991 coup attempt to launch a comprehensive package of radical economic reforms—with Yegor Gaydar as his principal economic strategist—in January 1992 (see inset). Political opposition, heightened by controversy over the hardships accompanying reforms, soon gained strength, however, and forced the removal of Gaydar as acting premier in December 1992. Reforms, nevertheless, continued under the new government, headed by Premier Viktor Chernomyrdin, even though opposition from the legislature made progress increasingly difficult. In September 1993, Yeltsin dissolved that legislature—a holdover from the Soviet era—and called new legislative elections for December 1993.

The politics of economic reform remain contentious. Voters in the December elections approved a new constitution, which gives Yeltsin much greater powers than he had under the old one. But the new legislature includes large factions representing his opponents—especially the traditionalist Communist and Agrarian Parties and the ultranationalist Liberal Democratic Party. Moreover, as power has devolved from Moscow to local and regional governments, a wide array of new economic decision-makers has emerged, further complicating the politics of economic policy. Organized crime groups and corruption also have emerged as important factors in Russia's efforts to transform its political and economic institutions.

Milestones of Political and Economic Reform in Russia

November 1991	Yeltsin granted special powers to rule by decree
December 1991	Dissolution of USSR
January 1992	Comprehensive package of radical economic reforms launched: price liberalization, reduction of state role in economy, liberalization of domestic and foreign trade, new tax system, changes in budget spending priorities, small-scale privatization, introduction of limited land ownership rights
June 1992	Yegor Gaydar appointed acting premier
July 1992	Single exchange rate adopted for all export and import transactions
	Russia requires all payments for trade with other former Soviet republics to go through Russian Central Bank
August 1992	IMF approves first tranche of stand-by loan to Russia
October 1992	Distribution of privatization vouchers to all Russian citizens begins
December 1992	Yeltsin's special decree powers expire
	Gaydar removed as acting premier Viktor Chernomyrdin appointed as premier
	Auctions of medium and large industrial firms for vouchers begin
January 1993	Voucher distribution ends
April 1993	Referendum votes confidence in Yeltsin and his reforms June 1993 IMF approves first tranche of systemic transformation loan to Russia
July 1993	Russia calls in all pre-1993 ruble notes, sets tough conditions for trade partners to receive new ones
September 1993	Yeltsin disbands Soviet-era legislature
October 1993	Armed clashes in Moscow
December 1993	Elections to new legislature
	New constitution approved by referendum
January 1994	New legislature convenes
April 1994	IMF approves second tranche of systemic transformation loan to Russia
June 1994	Voucher auctions end (with a few exceptions)

Progress Toward a Market Economy

Despite the political turmoil, Russia has made substantial progress in the initial stages of its economic reforms, particularly in liberalizing prices, production, and distribution, and privatizing state enterprises. Considerable work remains to be done, however, in rationalizing government finances and reducing cumbersome regulations. Moreover, the longer term challenges of transforming the financial system and developing the legal and institutional bases for a market economy remain formidable.

Liberalization. Since removing controls on the vast majority of producer and consumer prices in January 1992, the Russian Government has freed coal prices, gradually raised limits on oil prices, and cut hack subsidies on food prices, although some consumer prices continue to be controlled by local governments. Many prices have moved closer to world market levels, but energy prices remain substantially lower. In addition, the role of state authorities in allocating supplies among producers has fallen sharply. The share of materials delivered directly from producers to purchasers increased from 60-70 percent in 1992 to 80-90 percent in 1993, according to Russian official statistics, although government purchases of fuel and farm products remain significant.

Some producers, however, have been slow to respond to market signals, such as reducing prices in the face of falling demand and increasing output in response to rising prices. The main reasons probably include the difficulty of identifying price signals under conditions of high overall inflation, the inexperience of buyers and sellers in negotiating prices, the prevalence of monopolies, and decades of isolation from world prices as points of reference.

Macroeconomic Policies. Although the Russian Government has not tightened its finances enough to fully rein in inflation, it has made some progress in rationalizing its budget. The value added tax, introduced in 1992, has been a more stable source of revenue than the turnover tax it replaced, and the government plans to reduce tax rates on value added and profits in 1995. In addition, the shares of government spending devoted to defense, investment, and subsidies have been cut sharply since 1991. Formulas for calculating pensions were revised in late 1993 to provide more generous support for low-income recipients and less for people with higher incomes. Moreover, the federal government increased the shares of taxes and spending assigned to regional and local governments in 1993.

In many ways, however, Russia's fiscal system remains inadequate. Spending for social needs, such as housing and child care, continues to be funded largely by state enterprises, so that workers who are laid off or whose employers drop these services will not be covered. Most plans to transfer social spending to local governments remain on the drawing board. Also, funds for unemployment compensation and job retraining may fall short of needs when layoffs begin in earnest because revenues allocated for these purposes come from employer taxes based on wages paid.

Effective monetary policy is hindered by the Russian banking system, which still suffers from the legacies of its Soviet past. Many "commercial" banks are descendants of Sovietera state banks and have inherited loans that are unlikely to be repaid. Banks still grant new loans largely on the basis of connections with traditional borrowers rather thin assessments of risk, which most bankers are ill prepared to make. Moreover, the payments system remains antiquated and slow, and prohibitions on the use of cash for large transactions between firms remain on the books. Although the Central Bank and several large commercial banks have made some progress in automating transactions, deposit transfers still take weeks to clear.

Privatization. Government programs to privatize state property began in 1992 with sales of small, mostly consumer-oriented businesses and expanded in 1993 to include the privatization of medium and large industrial enterprises for vouchers distributed to all Russian citizens. As a result, 104,000 small businesses were transferred to private hands by the end of March 1994, and 13,000 medium and large industrial firms sold shares to the public, making stockholders of over one-third of the population (figure 1). In addition, 227,000 small "peasant" farms were formed, about two-thirds of large state and collective farms were reorganized, and the amount of land used for food production more than doubled. Furthermore, many entrepreneurs not included in these totals provided a variety of goods and services individually or in small groups. Rough estimates by Russian statisticians indicate that individual vendors and unregistered firms accounted for 40 percent of retail sales to the population in 1993.

Nonetheless, the rights of private property holders remain unclear in many respects. Controversy over planned legislation on land ownership is contributing to uncertainty over the rights of holders of all kinds of property and particularly limiting the impact of changes in farm organization. In addition, the workers and managers who control the majority of shares in many privatized firms are well positioned to promote their own interests at the expense of other stockholders. Moreover, the current instability and uncertainty have shortened managerial time horizons, thus constraining long-term investments, if not stifling them altogether.

Integration Into the World Economy. Russia's foreign trade system has moved away from extensive central controls over quantities of exports and imports, artificial exchange rates, and inconvertible currency. Instead, the present system is based primarily on export and import duties, exchange rates determined by supply and demand, and ready convertibility of rubles into hard currency for export and import transactions.

Some quantity controls remain in place, however—in the form of export quotas and licenses—largely because the government needs hard currency from key exports. Moreover, duties on both exports and imports continue to change frequently. Foreign investment in Russia remains small, despite tax breaks and easier profit repatriation as a result of the improved convertibility of the ruble. Potential investors continue to be frustrated by frequent changes in regulations, including tax rates, and by unclear lines of authority between government agencies at the federal, regional, and local levels.

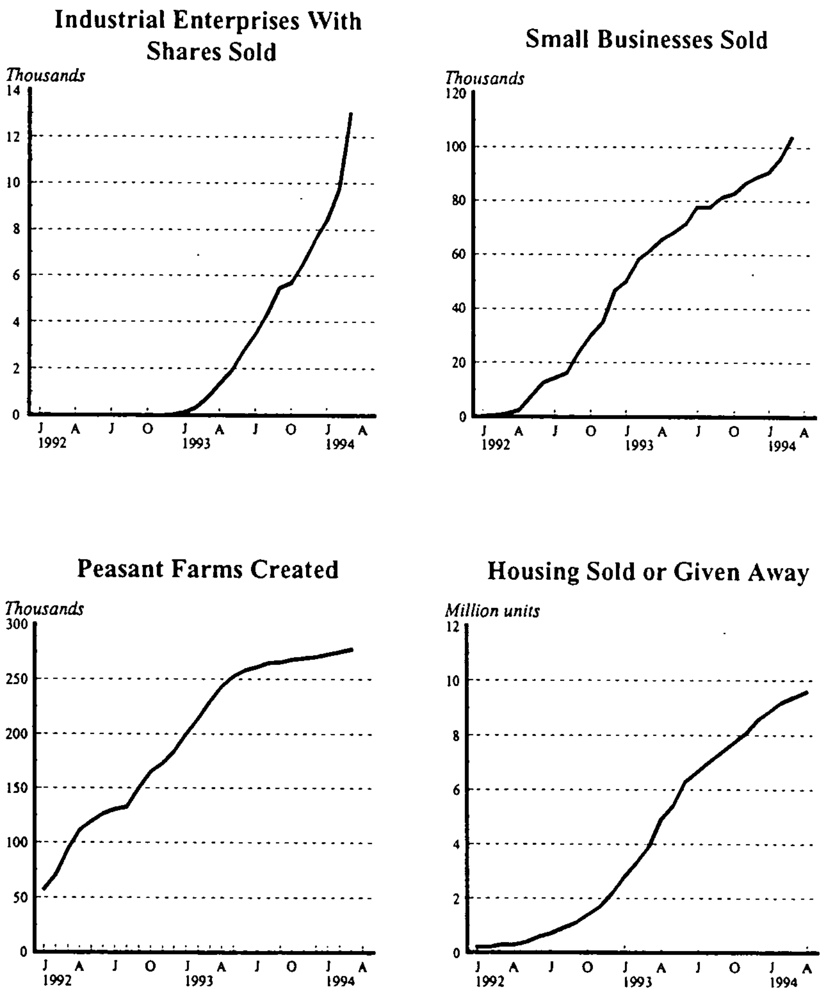
Development of the Legal System. The growing confrontation between Yeltsin and the Sovietera legislature impeded the enactment of new laws until after the December 1993 elections. The government submitted a package of some 50 draft laws to the new legislature in March 1994, but little action has been taken so far. Meanwhile, enforcement of existing legislation is weak, and contracts are difficult to enforce because the court and arbitration systems are just beginning to function. In addition, many regulations affecting business are subject to frequent changes. The Moscow city government, for example, has imposed periodic crackdowns on sidewalk kiosks selling consumer goods and levied transaction taxes on Russia's largest hard currency exchange.

Economic Troubles So Far

Russia's reforms continue to be accompanied by economic turmoil: declining output, disruptively high inflation, depressed foreign trade, difficult living conditions, and rising inequality of personal incomes. The rapidly expanding private sector is helping the economy respond to consumer needs, but restructuring of the industrial base has been limited. Assessment of these changes is

Figure 1

Privatization in Russia, 1992-94



complicated by the inadequacies of Russian official statistics— the primary source of numerical estimates in this paper (see inset)—but the general picture is clear enough.

Shortcomings of Russian Official Statistics

Russian official statistics almost certainly overstate the declines in real output and consumption of goods and services since 1991. First and foremost, changes in prices and quantities alone fail to reflect the improvement in consumer welfare resulting from the move toward a market economy. Under the old system, where central planners decided what to produce and how allocate it, large amounts of output were unwanted or wasted, and shortages became crippling when high inflationary pressures collided with price controls. Economic reforms have made producers more responsive to consumer needs and brought dramatic improvements in the availability of goods and services.

Furthermore, the statistical system that Russia inherited from the Soviet Union is poorly suited to measure small-scale economic activity in general and the growing private sector in particular. As a result, the contribution of the most dynamic part of the economy is underestimated. In addition, producers of all kinds of goods and services currently have strong incentives to understate their output in order to evade taxes and other obligations—a reversal from the Soviet era, when incentives to overstate output to demonstrate fulfillment of central plans predominated. Finally, widely varying changes in the prices and quantities of individual products result in substantial differences in economy-wide averages depending on whether more or less recent weights are used.

Macroeconomic Turmoil. Output continues to decline; real gross domestic product (GDP) decreased by 19 percent in 1992 and 12 percent in 1993, according to Russian official statistics (table 1). Moreover, the decline worsened sharply in early 1994, with real GDP down 17 percent in January-June, as compared with the same period last year. Inflation remains unacceptably high. Consumer prices increased at an average rate of about 20 percent per month in 1993, roughly the same as in February-December 1992. (The comparison excludes January 1992 because of the spike in inflation immediately following price liberalization.) This year, consumer inflation has slowed to less than 10 percent per month in February-June.

In part, the decline in output since 1991 reflects the collapse of central planning and disruptions in external trade, both within former Soviet territory and outside it. In addition, demand for defense and investment goods dropped sharply as the government tried to balance its budget, and consumer demand fell as the population faced steep price increases. The continuing inflation problem results mainly from the persistence of substantial budget deficits and the rapid growth of bank credit. The portion of the budget deficit financed by monetary expansion amounted to roughly 6 percent of GDP in 1992-93, and the ruble money stock increased at average monthly rates of almost 20 percent in 1992 and about 15 percent in 1993.

Table I
Russian Macroeconomic Indicators, 1991-94

	1991	1992	1993	1994 January-June[a]
	Annual percent change			
GDP	-13	-19	-12	-17[b]
Industry output	-8	-18	-16	-25[b]
Agriculture output[c]	-8	-2	-6	NA
Freight transportation	-7	-24	-25	NA
	Average monthly percent change			
Consumer inflation	8	18[d]	21	10
Money supply	NA	19	15	10[e]
	Percent of GDP			
Budget deficit[c]	NA	18	8.0	NA
Domestic financing[c]	NA	6	5.4	NA
Foreign financing	NA	12	2.6	NA
	Billion $US			
Exports	50.9	42.4	44.0	49[f]
Imports	44.5	37.0	33.0	34[f]

Source: Russian official statistics, except as noted

a. Preliminary.

b. As compared with January-June 1993.

c. Estimate.

d. Excluding January 1992, when prices increased by 296 percent immediately following liberalization.

e. January-April.

f. Adjusted to annual basis.

The drop in output and slowdown in inflation so far this year probably reflect tighter reins on Central Bank credit and perhaps on government spending. Also, interest rates have helped hold down demand for credit by remaining above inflation rates since late 1993. Efforts to limit government spending, however, have relied partly on delays in paying bills— notably, for purchases from defense industries and farmers. This tactic has contributed to large increases in debts in the economy at large and disruptions of production as suppliers who have not been paid stop deliveries.

Foreign trade remains depressed. Russian exports to countries outside the former Soviet Union in 1993 were 14 percent lower in dollar terms than in 1991, while imports were down 26 percent, according to official statistics. Trade with other former Soviet republics reportedly fell much more steeply, but problems of measuring that trade are particularly daunting because of changes in national borders and the breakup of the ruble zone. Foreign investment in Russia amounted to less than $1 billion annually in 1992 and 1993 and totals only $2 to $3 billion since the Soviet ban on such investment was lifted.

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Restructuring Limited. Restructuring of the Russian economy has been slow so far. Some progress has been made, especially in cutting back output of weapons and other goods that Soviet planners overemphasized, such as steel pipe and machine tools. Investment in new, more efficient factories has been hit hard, however, by inflation and the lack of market mechanisms for allocating the limited funds available. Private businesses, including private farms, continue to find credit very difficult to obtain. Moreover, layoffs of excess workers lag far behind declines in output. Nonetheless, unemployment rose from less than 2 percent of the work force in 1991 to about 6 percent in April 1994, according to estimates that Russian officials say are based on Western definitions. Also, many factories that have not discharged workers outright have made other adjustments, such as reducing the number of hours worked per week or placing workers on leave at less than full pay.

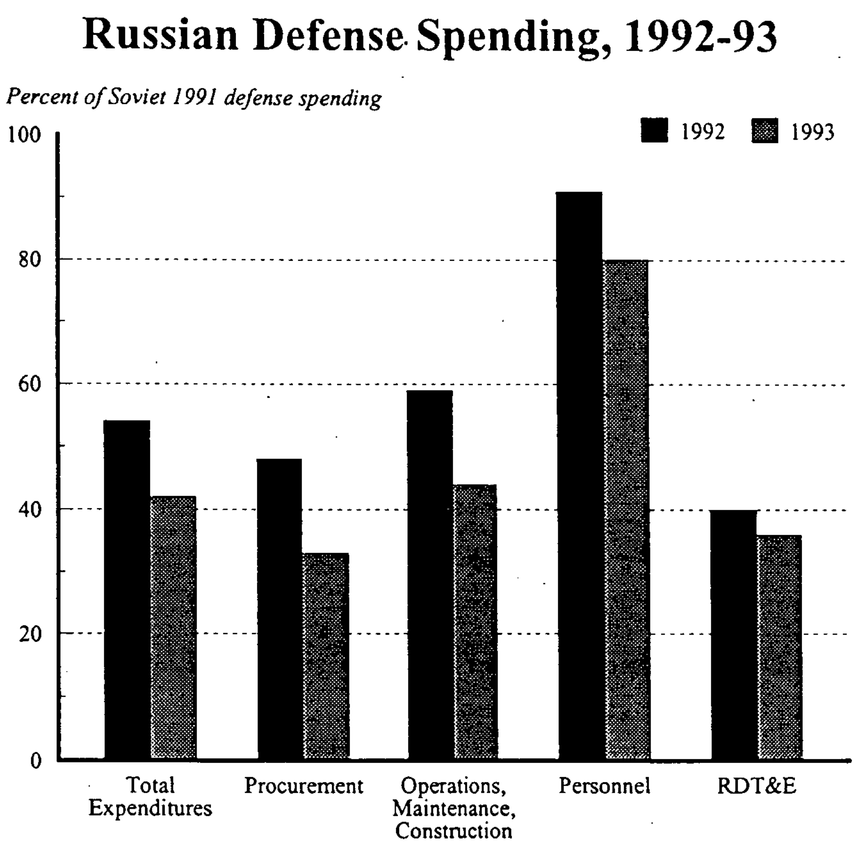
Defense Sector Struggling. Sharp reductions in defense spending have brought hard times for the military-industrial complex. Russia's total defense spending fell in 1992 to about 55 percent of 1991 Soviet defense spending and declined further in 1993 to only about 40 percent of the 1991 level (figure 2). As a result, the share of Russian GDP devoted to defense decreased from at least 15 percent in 1991 to roughly 10 percent in 1993. Weapons procurement and research, development, testing, and evaluation (RDT&E) took the deepest cuts, to about one-third of their 1991 Soviet levels. Spending on military personnel was down much less, to about 80 percent of the 1991 Soviet level. The number of troops fell at roughly the same rate as total defense spending, but reductions were concentrated in the lower paid ranks, leaving shortages of conscripts and junior officers and gluts of mid-grade and senior officers.

In the military-industrial complex, total output declined at about the same rate as overall industrial production in 1992-93, according to Russian official statistics. Output of military goods reportedly dropped more sharply, however—by 38 percent in 1992 and another 30 percent in 1993—and would have slid further except for a slight increase in arms exports last year. Civilian output also decreased, partly as a result of competition from imports of durable consumer goods. Increases in the production of spare parts for automobiles and some kinds of oil industry equipment were among the few bright spots.

Moreover, the defense industries are experiencing severe financial difficulties, especially since delays in government payments for military orders built up late last year. Many firms have survived by borrowing from banks and running up large unpaid bills themselves—including their wage bills—and some have tried to sell weapons technologies for hard currency (see inset). Workers also have felt the impact of financial problems. Wages in the military-industrial complex have fallen to only about two-thirds of the industry average, partly because large numbers of employees are not working full time. In response, many workers have left defense industries at their own initiative; employment has declined from 6 to 8 million workers in 1990 to 4 to 5 million at present, according to Russian officials.

Difficult Living Conditions. The material aspects of Russian living standards roughly stabilized in 1993 but remained substantially below 1990 levels. Real per capita incomes increased last year after falling sharply in 1992, according to Russian official statistics. Most of the gains were reaped by people with high incomes, however; wages and pensions both decreased in real terms. Nonetheless, consumption of many goods has begun to recover from the impact of widespread shortages in 1991 and huge price increases in 1992—partly because almost one-half of the population grow some of their own food, according to Russian surveys.

Figure 2


Russian Defense Spending, 1992-93
Percent of Soviet 1991 defense spending
1992
1993
100
80
60
40
20
0
Total Expenditures
Procurement
Operations, Maintenance, Construction
Personnel
RDT&E

Concerns Over Proliferation of Weapons of Mass Destruction

Russian officials have said they want Russia to play a key role in the nonproliferation of weapons of mass destruction, and Russian policy prohibits exports of nuclear, biological, or chemical weapons-related items, their missile delivery systems, and weapons-grade nuclear materials to countries of proliferation concern. Moreover, Moscow has made significant progress since early 1992 in identifying technologies of proliferation concern and establishing licensing procedures to regulate their spread.

Nevertheless, the Russian export control system is hampered by resource shortages, weak customs controls, and corruption. Weakened central authority, declining morale in the military, increased organized crime, and efforts by states like Iran to purchase weapons and related expertise will make the potential diversion of these items a continuing concern. Russian officials have stated publicly that some rogue defense firms are taking advantage of this disarray to offer weapons technologies for hard currency. In some cases, officials themselves view sales of items, such as civilian power station components or space launch vehicles (even those based on ballistic missiles), as vital sources of hard currency that pose little proliferation threat.

Our monitoring of the disposition and status of Russia's 27,000 or so nuclear warheads, as well as the strategic systems deployed to deliver them, has not yet detected any nuclear warheads or significant quantities of weapons-grade materials being smuggled out of the former Soviet Union. There have been numerous cases, however, in which low-enriched uranium, radioactive isotopes, and scam materials—notably, red mercury and osmium—have been offered for sale on the black market. Last month, moreover, the Russian Counterintelligence Service announced the confiscation of 3 kilograms of enriched uranium in St. Petersburg—the largest known attempted removal of nuclear weapon-usable material from the former Soviet Union.

Furthermore, countries of proliferation concern have been recruiting underemployed and underpaid scientists from Russia's weapons industries. As many as 1,000 Russian experts-including specialists in aerospace, communications, and computer science—work in China, according to some press reports. In addition, there are numerous press reports on Russian efforts to prevent missile experts from leaving for North Korea. Nonetheless, many of the scientists who have emigrated from the former Soviet Union are experts in basic disciplines, such as theoretical physics and mathematics, and are looking for civilian jobs in the West.

Meanwhile, the quality of life has improved in some respects but deteriorated in others. The positive changes include the near disappearance of shortages, queues, and rationing as a result of price liberalization and major improvements in the quality and variety of consumer goods and services, thanks to the liberalization of domestic and foreign trade. The quality of political life, too, has improved enormously with the greater openness and variety of the mass media and the spread of democracy.

On the negative side, the economic transition has been accompanied by rising inequality of personal incomes. Pensioners, recipients of social support, and workers paid from government budgets have experienced large reductions in their relative incomes. At the same time, many formerly privileged groups of the population have lost official positions, social status, and perquisites. Moreover, public services, such as health care, have deteriorated as local governments struggle to tighten their budgets.

Private Sector Booming. The private sector has grown rapidly as a result of the transfer of state property to private hands and the formation of new private businesses. As a result, this sector—ranging from traditional private farm plots to industrial firms part way through the privatization process—accounted for an estimated 40 percent of GDP in 1993, up from about 20 percent in 1991. The private sector made up roughly 40 percent of industrial and agricultural output and 65 percent of retail trade last year, but private shares of transportation and social services remained small.

Many workers and managers of recently privatized firms have not begun to act in the interests of the new owners, however. Some of these firms are just beginning to hold meetings of stockholders, and some are operating under arrangements that will allow government representatives to veto decisions made by the director or stockholders for three years or more. Moreover, loose credits, weak competition, and delays in enforcing the bankruptcy law have reduced pressures to improve efficiency.

Impact of Crime and Corruption. Rampant crime and corruption have emerged as key factors in Russia's attempt to reform its political and economic institutions, as well as a serious social problem (see inset). Criminal groups, reportedly with the assistance of some corrupt government officials, are infiltrating Russia's financial institutions, distorting the privatization process, and discouraging foreign investment. Some Russian officials even assert that organized crime groups control some 40,000 businesses and a majority of Russia's 2,000 banks. Perhaps more important, the growing power of criminal groups is fueling the perception that democratic and free market institutions are inherently corrupt. Public opinion polls show that such perceptions are eroding popular support for reforms and feeding the nationalist backlash. Indeed, Russian polls show that three-fourths of those who voted for Vladimir Zhirinovskiy in last December's elections cited the breakdown in law and order as the primary motivation for their choice.

Outlook Guarded

Russia's economic prospects in the coming months and years will depend crucially on the ability of political players to support needed but painful economic policies and survive in upcoming elections. For the first time in Russia's post-Soviet history, both the president and the legislature have been elected and must face reelection shortly or leave office. Politicians must worry about maintaining support in the face of the growing weariness of the population with low living standards and social dislocations. The tough choice between high inflation and rising unemployment will remain painful and politically controversial, as it has been since reforms began. Changes in the ownership of firms also will be controversial because they will be accompanied by rearrangements of economic power—with the losers including industrial managers who retain political clout, especially at local and regional levels.

Crime and Corruption Problems

According to the Russian Ministry of Internal Affairs, there are 5,700 organized crime groups, of which 150 to 300 are large, sophisticated criminal organizations. The wide-ranging activities of these groups include robbery, extortion, prostitution, and narcotics trafficking. Criminal groups also are involved in illegal exports, including weapons exports, and in financial crimes, including money laundering and illegal acquisition of subsidized credits. Many large groups have ties with criminal organizations in other regions of Russia, other former Soviet republics, and numerous countries worldwide, including the United States.

Widespread official corruption, including corruption in law enforcement organizations, is compounding the crime problem and undermining public confidence in governing institutions. Corruption is not new—Russia inherited much of the problem from the USSR—but the collapse of the old political and economic system and the slow process of building a legal infrastructure for the new one have created new opportunities for corruption. In addition, the low salaries of many public officials increase the temptation to supplement their incomes with bribes.

Critical Policy Choices. The short-term economic outlook for Russia is guarded. The present drop in output and buildup of unpaid debt have spurred calls for action from many political camps, and most of the proposed remedies would be inflationary. The government has resisted these pressures so far, but continuing resistance would bring a sharp rise in unemployment—perhaps to over 10 percent of the work force by the end of this year. If this happens, some of the people who are laid off would be at risk of falling through holes in the social safety net, particularly in regions where defense industries provide the bulk of employment.

But even if the pain of rising unemployment is postponed now, it cannot be put off indefinitely. Instead, the sooner inflation is brought under control, the sooner a foundation will be in place for future economic recovery. A turnaround could begin to take shape late next year, provided the government holds to policies such as:

- Further tightening of government spending and bank credit-specially if proposed reductions in tax rates are implemented in 1995.
- An adjustment of budget priorities to assure adequate funding for pensions, welfare payments, health care, and especially unemployment compensation.
- Persistence in developing the legislative and regulatory base for a market economy. The removal of regulations that hinder progress—such as recent reductions in some of the barriers to foreign investment—would be an important part of these efforts.
- Strengthening of the enforcement of laws against crime and corruption.

If progress is to occur in these areas—especially on the legislative and law enforcement fronts—the importance of political cooperation, persistence, and an effective working relationship between the executive and the legislature cannot be overemphasized.

Russia's transition to a market economy will continue to be controversial, however, and the current economic turmoil makes some inconsistencies and missteps inevitable. The most important thing will be to avoid policies that would result in major damage, such as:

- Substantial loosening of budget and monetary policies, which would push inflation back to dangerous heights.
- Political confrontation or gridlock, which could reverse progress made so far in privatization or delay the passage of crucial laws.
- Substantially enlarging the role of the Russian military in other Eurasian countries, which at best would be expensive and at worst could contribute to the expansion of present conflicts and mire Russian forces in ethnic strife (see inset).

Russian Military Relations With Neighboring Countries

Russian political and military leaders are seeking to extend their country's defense perimeter to the borders of the Commonwealth of Independent States (CIS)-especially in the south. To this end, Moscow is promoting a variety of collective security arrangements and bilateral military agreements with CIS countries:

- All CIS members except Moldova, Turkmenistan, and Ukaine have signed a collective security treaty; the Baltic countries remain uninterested in such ties.
- At a CIS summit in April 1994, all Central Asian and Caucasian states except Azerbaijan reportedly agreed to formalize Russian participation in CIS arrangements to guard their borders. Besides their military importance, such border guards help Moscow deal with the security problems posed by criminals and insurgency groups in neighboring countries.
- Russia is seeking formal arrangements for the use of military bases in CIS countries; agreements to maintain six Russian bases in Armenia and Georgia have been announced.
- Moscow also is pushing bilateral military ties, including cooperation in weapons procurement and arrangements for Russian officers to serve in the armies of other CIS countries—especially in Central Asia—and Russian military schools to train officers from CIS countries.

Russia probably will have to settle for less control over CIS armies and fewer military bases in CIS countries than it would like. Nonetheless, by virtue of its size, proximity, and historical ties, Russia will maintain a strong influence in the military affairs of most of its neighbors.

Help From Abroad. Foreign assistance and investment could provide the Russian economy with an important boost toward recovery, but only as supplements to sound Russian policies, not as substitutes for them. Russia has benefited from several kinds of foreign assistance, although amounts disbursed remain short of amounts pledged (figure 3). These various kinds of assistance work in several different ways:

- Trade credits and postponements of payments on foreign debt have helped free scarce hard currency for purchases of key imports. Most of the trade credits provide few concessions from commercial terms, however, and many remain unused because they are tied to specific goods that Russia does not want.
- Hard currency loans have helped finance Russian budget deficits and build international reserves. In 1992-93, however, budget deficits were too large and foreign financing was too small to prevent high inflation.
- Loans for investment projects have helped finance some new infrastructure—for example, in the oil industry—but most of the funds needed to restructure Russia's economy will have to come from Russian or foreign private investors.
- Technical assistance has ranged from industrial technology provided in connection with investment projects to job training for business and government managers and advice on drafting legislation and developing political parties. Russia also has used foreign advisers to help implement its privatization program.

The G-7 countries also have pledged a ruble stabilization fund, which would provide hard currency reserves that could be used if needed to support the introduction of a fixed exchange rate. If Russia meets the strict IMF conditions required to receive such a fund—a difficult task—pegging the ruble would help stabilize the domestic prices of imports and reduce the risk of exchange rate fluctuations for Russia's trading partners. Poland benefited from such a fund when it launched its "big bang" of economic reforms, but other countries, including Latvia, have managed to rein in inflation and boost trade with floating exchange rates.

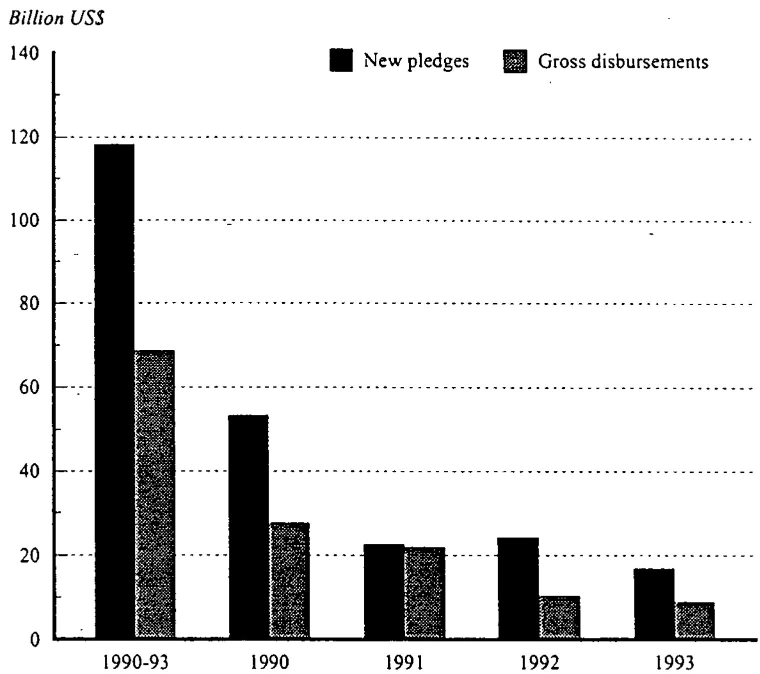
Ultimately, foreign investment—and the return of Russian capital that has fled abroad—have the potential to provide much larger amounts of financing for Russia's economic transformation than foreign assistance can. Moreover, such investment would not generate debts that must be repaid regardless of the outcome of the projects funded; investors share in losses as well as rewards. Substantial flows of foreign investment, however, typically do not precede sound economic policies but follow them.

Other Eurasian Countries

Outside Russia, the other Eurasian countries all continue to move toward market economies, but their progress varies greatly. The Baltic countries, which generally have been most consistent in pursuing economic reforms and tight financial policies, are now in the strongest economic position. At the other end of the spectrum, the Caucasian states and Tajikistan remain mired in armed conflicts that have frustrated some serious reformers and brought sharp drops in output, soaring inflation, and severe disruptions in external trade. Between these extremes, the other new nations have moved forward at rates that depend largely on their policies to date.

Figure 3

Foreign Economic Assistance to Russia, 1990-93



Leaders

Estonia, Latvia, and Lithuania were the first of the former Soviet republics to reject the old political and economic system, and all have combined the move back to national independence with far-reaching economic reforms. All three countries have liberalized domestic economic activity and foreign trade, and all have made progress in privatizing state property, despite disputes over the rights of pre-World War II owners. In addition, all have persisted with tight budget and credit policies to achieve the lowest inflation rates among the Eurasian states—averaging less than 5 percent per month, or 80 percent on an annual basis, for the past year or more. These accomplishments have attracted relatively large inflows of foreign investment, as well as continuing financial support from the IMF and World Bank.

Mixed Progress

Moldova, after suffering from the effects of armed clashes over the status of the Dniester region in 1992, has made progress during the past year in liberalizing prices and foreign trade, privatizing small firms, and distributing small farm plots to the population. In addition, financial stabilization efforts have recently reduced inflation to single-digit monthly rates. Kazakhstan and Kyrgyzstan have made good progress in liberalizing prices, production, and foreign trade and in privatizing state property. Inflation remains very high in Kazakhstan but has recently slowed to single-digit monthly rates in Kyrgyzstan.

Strugglers

Ukraine and Belarus have begun the transition to market economies, but political gridlock has slowed reforms and, in Ukraine, brought a series of starts and stops. Beth countries have made limited progress in liberalizing prices, output, and domestic trade, and both have proceeded slowly with the privatization of small firms. In addition, both have pursued loose budget and credit policies, which have failed to prevent substantial declines in output but did bring Ukraine the highest inflation of all the Eurasian states in 1993. The presidential runoff elections on 10 July in both countries suggest that Ukraine is likely to step up the pace of reforms somewhat but Belarus may backtrack.

Uzbekistan, after two years of limited progress on economic reforms, has improved its tax system, liberalized foreign trade, and expanded privatization since early 1994, but inflation remains very high. Turkmenistan also has pursued a course of slow economic reforms but has taken steps since fall 1993 to expand price liberalization, step up the privatization of small-scale retail trade and consumer services, and modernize its budget and baling systems. Armed conflicts have contributed to the stalling of most economic reforms in Tajikistan and the Caucasian states, although Armenia and Georgia have made notable progress in privatizing farms.

PREPARED STATEMENT OF WILLIAM GRUNDMANN

Mr. Chairman and distinguished members of the Committee, I am pleased to again offer the Defense Intelligence Agency's perspective on military and military-economic developments in Russia and Eurasia. I will focus my comments on Russia's continuing endeavors to reformulate its national security policy, restructure its armed forces, and reform the defense industrial base in the post-Cold War geopolitical environment. I will also point to some of our continuing concerns regarding the potential for proliferation of sensitive technologies and compliance with treaties and control regimes governing weapons of mass destruction and delivery systems.

EVOLVING NATIONAL SECURITY POLICY

Two years after the dissolution of the USSR, Russia's evolving interpretation of its national interests is increasingly leading it to more assertive foreign and security policy goals. Russia views itself as a great power that must be taken into account on the world stage. While continuing selective cooperation with the West, Moscow will insist on being treated as an equal. Russia's leaders see the other republics of the former Soviet Union—the so-called "near abroad"—as a zone of special responsibility and part of Moscow's historic sphere of influence. Russia's more assertive foreign and security policies in the near abroad have been tempered by the need to avoid heavy casualties and excessive costs.

Russia views the resurgence of ethnic, nationalist, and religious conflicts in the former Soviet Union as threatening its stability and potentially leading to a large-scale war. Within Russia, Chechenya in the turbulent north Caucasus area has declared independence. Moscow has committed troops to stem ethnic clashes in nearby North Ossetia. In the near abroad, Russia is involved to varying degrees in a number of conflicts. These include the Transdnester region's struggle to secede from Moldova; the Abkhazian war in Georgia and secession movement in South Ossetia; the Armenia-Azerbaijan war; and civil war in Tajikistan. In all these conflicts, Moscow considers peacekeeping a legitimate means to maintain stability. Russia has trained elements of two divisions for peacekeeping and deployed peacekeepers to South Ossetia, Moldova, Georgia, Tajikistan and the former Yugoslavia. Peacekeeping, however, is defined very broadly to encompass traditional missions such as cease-fire monitoring, as well as a version of peacemaking in Tajikistan that is essentially counterinsurgency combat.

The dispute over strategic nuclear forces on Ukrainian territory was eased by the January 1994 Russian-Ukrainian-American Trilateral Statement. Nevertheless, Russian-Ukrainian relations remain strained by the struggle of the largely Russian- populated Crimean Peninsula to break away from Ukraine. Although Moscow's official response to Crimean secession efforts has been restrained, Kiev is likely to view any support of Crimean separatists by Russia as threatening its territorial integrity, further straining relations and possibly slowing or halting Ukrainian fulfillment of the Trilateral Statement.

Ukraine and Russia also continue to dispute the status of the Black Sea Fleet, which is based largely in Crimea. The primary issue is not the division of ships, but rather ownership and control of bases and fleet infrastructure. Crimean separatists have played upon this issue in an effort to gain Russian support for their independence movement. Some altercations have broken out between Russian and Ukrainian servicemen over control of the Black Sea Fleet facilities.

In relations with the West, Moscow took the first step in joining NATO's Partnership for Peace on 22 June after a vociferous domestic debate, giving hope that Russia can be embraced in a cooperative dialogue on future European security needs. There are, however, still major factions in the military and political leadership who view the Partnership program with suspicion, describing it as an attempt to impose a NATO-dominated security system that denigrates Russia's great power status.

Across the Moscow political spectrum there is agreement that a strong, viable military is necessary to defend Russia's interests and buttress its claim to great power status. Major disagreements remain, however, over the size, shape, and role of the armed forces needed in the post-Cold War world and over the levels of financial and industrial resources Russia can afford to devote to the military. I will review these issues in the remainder of my testimony.

MILITARY DEVELOPMENTS

After a period of disarray following the dissolution of the USSR, the Russian Ministry of Defense made some progress last year in reorganizing the military and adapting its doctrine and training to new fiscal realities and post-Cold War threat perceptions. Nevertheless, the military continues to confront grave fiscal, personnel, and structural problems, which are unlikely to be overcome until the late 1990s.

Approval of a new military doctrine last November provided the Defense Ministry a firmer basis for planning future forces and operations. The document generally reflects the conservative views of the military leadership. The doctrine acknowledges that Russia has no current "enemies," but "military dangers" continue to exist. While recognizing regional conflicts—and their possible escalation—as the most immediate threat to peace, it lays out requirements for maintaining capabilities across the spectrum of conflict. This includes nuclear warfare, and calls for the development of high-technology weapon systems. It authorizes stationing troops beyond Russia's borders and employing forces in peacekeeping missions. It assigns the forces a mission to uphold internal stability, marking a major departure from the Soviet era, when this role was largely confined to internal security troops. In recognition of the key role nuclear farces play in assuring deterrence in both nuclear and non-nuclear war, the doctrine dropped the longstanding pledge not to be the first to use nuclear weapons.

The Defense Ministry has continued with its program of force withdrawals, reductions, and reorganization. From about 2.8 million in early 1992, authorized strengths have fallen to now slightly more than 2 million. President Yeltsin affirmed a 1.5 million goal for reductions last month. He apparently overrode military desires to maintain a force of around 2 million by accepting counterarguments that a larger force is unrealistic given budgetary constraints.

In any event, the on-hand levels of Russia's armed forces are well below authorized strength because of overgenerous draft deferments, medical disqualifications, widespread draft evasion, ineffective enforcement, and inadequate retention rates. Military leaders complain about shortages in the enlisted ranks of 40 percent or more as well as junior officer shortfalls that are severely degrading readiness. While Defense Minister Grachev apparently now accepts the requirement to reduce authorized strength further than he wants, the billets eliminated will be overwhelmingly empty, unstaffed ones. Furthermore, military leaders have indicated they believe the undermanning problem will be solved in 1995.

As they downsize, the armed forces are moving to restructure according to new mobile defense concepts. They are forming new contingents referred to as covering forces, mobile forces, and strategic reserves. The highly ready covering forces are meant to thwart low-intensity aggression. They would be backed up by rapidly deployable mobile forces—including airborne, naval infantry, helicopter and other units—to defend against mid- intensity aggression. Strategic reserves consisting of low-readiness forces and stored equipment would be mobilized in the event of large-scale conflict.

Russia is building up forces along its western borders, which were virtually undefended when it declared independence in 1991. The Moscow and North Caucasus Military Districts have joined the Northern (former Leningrad) MD as front-line border districts. All are being significantly reinforced or reorganized. They now contain 15 ground divisions and 13 brigades. Other districts are also being strengthened as part of the plans for developing mobile forces capable of rapid reinforcement to any region.

The Russian buildup in the North Caucasus Military District in southern Russia poses potential problems in complying with the Conventional Armed Forces in Europe (CFE) Treaty. This district, along with the Northern Military District, is included in a so-called flank zone with specific equipment limits under the treaty. Ground force equipment limited by the treaty in both districts could exceed limits coming into effect in 1995, unless Russia changes its policy. Although the Russians probably intend to abide by overall treaty ceilings, they are seeking relief from the flank zone limits in various ways. They contend the buildup is necessary to meet vital security concerns—the violence, instability, and other threats on their southern borders. They add that the flank limits, negotiated during the Cold War, are outmoded, discriminatory, and deny Moscow its right to base forces internally where it deems necessary.

When Russia finishes withdrawing units from Germany this summer, there will be no forces stationed beyond the borders of the former USSR. Moscow has also drawn down forces in other former Soviet republics, although more than 100,000 troops remain, including strategic nuclear and general purpose forces. Russia has pulled out of Azerbaijan and Lithuania and significantly reduced forces in Estonia, Latvia, Georgia, and Armenia. Russia and Latvia signed an agreement for the withdrawal of the roughly 9,000 remaining Russian troops by 31 August. Only about 3,000 Russian troops remain in Estonia; however, the residency status of Russian military retirees remains an unresolved issue, impeding agreement on troop withdrawals.

Russia has declared that it will retain residual forces in the near abroad. Early this year, Moscow signed a friendship treaty with Georgia allowing retention of three bases and 23,000 troops there after 1995. Military officials also disclosed plans to seek 27-30 military bases in other Eurasian states where Russian troops are currently located. They emphasize this will be done with the agreement of the host country. In April of this year, President Yeltsin signed a decree making these plans official policy, and in June Defense Minister Grachev obtained agreement to retain a base in Armenia.

Russian objectives in maintaining a residual military presence include reestablishing a security perimeter at the former Soviet border, maintaining stability within the former USSR, keeping access to key military facilities, and protecting ethnic Russians. Military facilities Moscow may seek to retain probably will include garrisons in Georgia, Armenia, Azerbaijan, Moldova, and Tajikistan; Black Sea Fleet facilities in Ukraine; the Baykonor Space Launch Center in Kazakhstan; and various satellite control or tracking sites, ballistic missile early warning radars, and intelligence collection sites throughout the former Soviet Union. Russia will also continue to station up to 40,000 of its border troops in Georgia, Armenia, Turkmenistan, Tajikistan, and Kyrgyzstan.

The combat readiness of Russia's military has been severely degraded by force withdrawals, reductions, and reorganization, as well as personnel and resource shortfalls. Troop training is conducted primarily at low levels, and pilot flying hours and ship sailing days have been sharply curtailed. While the numbers of large-scale field training exercises dropped sharply, commanders and staffs have been actively involved in strategic level command post exercises evaluating planned force structure changes and employment plans.

Morale remains a major problem. Career personnel are dismayed by housing shortages in Russia, poor career prospects, pay interruptions, erosion of living standards by inflation, and the possibility of assignment to such distasteful missions as curbing ethnic strife. Among conscript soldiers, significant numbers of suicides, deaths, and injuries from accidents or physical abuse continue.

The combat readiness of general purpose forces is at or near its nadir. Russia's military has little capability for large-scale, offensive operations. Despite this dismal picture, the military has preserved unit integrity, and the command and control system remains functional. Russia retains a significant capability for local or regional operations. Readiness is also starting to improve. The armed forces recruited approximately 120,000 contract (volunteer) personnel in 1993, and they are authorized to recruit 150,000 more this year.

With the readiness of conventional forces at a low level, Russia increasingly views nuclear weapons as the basis for deterrence and security. Strategic nuclear forces continue to maintain adequate levels of readiness and are capable of launching a nuclear strike in minutes. The Russians appear committed to reaching force levels around START II limits in about 10 years. As a result, the strategic forces will undergo drastic changes and reductions.

Limited modernization of the strategic nuclear forces continues. By 2005, land-based forces will be based on the single warhead road-mobile TOPOL (SS-25), a road-mobile follow-on, and a silo-based version designated the TOPOL M. Defense Minister Grachev indicates that priority will also be given to developing a new generation of submarines. We expect a new ballistic missile submarine to be deployed sometime after the turn of the century. In addition, the Russians are emphasizing development of new automated command and control systems and highly-survivable control facilities for nuclear forces.

The Russian Strategic Rocket Forces commander has stated that Moscow maintains centralized combat command and control over strategic forces in Ukraine, Belarus, and Kazakhstan. Ukraine has acknowledged that it exercises only administrative and not operational control over the strategic missile forces based there. All strategic nuclear forces are believed to contain sufficient and redundant safeguards to prevent unauthorized use.

Russia also retains a sizable number of tactical nuclear weapons, all located on its territory. Moscow is reducing and consolidating these weapons in central storage facilities. This is consistent with initiatives announced by President Gorbachev in 1991 and President Yeltsin in 1992 to dismantle all ground force nuclear warheads, reduce air-launched weapons, and reduce and consolidate naval and air defense weapons. Tactical nuclear warheads have been cut by 20-25 percent since 1991.

MILITARY DEVELOPMENTS IN OTHER FORMER SOVIET STATES

Briefly turning to military developments elsewhere, the Ukrainian defense ministry's program to restructure and modernize its armed forces has slowed because of the dramatic economic downturn. Although the armed forces are expected to be reduced from the current 525,000 to 450,000 by 1995, poor economic conditions—especially fuel shortages—have degraded readiness. Conscription shortfalls continue, high inflation has devalued military salaries, and the critical shortage of housing has contributed to increased desertions, crime, corruption, and discontent. Manpower levels probably will continue to fall and may result in shortages of junior officers, whose dissatisfaction with their impoverished economic status will impel them to leave the service.

In Belarus, the defense ministry's plan to reduce its inherited force of 145,000 to 75,000 by next January is almost complete. Its failure, however, to meet the financial and social needs of servicemen has led to growing discontent, personnel shortages, and reduced force effectiveness. The loyalty of the mostly Russian officer corps remains questionable. Belarus has steadfastly maintained its commitment to denuclearization. It signed the START treaty and agreed to accede to the nuclear Non-Proliferation Treaty. Moscow is withdrawing its nuclear forces. As indicated by the elections this week, Belarus is backing away from its policy of neutrality in favor of closer alignment with Russia because of historic and cultural ties and dependence on Russia for energy, trade, and military aid.

Moldova's efforts to establish armed forces are hindered by the dispute with the pro-Russian breakaway Transdnestr region, financial constraints, and a shortage of trained, loyal officers. Moldova probably will have a maximum of 10,000 men in its armed forces; it should have little problem maintaining that strength. The Baltic states' fledgling forces have developed only a limited capability to secure the borders and fulfill some police functions.

To the south, the Central Asian states except Tajikistan claimed jurisdiction over former Soviet general purpose forces on their territory. Lacking resources and experience, they are moving slowly to form independent militaries. Russia retains substantial influence over former Soviet forces, particularly the officer corps in Central Asia, and in some cases actual de jure control over certain forces. Many senior officers are still ethnic Russians. However, the Central Asians will replace most Slavs remaining in their militaries over the next 10 years. Uzbekistan, the most populous state in the region, is vigorously promoting its own military personnel and traditions.

The militaries of the three Transcaucasus states are small, poorly organized, and focused on ethnic and territorial disputes.

DEFENSE SPENDING

Returning to our look at Russia, Moscow has significantly cut defense spending in response to severe economic constraints and changing post-Cold War security requirements. Defense outlays in 1993 were less than 30 percent of peak Soviet levels in the late 1980s. This reflects both the breakup of the Soviet Union and defense downsizing in Russia. Spending on weapons procurement and military R&D is estimated to have been cut to about 20 percent of peak Soviet levels, as the Ministry of Defense focused limited spending on personnel-related activities.

Because Russia's economic decline has been almost as steep as defense reductions, the defense burden probably remains at somewhat more than 10 percent of the Gross National Product. The burden appears lower than this according to Russia's official defense budget, which we believe still does not capture the full costs of defense because of remaining subsidies and contributions to military programs from other line items in the state budget.

Although the government had planned to hold the defense budget essentially level in 1993, spending actually fell in real terms by about 20 percent. The Finance Ministry sequestered funds for government programs in an effort to reduce the budget deficit. The result was underfunding of defense programs and late disbursement of monies, which were rapidly devalued by inflation. Military personnel often went months without pay, and military garrisons accrued large debts for local utilities and supplies. Arrears for weapons and equipment purchases also mounted, leading to late wage payments, worker furloughs, and some layoffs at defense plants.

The acrimonious debate over the 1994 defense budget reflected the severe financial pressures on the military and defense industry. The Parliament finally approved a budget on 24 June, nearly six months into the year, which represents a compromise between proponents of fiscal restraint and the advocates of fiscal relief for the military and defense industry. While falling short of what the Ministry of Defense had asked for, the budget could provide a boost in spending on both weapon procurement and research and development (R&D). Much will depend, however, on the economic and financial situation during the remainder of the year.

If inflation in 1994 stays lower than the government's forecast (as it has thus far at less than 10 percent per month), then the approved defense budget could translate into a real increase in defense spending of about 10 percent over 1993, with procurement growing almost one-quarter and R&D spending almost doubling. However, Moscow's ability to collect adequate tax revenues to support the full defense budget is highly problematic. Tax revenues in the first 6 months of 1994 are down about 30 percent. Unless the government finances defense at the expense of other priorities—which it seems disinclined to do—defense spending probably will fall again in real terms. As the government has learned from painful experience in the last few years, making up for tax revenue shortfalls by printing rubles will trigger higher rounds of inflation that in the end erodes the value of defense outlays and other government expenditures. From his recent statements, President Yeltsin apparently sees more defense cuts in the offing this year.

WEAPONS PRODUCTION AND THE DEFENSE INDUSTRIAL BASE

The defense industry continues to produce a broad array of weapon systems for Russian forces and export. Overall output, however, has declined markedly over the last few years in nearly all weapon categories, as shown in table 1. Output of most weapons is likely to remain low for the remainder of the decade. We noted in last year's testimony that some weapons—tanks and certain fighter aircraft—were being produced in excess of domestic or foreign orders in an effort to keep plants running and workers occupied. This overproduction appears to be declining, suggesting that some rationalizing is slowly taking place.

Defense factories or production lines within factories were idle for significant intervals in 1993. This shift to intermittent operations rather than program terminations or plant closures was an effort to retain defense industrial and R&D capacities in the midst of sharp cuts in procurement spending. In many cases, this reflects Russia's need to maintain a core production capability. In other cases, it is probably linked to the still considerable influence defense industries wield in the economies of major cities and industrial regions.

Some industries in other Eurasian states—for example, Ukraine and Georgia—continue to operate as part of the general network of defense manufacturers, although the degree of cooperation with Russia varies considerably. During 1993, Russia reached several agreements with other former republics to maintain the supply and manufacturing links established under the integrated defense industrial system of the former USSR. Some of these agreements suggest prospects for longer term bonds, as may be the case with Belarus. Over the longer run, however, Russia will try to lessen reliance on defense industrial assets outside its territory where prospects for future cooperation are questionable—for example, with Ukraine.

The number of continuing military-related research projects and development programs is far lower than at any time during the previous 25 years of the USSR. Nevertheless, the number remains higher than in any Western country. Many programs still in the early stages of research are unlikely to reach full scale development or production in the future. In contrast to the Soviet era, when most weapons successfully tested were produced and deployed, the Russians are expected to be more diligent at winnowing out projects as they advance through R&D and much more selective in deciding which weapon systems to put into series production.

Some programs that have persisted in engineering development through the early-to-mid 1990s probably will enter production, with a portion targeted for export. Modernization efforts should include strategic missiles, a new class nuclear-powered attack submarine, improved combat aircraft, some types of mobile, high-firepower land arms, and air defense upgrades—all with some degree of improved battlefield integration capabilities. In addition, the Russians are expected to make improvements—for example, better munitions, communications, and sensors—to existing weapon systems.

For the longer term, Russian military leaders have indicated that R&D should emphasize leading technologies such as stealth, precision weapons, command and control, and advanced electronics, and weapons based on "new physical principles" such as lasers and radio frequency weapons. Russia will be hard pressed, however, to find resources for the investments needed to complete development of these technologies and bring them into production in the future.

DEFENSE INDUSTRY CONVERSION, PRIVATIZATION, AND RESTRUCTURING

Reform of the defense industrial complex has become a key element of political and economic debate in Russia. Radical reformers envision a greatly reduced, almost wholly privatized defense industry that is well integrated into the overall economy. Centrists and conservatives seek to downsize defense industry slowly with the aim of preserving, through government intervention, its advanced R&D, production capabilities, and skilled manpower. They envision a reduced but still robust core of defense industrial facilities remaining under state control.

The government took several steps to shore up defense industry last year, responding to the growing influence of the defense industrial lobby and the threat of labor unrest among defense workers facing low wages, late pay, furloughs, and potential unemployment. A November 1993 Presidential Edict on Stabilizing Defense Industry granted defense workers wage hikes above the industrial average and provided for advanced payments, inflation adjustments, and guaranteed profit margins on defense orders. Similar decrees were signed in December providing generous support to the space industry and to about 70 high-priority national science centers. Nevertheless, these and other measures proved to be largely paper victories for the defense industrial sector because of the government's continued lack of financial resources to fully implement them.

This difficult financial situation increases the pressure for conversion from defense to civilian production. Little genuine conversion has taken place, however. Progress has been hindered by many factors: the general political instability and economic dislocation; paltry government funding, which defense managers often have diverted to other uses such as paying wages; bureaucratic infighting; resistance from defense industrialists and their government supporters; and cautious foreign investment. The U.S. government for its part is providing start-up capital for sound business ventures with Russian defense plants that are looking to convert. Some $40 million currently is earmarked for this effort, which could attract several times that amount in private investment.

One of the most serious impediments to conversion has been the government's inability to agree upon an affordable long-range armaments program and the defense industrial capacities needed to fulfill it. In the absence of a clear plan, many defense enterprises continue to sit on the fence, unable to adjust to changing conditions and hoping to be among the future defense producers. The problems of adjustment are more difficult than those confronting defense plants in the West. Russian plants provide workers an array of social benefits such as housing, health care, day care, and recreational facilities. This social safety net ties workers to plants, limiting labor mobility. The problem is particularly acute at the more than 70 defense industry towns where defense output accounts for most employment. Simply closing these plants is not considered an acceptable option, and cutbacks in the defense industrial labor force have not kept pace with cuts in weapon orders. Many plants are surviving by accumulating huge debts to banks and suppliers.

APPLICATION OF MILITARY TECHNOLOGIES TO COMMERCIAL MARKETS

Certainly not all defense industrialists are waiting for government direction and funding, particularly those representing the most technologically advanced sectors of the Russian defense complex. Russian aerospace industries have been very actively seeking to market space hardware and launch services. Joint ventures have been established with a number of Western firms, including US companies. For example, the Khrunichev State Scientific Production Center established a joint venture with Deutsche Aerospace AG in May to provide launch services and a reusable space capsule named "Express." In addition, missile designers are marketing ballistic missiles as space launch vehicles (see table 2).

After a disastrous foray into the food processing industry under an early government conversion program, Russia's aviation sector settled on the more promising course of concentrating its conversion efforts on commercial aviation. Joint ventures and technology improvements, however, have mostly flowed into Russia from Western partners, rather than outward from Russian military aviation assets. Western companies are assisting Russian designers and manufacturers in producing aircraft engines with greater efficiency, longer lifetimes, and lower maintenance requirements. Avionics cooperation has focused on incorporating Western systems to make Russian airframes more attractive on the international market.

Little direct transfer of-military technologies to civil aircraft designs has occurred. Mikoyan and Sukhoi have both offered supersonic business jet concepts based on their extensive work with high-performance fighters, but the projects appear to be divorced from any real market demand. Most commercial aircraft programs are evolutionary developments of longstanding Soviet-era designs. An exception is the recent increase in light utility/general aviation models for the Russian and Eurasian market. Many of these lower technology designs are planned for or entering production at factories that also make military aircraft, but we anticipate little impact on military programs.

Among Russian defense industrialists' more ambitious plans is the creation of large financial industrial groups around important defense plants. These entities are intended to combine defense plants, banks, insurance companies, and other financial institutions into conglomerates producing both civilian and military goods predominantly for the export market. It remains to be seen whether they can achieve a measure of the success attained by the Japanese and South Korean models on which they are supposed to be based.

ARMS EXPORTS

Many Russian arms industries are banking on weapons exports to forestall the need to convert excess production capacity to civilian uses. Arms exports receive high-level support because officials view them as a means to avoid unemployment in the ailing defense sector and generate much-needed hard currency. Nevertheless, the declining international market for arms and stiff competition from Western producers are frustrating this effort. The value of the former Soviet Union's arms exports have bottomed out at $2 to $3 billion annually, after declining steadily from almost $22 billion in 1987. Last year, Russia accounted for over 95 percent of the total.

Much of the decline reflects the end of Cold War motivated arms deliveries to poor Third World client states, such as Afghanistan, Angola, Ethiopia, Cuba, and Nicaragua, which in the past received weapons free or deeply discounted. Generous loan or barter programs with major recipients such as India and Syria were also scaled down significantly. Some trade was lost in complying with UN arms embargoes, particularly against Iraq and Libya.

Moscow's most recent strategy is to offer arms in exchange for Russian debt. In the past two years, Russia has signed arms-for-debt agreements with several countries with a total value of about $2 billion. Last year, debt swaps accounted for over 40 percent of the value of Russia's arms exports. These agreements will help some plants survive, although they will by no means solve the problems of the defense sector.

The Russians are working hard to promote arms exports. They regularly enlist Western marketing experts to develop professional brochures and videos for international arms fairs. They have tried to counter the view that their weapons performed poorly in the Gulf War by giving live-fire demonstrations of some of their most sophisticated systems. They are also planning to establish training and repair bases around the world to improve after-sales supports an area where Western arms suppliers offer superior service. For example, the Indian press reports Russia will build a maintenance center in India to service MiG series aircraft. These kinds of sales efforts could boost Russian arms exports moderately to $4 to $6 billion by the turn of the century, although they will not bring a return to Soviet-era export levels.

Moscow also wants to break into the lucrative market for upgrading older Soviet hardware, particularly aircraft. For example, Russian defense enterprises are examining potential joint ventures with Western firms to retrofit the older MiG-21 and -23 fighters with upgraded avionics and weapons packages. However, the upgrade market is as competitive as the broader arms market.

Last November, President Yeltsin centralized most arms export authority under a new organization, Rosvooruzheniye, to bring some order to what had become a free-wheeling rivalry among enterprises and government organizations to make weapon sales. This May, however, Moscow yielded to pressure from defense industrialists and again granted defense plants the right to participate directly in the arms trade. The May decree allows plants to apply for licenses authorizing them to sign sales contracts independently of Rosvooruzheniye.

The government continues to maintain oversight through the Interdepartmental Commission for Military-Technical Cooperation, which reviews arms sales agreements and advises President Yeltsin on contracts involving weapons not previously exported or countries that have not previously received Russian arms. For example, the Ministry of Foreign Affairs, which is a member of the Commission, has blocked weapon sales to Pakistan.

The growing power and influence of organized crime groups in the former Soviet Union raises concerns in the West. The potential exists for such groups to use bribes and influence over government officials to funnel sophisticated weapons through gray arms markets to terrorist organizations or countries hostile to the West. This is especially true for easily concealed weapons and equipment, such as manportable surface-to-air missiles or night vision equipment, that are difficult to track.

PROLIFERATION

Raising even more apprehension in the West is the possible proliferation of materials, technologies and expertise relating to weapons of mass destruction. We have no convincing evidence of significant transfers, but remain concerned that poor government controls and the difficult internal situation increase their likelihood.

Russia, Belarus, Kazakhstan, and Ukraine are the only Soviet successor states considered to have the capability for proliferation of weapons of mass destruction. They inherited the largest stockpile of nuclear, chemical, and biological weapons in the world, as well as large numbers of delivery systems and an extensive scientific base. Their governments have foresworn any intention to transfer technology related to weapons of mass destruction and are making efforts prevent it. Despite high-level support for establishing effective export controls, however, legal, personnel, and funding problems are slowing progress. In Russia, many of the same agencies involved in enforcing export controls are also responsible for promoting weapon sales.

The so-called "brain drain" of Russian scientific expertise is a potentially worrisome avenue for technology transfer. Russia's scientific and technical labor force has declined by about 10 percent a year since 1990 because of funding cuts that reduced many to poverty-level wages. Many scientists and technicians have turned to other pursuits in the private sector, but a number have been approached and some recruited by other countries. Numerous reports have surfaced of Russian scientists traveling at least for short periods to the Middle East and Asia, including China. To what extent technological know-how may have been transferred is unclear, but such trips raise growing concern in the West that significant military technology could fall into the wrong hands. Monitoring the travel and emigration of scientists will continue to be a struggle for Russia's overstretched security apparatus. Current economic hardships increase the incentives for corruption in obtaining false passports and visas.

The possibility of nuclear weapons proliferation warrants special mention because of the publicity it has received in the West. Thus far, Russia, Belarus, and Kazakhstan have ratified the nuclear Non-Proliferation Treaty, and Ukraine is expected to ratify it later this year. While many scientists have emigrated, very few, if any, have detailed knowledge of nuclear weapons designs. Viktor Mikhailov, head of the Russian Ministry of Atomic Energy, has stated that only 2,000 to 3,000 scientists possess such knowledge. Located in a few institutes, they are still closely monitored by Russian authorities.

The U.S. through Nunn-Lugar funds is assisting nuclear weapon scientists to find employment in non-weapons areas. For example, after almost 2 years 9f negotiation and planning, the International Science and Technology Center, sponsored by the U.S., Japan, and the European Union, began provisional operations in Moscow this spring with the aim of providing alternative work for weapons scientists. The Center, which still must be approved by the Russian parliament, is opposed by some defense industrialists who see it as a way for the West to gain access to Russia's research laboratories and scientists.

A new concern in Russia and the West is the potential involvement of organized crime groups in proliferating nuclear materials. FBI Director Louis Freeh and his Russian and German counterparts have testified before the Senate on cases involving theft and smuggling of low-grade nuclear materials. However, we have no convincing evidence, despite some allegations in the press, that any weapon-grade nuclear materials have been sold or transferred to third parties.

COMPLIANCE WITH TREATIES AND CONTROL REGIMES AFFECTING WMD

Another area of concern is compliance with international treaties and regimes related to weapons of mass destruction and their means of delivery. Last year, the Russian government pledged adherence to the Missile Technology Control Regime (MTCR). Following signature of a series of space-related agreements with the US, Russia also published new national export control regulations. However, progress in implementing control mechanisms has been uneven. Widespread corruption and resource shortages continue to obstruct Russia's efforts to control missile-related technology exports, despite repeated expressions of willingness to work with the West in their control.

Ambivalence within the government over missile-related hardware and technology sales restrictions and the Russian missile and space industry's outright opposition also undermine President Yeltsin's promise of MTCR adherence. Many organizations are continuing—in some cases with Moscow's knowledge or acquiescence and in some cases without it—to try to sell missile-related hardware and technology to China and Third World countries.

Concerns also remain over possible efforts to circumvent the provisions of the Chemical Weapons Convention (CWC). These activities began to come to public light when a Russian scientist, Vil Mirzayanov, published an article in September 1992 accusing the Defense Ministry of continuing to develop and produce chemical warfare (CW) weapons. Dr. Mirzayanov charged that Moscow had greatly understated the size of its stockpile, secretly disposed of thousands of tons of chemicals, and developed a new highly-toxic chemical weapon. Mirzayanov was arrested for divulging state secrets. These charges were dropped in March of this year, but not before further allegations were made of past and present chemical-weapons related activity that contradicts official Russian declarations and appears at odds with the behavior of a country committed to abandoning its chemical weapons program.

Evidently, much of what Mirzayanov and his compatriots alleged was true. Not only were the charges against him dropped, but the head of the Presidential Commission responsible for overseeing compliance with chemical and biological warfare arms control agreements was fired. The activities designed to evade the Chemical Weapons Convention were so comprehensive and thorough that we believe we must maintain constant vigilance to determine whether they continue. The international community will remain skeptical until Russia thoroughly accounts for past efforts aimed at continuing a CW program under the guise of civilian chemical production after the CWC enters into force.

In April 1992, Russia took the unprecedented step of acknowledging that the Soviet Union had maintained a clandestine offensive biological warfare (BW) weapons program after 1972 in violation of the Biological and Toxin Weapons Convention (BWC). President Yeltsin pledged to terminate the program. However, evidence from a variety of sources indicates military and civilian officials in positions of influence over BW activities are involved in an organized effort to misrepresent the size, scope, and maturity of the former program and to preserve key elements of an offensive BW capability. Even though some of these individuals have been removed from their positions, the Russian government has not yet provided a full disclosure of all BW agent stockpiles and weapons.

Although President Yeltsin's actions show an intent to end the offensive BW program, comprehensive elimination requires nothing less than full disclosure, conversion of all BW facilities to civilian or defensive pursuits, and identification and destruction of all BW agent stockpiles and weapons.

OUTLOOK

Senator, one of the major challenges facing Russia over the next several years is to continue reshaping its military and defense industrial base into a force capable of guaranteeing national security within the context of a democratic society and market-oriented economy. As my review of recent developments indicates, remarkable progress has been made since Russia became independent and much work remains to be done.

While the West no longer faces the formidable Soviet military threat of a few years ago, Russian military forces will remain among the largest in Eurasia. Russia will retain a capability to develop and produce a wide range of strategic and conventional weapons. The potential for local and regional conflicts and the proliferation of sensitive weapon-related technologies remain high. The West's great challenge is to help Russia emerge as a constructive member of the European and Asian security systems. One of the Military Intelligence Community's priority missions is to support Western assistance efforts while continuing to carefully assess Russia's progress toward this goal.

This concludes our testimony. Thank you, Senator and distinguished members of the Committee.

Table 1

WEAPONS PRODUCTION IN THE FORMER SOVIET UNION AND RUSSIA			
Weapons Categories	**1991 (USSR)**	**1992 (Russia)**	**1993 (Russia)**
Tanks	900	700	200
Infantry Fighting Vehicles & Armored Personnel Carriers	1,900	1,000	300
Bombers	30	15	5
Fighters/Figher Bombers	325	150	75
Attack Helicopters	15	0	10
Submarines & Major Surface Combatants	13	7	6
Strategic Ballistic Missiles	175	70	35

Table 2

PROPOSED SPACE LAUNCH VEHICLES (SLVs) BASED ON STRATEGIC BALLISTIC MISSILES[a]

Missile System	SLV Name	Developer	Remarks
SS-18	SS-18K	NPO Yuzhnoye, Ukraine	Proposed Conversion Project.
SS-19	Rokot	Krunichev Plant, Russia	Test launching has occurred from Kazakhstan.
SS-24	Space Clipper	Pavlohrad Plant, Ukraine	Proposed air-launched booster. Unclear if stages distinct from SS-24.
SS-20/SS-25	START/ START-1	Moscow Institute of Thermal Technology (MITT)	One launch to date of SS-25 with added stage. In future, some boosters may be newly produced and different from SS-25.
SS-N-6	Zyb'	Makeyev SLBM Design Bureau, Miass, Russia	Two launches to date; commercially available.
SS-N-8	Vysota	Makeyev SLBM Design Bureau, Miass, Russia	Proposed sea-launched SLV
SS-N-18	Volna	Makeyev SLBM Design Bureau, Miass, Russia	Proposed sea-launched SLV
SS-N-20	Rif-M	Makeyev SLBM Design Bureau, Miass, Russia	Proposed air-launched SLV; may be based on a modernized SS-N-20.
SS-N-23	Shtil'	Makeyev SLBM Design Bureau, Miass, Russia	Proposed ground-launched or air-launched SLV. Several variants possible.

a. Programs depicted above are described in literature and advertisements from various Russian/Ukrainian industrial and governmental entities. Other Russian and Ukrainian SLVs are based on older model ICBMs and IRBMs, purpose-built SLVs, and "other technology" SLV proposals (which are not apparently linked to extant missile systems). These latter categories are not included in this table.

PREPARED STATEMENT OF JOHN E. MCLAUGHLIN

Rough Road to Markets in Russia and Eurasia

Russia and the other successor states of the former Soviet Union have embarked on an enormously complex and difficult economic transformation—one that is more than ever bound up with the parallel political transformations under way in the region. All of these new states inherited a daunting legacy—the world's longest period of central economic planning and Communist domination, and, consequently, a lack of experience with democracy and the rule of law. The new countries have traversed a variety of political and economic paths since setting out on their own in December 1991, and the going has not been easy anywhere.

Russia

Despite the diversity of effort under way, Russia continues to strongly influence developments throughout the region because of its size, its power, and its wide-ranging ties with the other Eurasian countries. In many respects, Russian economic reforms have made enormous progress in the two and a half years since the breakup of the Soviet Union. Market institutions are filling the breach left by the breakdown of the old command economy, and Russian policymakers are quickly learning that tighter fiscal and monetary policies eventually lead to a healthier, more stable economy. But the goals of a thriving market economy and Western levels of mater prosperity for Russian citizens remain a long way off, and the road there will be difficult, with many twists and turns that will severely test Russia's new democratic institutions and leaders.

Progress on Economic Reforms

Russia's major achievements in economic reform include the following:

- The Russian Government removed controls on the vast majority of producer and consumer prices in January 1992 and has further liberalized the prices of oil, coal, and key foods since then. Many prices have moved closer to world market levels, although energy prices remain substantially lower.
- The role of state authorities in allocating supplies among producers has fallen sharply, and roughly two-thirds of retail sales took place outside state channels last year—up from about one-third in 1991.
- Government programs to privatize state property have transferred 104,000 small businesses and shares in 13,000 medium and large industrial firms to private hands since January 1992. As a result, the private sector—ranging from traditional small farm plots to large industrial enterprises part way through the privatization process— accounted for about two-fifths of gross domestic product in 1993, up from one-fifth in 1991, as you can see from this chart.
- Russia's foreign trade arrangements have moved a long way from the old Soviet system, which relied on extensive central controls over quantities of exports and imports, accompanied by artificial exchange rates. The present system, In contrast, is based primarily on export and import duties, with exchange rates determined by supply and demand. Some central controls remain in place, however, in the form of export quotas and licenses for key earners of hard currency, such as oil and gas.

- And in the face of severe pressure from anti-reform elements during and after the December 1993 election, the Russian Government has generally stayed on course.

These achievements are substantial, but less progress has been made in other key areas:

- The financial system remains underdeveloped, with an antiquated and slow payments mechanism, and the legal system necessary to support a market economy is only beginning to emerge. Little progress has been made in passing new laws, although Russian voters approved a new constitution in December 1993, and enforcement of existing legislation is weak. Contracts also are difficult to enforce because the court and arbitration systems are just beginning to function.
- Restructuring of the Russian economy has been slow so far. Layoffs of excess workers lag far behind declines in output, and investment in new, more efficient factories has been minimal.
- Spending for social needs—especially for housing, public utilities, and child care— continues to be funded largely by state enterprises, many of which are in serious financial difficulty themselves. Also, funds for unemployment compensation and job retraining may fall short of needs when layoffs begin in earnest because revenues for these purposes come from taxes that are based on wages paid. Indeed, many Russians are worried as the social safety net unravels beneath them and there is little to take its place.

Economic Troubles So Far

The uneven economic transition from plan to market and the simultaneous loss of empire and trading partners have had a dramatic impact on economic performance. But efforts to assess these changes are complicated by the inadequacies of Russian official statistics. First and foremost, changes in prices and quantities alone fail to reflect the hard-to-measure improvements in economic welfare that movement toward a market economy has brought. Under the old system, where political leaders and bureaucrats decided what to produce and how to allocate it, large amounts of output were unwanted or wasted, and shortages were pervasive. Although measured output declines do reflect decreases in unwanted production, they do not fully capture improvements in distribution, thanks to emerging markets. Second, the statistical system that Russia inherited is poorly suited to measuring small-scale economic activity in general and the private sector in particular. As a result, official statistics do not fully reflect increases in private sector output—especially from savvy entrepreneurs who do not register with the authorities or who underreport their activities.

Nevertheless, the general economic picture is clear enough. Real gross domestic product decreased by 19 percent in 1992 and 12 percent in 1993, according to Russian official statistics. The decline worsened sharply early this year—as the chart illustrates—with real GDP down by 17 percent in the first half of 1994, as compared with the same period last year. Inflation remains high—as the next chart shows—although the rate of increase in consumer prices has slowed from an average of about 20 percent per month in 1993 to under 10 percent per month since February 1994.

The recent drop in output and slowdown in inflation reflect slack demand as a result of tighter reins on both Central Bank credit and government spending. Moreover, interest rates have helped hold down demand for credit by remaining above inflation rates since late 1993. But the government's spending restraint has been achieved in large part by simply withholding budgeted outlays. This, in turn, has contributed to rising debts throughout the economy, disruptions of production as disgruntled, unpaid suppliers stop deliveries, and increasing labor unrest by workers lacking paychecks. Pressure is mounting for the government to make good on its obligations, which would quickly push inflation up again.

Some restructuring of the Russian economy has begun, especially in cutting back output of weapons and other goods that Soviet planners overemphasized, such as machine tools. But investment in new, more efficient factories has ground almost to a halt because of inflation, the lack of market mechanisms to better allocate funds, and enterprise owners seeking only quick profits in such a risky business climate. Moreover, excess workers continue to draw salaries in many industries, although unemployment has risen to about 6 percent of the work force, according to estimates that Russian officials say are based on Western definitions. Many firms that have not discharged workers outright have made other adjustments, however, such as reducing the number of hours worked per week or placing workers on leave at less than full pay.

In material terms, Russian living standards have roughly stabilized but remain substantially below 1990 levels. Indeed, consumption of many goods has begun to recover from the impact of widespread shortages in 1991 and huge price increases in 1992. And the availability, quality, and variety of goods have improved greatly, thanks to the liberalization of prices and of domestic and foreign trade. But the economic transition has been accompanied by rising inequality of personal incomes—an anathema to many Russians reared on egalitarianism. And public services, such as health care, have deteriorated sharply as local governments struggle to tighten their budgets.

Moreover, rampant crime and corruption have emerged as key factors in Russia's attempt to reform its political and economic institutions. Criminal groups, reportedly with the assistance of some corrupt government officials, are infiltrating Russia's financial institutions, distorting the privatization process, and discouraging foreign investment. Some Russian officials even assert that organized crime groups control some 40,000 businesses and a majority of Russia's 2,000 banks. Perhaps more importantly, the growing power of criminal groups is cling the perception that democratic and free market institutions are inherently corrupt. Public opinion polls show that such perceptions are eroding popular support for reforms and feeding the nationalist backlash. Indeed, Russian polls show that three-fourths of those who voted for Vladimir Zhirinovskiy in last December's elections cited the breakdown in law and order as the primary motivation for their choice.

Rough Road Ahead

Russia's economic prospects in the coming months and years will depend crucially on the ability of political players to support needed but painful economic policies and survive in upcoming elections. The politics of economic reform, however, remain contentious. Voters in the December election approved a new constitution, which gives President Yeltsin much greater powers than he had under the old one. But the new legislature includes large factions representing his opponents—especially the traditionalist Communist and Agrarian parties and the ultranationalist Liberal Democratic Party—as you can see from this chart. To secure implementation of his decrees and avoid another dramatic confrontation with opponents, Yeltsin must increasingly seek compromise with these legislators, build issue-oriented coalitions, and employ his new powers judiciously. Moreover, as power has devolved from Moscow to local and regional governments, a wide array of new economic decision-makers has emerged, further complicating the politics of Russia's market transition.

At the same time, both the president and the legislature have been elected for the first time in Russia's post-Soviet history and must face reelection shortly or leave office. Politicians must worry about maintaining support in the face of the growing weariness of the population with low living standards and social dislocations.

In the short term, Russia continues to face the tough choice between high inflation and rising unemployment. The present drop in output and buildup of unpaid debt have spurred calls for action from many legislators, and most of the proposed remedies would be inflationary. The government has resisted these pressures so far, and continuing to do so would bring a sharp rise in unemployment—perhaps to over 10 percent of the work force by the end of this year. If this happens, labor unrest would intensify, particularly in regions where defense industries provide the bulk of employment. But even if the pain of rising unemployment is postponed now, it cannot be put off indefinitely. Instead, the sooner the inevitable layoffs occur, the sooner a foundation will be in place for future economic recovery.

In the longer term, much work remains to be done in developing the legal and regulatory base for a market economy. The task of restructuring Russia's aging and obsolescent industrial base also is formidable, will take years to achieve, and must be done largely by the Russians themselves. Although foreign economic assistance can have an important impact on some specific problems, Russia itself must push ahead with policies that will instill enough confidence in its future to bring the billions of dollars of capital flight back home and to boost private foreign investment. Political cooperation, persistence, and an effective working relationship between the executive and the legislature would go a long way to accomplish all of this; confrontation would bring harmful delays.

Other Eurasian States

Outside Russia, the other Eurasian countries also are continuing to move toward market economies, but their progress varies greatly. The going has not been easy anywhere, but it has become clear that more rapid reforms are beginning to yield payoffs that slower approaches have not achieved.

Ukraine and Belarus, for example, lag behind Russia in economic reforms to date. Both countries have made limited progress in liberalizing prices, output, and domestic trade, and both have proceeded slowly with the privatization of small firms. But both also have pursued very loose budget and credit policies, which have failed to prevent substantial declines in output but did bring Ukraine the highest inflation of all the Eurasian states in 1993. The statements and records of the new leaders chosen in presidential runoff elections in both countries last Sunday suggest that Ukraine is likely to step up the pace of reforms somewhat but Belarus may backtrack.

Russia's other Eurasian neighbors have progressed toward market economies at rates that depend largely on their policies to date. At one end of the spectrum, the Caucasian states and Tajikistan remain mired in armed conflicts that have frustrated some serious reformers and brought sharp drops in output, soaring inflation, and severe disruptions in external trade. At the other end, the Baltic countries, which generally have been most consistent in pursuing economic reforms and tight financial policies, are now in the strongest economic position. Their lesson—that persistence and financial discipline payoff—is reinforced by the experience of the East European countries, which my colleague will now describe.

CHINA'S ECONOMY IN 1993 AND 1994: THE SEARCH FOR A SOFT LANDING

FRIDAY, JULY 22, 1994

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:00 a.m., in room SD–628, Dirksen Senate Office Building, the Honorable Jeff Bingaman (Member of the Committee) presiding.

Present: Senator Bingaman.

Also present: Richard Giragosian, professional staff member.

OPENING STATEMENT OF SENATOR BINGAMAN, MEMBER

SENATOR BINGAMAN. This is a Joint Economic Committee hearing on the economy of China.

Throughout the Cold War, there was an obvious need to monitor developments in the large Communist and nuclear-armed country, which shares a common border with the Soviet Union and which subscribes to many of the ideological beliefs of the former Soviet Union.

Today, we still have a very strong interest in the changes taking place in China and obviously need to pay very close attention to them. According to recent estimates, China is now the world's largest economy behind only the United States and Japan.

Although China is a low-income, developing country, its dynamic economy and its huge population make it a large participant in world trade. China, of course, is one of the major trading partners of the United States, and frankly it is one of our major trading problems.

Our bilateral trade deficit with China is our second largest behind only that of Japan. It grew again in 1993. It appears to be still growing. We will get an estimate of that today on a likely bilateral trade deficit for 1994. Many would argue that Beijing's trade policies, which have had the overall effect of promoting exports and restricting imports, are largely responsible for our unfavorable trade balance.

China has been promising to reform its trade policy and to become less protectionist, but as the report today will indicate, the trade deficit does continue to grow.

For 1993, this unacceptable situation continued as the trade deficit grew to 22.8 billion. Our trading deficit with China is growing faster than the deficits that we have with any other major trading partner.

Testifying this morning is Martin Petersen, Director of the Office of East Asian Analysis of the CIA.

Mr. Petersen, we have the new report you just issued on the economy of China.

Please take whatever time you like to summarize your findings, then I will have a few questions. Go right ahead.

[The paper presented to the Committee by the Central Intelligence Agency starts on p. 69 of Submissions for the Record:]

STATEMENT OF MARTIN PETERSEN, DIRECTOR, OFFICE OF EAST ASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY: ACCOMPANIED BY CHRISTIAN LANSING, SENIOR ANALYST, CHINA DIVISION.

MR. PETERSEN. Thank you, Mr. Chairman. Good morning.

It is a pleasure to be here today to present our annual assessment of the Chinese economy.

I believe you have a copy of our written report, *China's Economy in 1993 and 1994: The Search for a Soft Landing*. As usual, it includes an annex on China's trading patterns with its major partners and a chronology of political and economic developments in China.

With me today is Mr. Chris Lansing, our Senior Analyst on China's Domestic Economy.

I will focus on two topics in my prepared remarks today, Mr. Chairman: The major trends in China's economic performance in the last year, and Beijing's search for more effective tools to manage economic growth in the future.

The Chinese leaders today are struggling with many of the same issues as when I addressed this Committee a year ago. Specifically, they are still trying to bring China's surging economy under control.

In my testimony last year, we focused on the factors behind the current economic boom.

To recount, the expansion was spurred by Deng Xiaoping's tour to Southern China in early 1992, which marked an end to the 1989-1991 retrenchment and gave the green light to local officials to go ahead with their own development plans. In response, domestic banks and other financial institutions greatly increased their lending. Indeed, the broad money supply, the M-2, expanded by roughly 30 percent in 1992. I also noted the upsurge in entrepreneurial ventures, and in particular the rapid growth in the service-sector firms engaged in real estate development and trade. These trends have continued through 1994.

China continues to chalk up impressive growth rate. Indeed, it remains the world's fastest growing major economy.

I would like to direct your attention to Figure 1.

As the left panel shows, in 1992 and 1993, China's GNP increased by over 13 percent. Growth has continued in 1994 at nearly these rates. The GNP in the first half of 1994 was up by 11.6 percent, compared to the same period last year.

Heavy investment spending, much of it undertaken by local officials, continues to be the major factor behind the economic expansion. Domestic bank lending increased by over 20 percent in 1993, while direct foreign investment jumped by 130 percent to nearly $26 billion. This capital expansion helped to boost nominal investment in fixed assets by over 50 percent last year.

This investment went to build factories and upgrade production equipment, to construct highways, railways, power stations and other infrastructure project, as well as such urban development projects as housing construction.

This generated strong demands for construction materials and producer goods, such as steel and machine tools, and helped to boost overall industrial output by over 23 percent last year, a record high for China's reform period.

Per capita incomes are also increasing, which is helping to boost the demand for consumer goods. To help keep incomes ahead of inflation, for example, the regime authorized a new round of wage adjustments for many government workers that began in late 1993.

Nominal per capital urban incomes increased by 28 percent last year and grew at an annual rate of nearly 28 percent in the first five months of 1994.

There is a downside, however. The economic expansion continues to generate inflation as well as other signs of economic overheating.

Again, turning to Figure 1, the right panel shows that urban inflation topped 23 percent in 1993, up sharply from the 13 percent rate in 1992. As I stated last year, these inflation rates are far below those of some other countries, including some in Eastern Europe and some of the former Soviet republics, but they are alarming to Chinese leaders and to the population at large.

If I can direct your attention to Figure 2. The red bar shows that China's trade balance slipped into the red in 1993. Beijing registered a $12.2 billion trade deficit, the first annual deficit since 1989 and the largest since 1985. The trade deficit reflected the strong domestic demand for important industrial goods and consumer goods that drove imports up by 29 percent. Domestic demand also limited the volume of goods available for export. Export totals only increased by 8 percent last year, compared with 18 percent in 1992.

Let me turn for a moment to our own trade with China. Despite the global trade deficit, China continues to run a trade surplus with the United States.

As the yellow bars on Figure 2 indicate, this surplus continues to grow. According to U.S. Department of Commerce statistics, our trade deficit with China last year reached $22.8 billion, a 25 percent increase over 1992, and as you stated in your own remarks, second only to the deficit we run with Japan.

One factor in the growing deficit is the relocation of manufacturing facilities from other rapidly developing areas in Asia to China. This had the impact of shifting a portion of the U.S. trade deficit that the United States runs with such booming economies as Hong Kong and Taiwan to China. Our aggregate deficit with these three economies has grown more slowly than our deficit with China alone.

The aggregate deficit increased last year and reached $31 billion, up 20 percent from a deficit of $26 billion that we ran with these three economies in 1987.

SENATOR BINGAMAN. The three are China, Taiwan and who?

MR. PETERSEN. Hong Kong. During the same period, though, Mr. Chairman, our deficit with China increased by 700 percent.

If I can direct your attention now to Figure 3. It illustrates China's success in expanding its share of the U.S market. As indicated by the yellow line, in 1993, China held nearly 6 percent of the total U.S. market for imports, up from less than 2 percent in 1987. Much of this is low-tech consumer goods. China's share of the U.S. market for toys, games and clothing, the leading categories of Chinese exports to the United States remained steady or increased slightly last year.

China also increased its share of the U.S. market for imported footwear, from about 30 percent in 1992 to 40 percent last year.

China is also beginning to expand its share of the U.S. market for more sophisticated goods like consumer electronic products. The total value of telecommunications equipment, such as phone sets, reached a billion dollars last year and accounted for 6.5 percent of the U.S. market.

China, of course, is an important and rapidly expanded market for U.S. exporters. Indeed, U.S. sales to China last year increased by 17 percent, far faster than the 3.9 percent increase in U.S. global exports.

The China market is particularly promising for U.S. high-tech exporters. China purchased over $2.2 billion last year in U.S.-produced aircraft and associated parts, about 7 percent of U.S. global exports of these projects.

But again, as the red line on Figure 3 shows, the total U.S. share of the China market for imported goods has held fairly steady in recent years. If this trend continues, the U.S. deficit with China will increase by nearly 23 percent this year to roughly $28 billion.

I would like to now turn to my second topic: The initiatives Beijing has taken over the last year to control growth and reduce inflation.

When I appeared before the Committee last year, Beijing had just launched its 16-point program, which it hoped would gradually reduce growth rates to sustainable levels. Under the program, Beijing ordered state banks to recall unauthorized loans. They stepped up quota sales of government bonds. They called for cutbacks in administrative spending, and they generally tightened Beijing's control over local development projects.

But the 16-point program failed to achieve the goal last year for the reasons we point out in our report, and Beijing continues to struggle with the problems of economic overheating.

The regime has had some success. Again, turning your attention back to Figure 1, you can see that the national growth rate has begun to ease. In the first half of 1994, China's GNP increased by 11.6 percent compared to the same period last year, indicating a slight cooling from last year's 13.4 percent growth rate.

The urban inflation rate, while easing a bit, remains stubbornly high, however. Urban year-on-year inflation rates have remained above 22 percent since last December.

Beginning early this year, Beijing introduced an important new element to its reform program designed to improve the regime's long-term ability to manage the economy. Beijing enacted a sweeping overhaul of its tax system in January to boost the proportion of revenues earmarked for central coffers. This new system is designed to make the taxation system more transparent, less subject to negotiation between the center and the provinces and to enhance central control over revenues, while enforcing greater discipline on local officials.

Beijing is also taking steps to strengthen the banking system, particularly the Central Bank. The goal is to enable it to better control the money supply through indirect levers, such as interest rates and the buying and selling of government bonds.

Finally, Beijing is also moving to put state enterprise reforms and capital market experiments on a stronger legal footing. A law just implemented, for example, should help clarify ownership and management rights for these enterprises.

These and other recent steps break new ground for Beijing. We refer to them in our report as centralizing reforms to distinguish them from reforms that have often devolved economic authority to local levels.

Once in place, and if effectively implemented, these measures could enable the regime to go ahead with additional market-oriented reforms, while avoiding some of the overheating problems that have troubled past reforms.

Of course, Beijing faces major challenges in realizing the potential gains from these reforms. Some of the new measures are resisted by local officials. They see them as a threat to their autonomy.

We have already seen some slippage in the program, including the implementation of the new tax system, and we expect Beijing to encounter further setbacks.

Earlier this month, the regime failed to enact a new Central Banking and Securities law, in part because of debates over the extent of control Beijing should have over these key areas.

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In short, the process of establishing more effective economic institutions like a strengthened Central Bank and a sounder regulatory framework for financial markets will not be easy nor fast.

Thus, while the steps Beijing has taken hold out the promise for smoother, sustainable development, it is possible that the soft landing Beijing seeks will prove as elusive this year as it did last, and China may experience another cycle of relaxation and retrenchment as it grapples with the contradictory pressures to both stimulate growth and control inflation.

That concludes my formal statement, Senator. I would be happy to take any questions you may have.

SENATOR BINGAMAN. Thank you very much.

Let me ask a few questions about the trade deficit.

Obviously, as least as I understood it, the trade balance with the world generally has turned pretty sour on them in the last year. That is, in 1992, they had a reasonable surplus; in 1992, they had a substantial deficit.

What countries increased their exports to China, or what accounts for that? Was there a significant shift in the trade balance vis-a-vis Japan or vis-a-vis Western Europe?

MR. PETERSEN. A couple of things, Senator. Projecting forward China's overall trade balance for 1994, at present, they are still running a deficit for the first half year, but they achieved an $820 million surplus in June. So it is improving. They are not going to run quite the deficit that they ran last year.

They run a surplus with the United States. They run a surplus with Japan. They run a surplus with the United Kingdom. They run a deficit with Taiwan, South Korea and Hong Kong. I think last year they ran about a $3.3 billion surplus with Japan.

SENATOR BINGAMAN. How did that relate to their previous year's surplus?

MR. PETERSEN. I think they ran a larger surplus in 1992.

Chris, do you have those numbers?

Mr. Lansing. I am looking for them now.

The share of China's market for imports that Japan holds has increased steadily since 1990. In 1990, Japan held a 12 percent share of the Chinese market. That was up to 18 percent by 1993.

What we are seeing here, in part, as the Chinese economy speeds up growth and overheats, is the demand for imports picks up substantially—imports of steel and cement, materials to support their construction boom.

Countries such as Japan and to some extent Russia and others on the borders are in a position to benefit from this rapid expansion, and they can chalk up trade gains when China's economy is in an expansion phase.

SENATOR BINGAMAN. So Japan has increased its percentage of the goods that are exported into China from 12 percent to 18 percent, from 1990 to 1993?

Mr. Lansing. That is the share of the Chinese market Japan holds.

SENATOR BINGAMAN. Their share of the Chinese market.

What happens to our share of the Chinese market during that same period?

Mr. Lansing. That goes back to our Figure 3.

MR. PETERSEN. It has held pretty even, about the 9 percent range. It is the red line there on top.

SENATOR BINGAMAN. Okay. So there has been a slight decline, but not dramatic as a percentage of the Chinese market?

MR. PETERSEN. Right. And one of the reasons for that is that what we export to China tends to fall into two groups, either very price-sensitive things where there is a lot of competition in the world—agricultural goods, chemicals and that sort of thing—or big ticket items like aircraft—last year $2.2 billion—where people are going to buy once and are not going to buy again for quite a while.

If you have your copy of the report in front of you, there is a set of tables that give you a breakdown of the top ten imports from the United States and China's top ten exports to the United States.

Just looking down there, you can see that in 1993 their number one import from the United States was aircraft, followed by motor vehicles and telecommunications equipment. Then, when you get below that, you get into things like fertilizer, wheat and oil and some of these other things.

SENATOR BINGAMAN. When you made your report to us a year ago, I believe, or maybe it was two years ago, you gave us a very detailed appendix listing steps that the Chinese Government had taken and provisions they had put in law or regulation or practice to prevent U.S. exports into China, essentially. I think the case was made very strongly in that report, at least that is the way I understood it, that the imbalance in our trade with China was very much a result of conscious policies that the Chinese Government had pursued. Is that still the case?

MR. PETERSEN. I am going to ask Chris to expand on that. I believe that is less so now.

Mr. Lansing. In general, I believe the Chinese are making progress in reducing tariffs and some quotas. This is in part because of their interest in joining the GATT and the World Trade Organization to be established next year. At the same time, we see China continuing to produce policy statements and documents that attempt to claim infant industry protection for some of their industrial sectors, such as automobiles, and some of the policies that they are discussing putting in place do involve continued quotas and continued restrictions on investment and direct sales into China.

So, in other words, while the trend is toward trade liberalization, we still see some evidence that the Chinese are looking at trade restrictions to protect their domestic industries and, in particular, their state-owned enterprises.

SENATOR BINGAMAN. If the trend is toward trade liberalization, how do you account for the dramatic increase in the deficits that we are running with China? I mean, wouldn't a free-trade arrangement with China bring our trade relations with them more into balance, or is that not true?

MR. PETERSEN. I think there's two sides to that. First, as I mentioned earlier, it is the nature of some of the things that we export, but it is also found in the nature of some of the things that we import. We particularly import from China low-cost manufactures and consumer goods. China is very efficient at producing the toys, the games, the textiles and the footwear that we buy so much of. That is part of the equation.

Mr. Lansing. Absolutely. And of course, when we are talking about market share, again, as Mr. Petersen indicated in his testimony, the absolute sales of U.S. firms into China is continuing to increase. It increased 17 percent last year, far faster than our global exports increased.

SENATOR BINGAMAN. How fast did their exports to the United States increase last year?

MR. PETERSEN. Their exports to the United States last year were up 22.6 percent, and our sales to China were up 17.3 percent last year. The latest figures I have for the first part of 1994 looks like their exports to the United States are up about 20 percent. So far, our sales to China are up about 12 percent.

That is one of the reasons we are going to end up with about a $28 billion deficit this year.

SENATOR BINGAMAN. What accounts for the rate of decline of increase in our exports to China, if you say ours are going to be up about 12 percent?

MR. PETERSEN. They are running at 12 so far. Part of it is, we had those very large ticket sales last year in aircraft—the $2.2 billion. So that raises the numbers.

Chris, do you have other thoughts on that?

MR. LANSING. Again, on the Chinese side of the equation, selling into the United States market, we remain, as you know, the most open market in the world, and the Chinese are selling goods to us that are in high demand, even at times when the U.S. economy is slowing down. So the Chinese were able to expand their share of the market effectively in the late 1980s and 1990s, and that trend is still continuing.

They are very competitive in high-demand articles—footwear, clothing, and so on. The Chinese share of U.S. imports of footwear increased to 40 percent last year, as Mr. Petersen indicated.

The United States continues to make gains in its dollar-value sales into China, but we are facing strong competition from other national producers.

SENATOR BINGAMAN. Is the imbalance in our trade relations with China the subject of any kind of initiative on our part? Are we doing anything to try and deal with this? I haven't heard anything about it for months.

MR. PETERSEN. USTR, Commerce and others are in a much better position to answer that question than we are. I am sure you are aware that we have a number of MOU's and understandings with China on things like intellectual property rights. There is the GATT negotiations. I think efforts are being made, but others are better able to address that issue.

SENATOR BINGAMAN. Let me ask about the expenditures of the Chinese on their military. My understanding is that there continues to be a dramatic increase in Chinese Government expenditures on their military. Could you describe that and make any comments you would like about it.

MR. PETERSEN. It is easier for me to address this in our closed session. I will be prepared to go into more detail, Mr. Chairman, but in general, yes, we are still seeing China pour resources into military modernization. it is very difficult to quantify exactly how much they are spending, because most of the budget is not reflected in the state published budget.

We are seeing new capabilities and new equipment coming into the Chinese military. The PLA is a very important source of political influence within China. That is one reason. They are also dealing with a different security situation in East Asia, which is also a driver in this.

So, yes, we are still seeing them making a real effort to modernize their military capabilities.

SENATOR BINGAMAN. One of the sources of tension between ourselves and China over the last several years has been their sales of defense technology, weaponry and missiles to the Middle East and other places. Is that continuing?

MR. PETERSEN. Again, I will be happy to address this in more detail in the closed session.

Let me say that I see nothing that convinces me that there has been a fundamental change in Chinese behavior in this regard.

SENATOR BINGAMAN. Okay.

MR. PETERSEN. It is still a matter of concern.

SENATOR BINGAMAN. Okay.

You predicted the size of the trade deficit for 1994. Do you have any projections as to the size of the trade deficit in years beyond that, given the trends that you have seen in the last few years?

MR. PETERSEN. Clearly, there are a lot of variables here, but looking at the trends that we have seen so far and projecting that, I think we are going to continue to see that deficit grow. The rate of increase may slow, however, for a couple of reasons, depending on what happens with Chinese access to GATT, whether they continue to liberalize their markets.

Chinese efforts to change their export mix to us, plus, I think, the fact that the Chinese are going to find more competitors in the sorts of low-tech consumer goods, which they are selling to the U.S. market, suggests to me that the rate of increase may decline a bit, but I think the actual gap will continue to grow, basically because it is so great right now.

I have trouble seeing them turning that around significantly in the next few years.

SENATOR BINGAMAN. Do you see any significant opportunities for us to increase exports to China?

MR. PETERSEN. Yes, I think particularly for telecommunications, technology exports, that sort of thing. I think China is going to be importing an awful lot of that sort of thing as they try and modernize and build their industrial base.

Chris, maybe, you can add to that, too.

MR. LANSING. Just to elaborate, in the late 1980s and early 1990s, we saw the size of the trade deficit that we run with China increase at between 23 percent and as high as over 70 percent in some years. Of course, that was from a relatively low base.

But, nevertheless, as Mr. Petersen says, we expect that that rate of increase may moderate somewhat simply because the Chinese will be facing more competition in the low-technology consumer goods that have done so well, and the opportunities, as China's economy continues to expand, for power generation, telecommunications and other high-technology goods, in which U.S. producers are very competitive.

SENATOR BINGAMAN. So you think those are the two areas—power generation and high-tech consumer goods—where we have the potential to export to China?

MR. LANSING. Among some others.

MR. PETERSEN. Energy as well. Oil equipment, that sort of thing.

MR. LANSING. We already hold a share over 60 percent of China's market for imported oil drilling, gas drilling and exploration equipment.

SENATOR BINGAMAN. How much of China's energy needs are, in fact, coming from imported energy?

MR. PETERSEN. I think, for the first time probably since the Daging oil fields came on in the sixties, China finally became a net oil importer last year. We have been projecting that in the middle nineties, for a number of years now, and they actually crossed that line. I don't know. Off the top of my head, they just barely crossed the line. But clearly, I think, with the industrial expansion, with the aging of the Chinese oil fields and the rest of it, they are going to become more and more a net energy importer.

MR. LANSING. Yes, they imported approximately 4 million metric tons last year of crude oil, and that's the first time they had become a net importer of oil, as Mr. Petersen said, for several decades. However, their primary energy source remains coal, and they have abundant resources in coal, and the oil contribution to this should not offset the fact that they are largely self-sufficient in energy production.

SENATOR BINGAMAN. As I recall, I think there was reference to the fact in last year's report. You talked about how the Chinese economy was overheating or close to that, and you thought that the pattern that you had seen in China was that they would get the economy revved up to that level, and then they would impose restrictions on imports and do other things to calm the economic activity, and then they would have to once again gear things up. And you were predicting, or at least I recall that you were predicting, that there would be one of these contractionary phases. Has that happened?

MR. PETERSEN. I think that what we were talking about last year is that they were running the risk of repeating yet another bust-and-boom cycle that we had seen so often, unless they could learn lessons from previous experience. I think that what we have seen in this last year is, rather than slamming on the brakes, as they have so often in the past, they pumped them a bit. They are still struggling to put in place through the banking laws and some of the regulatory reforms, and the rest of it, the macroeconomic levers that will allow them to adjust the economy without having to cut off credit, which has been one of their major vehicles in the past.

They are still struggling with this. They are still growing at over 13 percent for two years in a row. They are probably going to be somewhere in the 11 to 13 percent rate this year. They have real problems with keeping inflation, particularly in the urban areas, under control. They haven't solved this by any means.

What they are attempting to do is to just be a little smarter about how they put on the brakes than they have been in the past.

So there is a learning curve. I think, maybe, they are a little further along than they have been in the past.

SENATOR BINGAMAN. All right.

We are going to go into closed session, and I will pursue some of these other subjects then.

Thank you very much for coming.

[Whereupon, at 9:35 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

CHINA'S ECONOMY IN 1993 AND 1994: THE SEARCH FOR A SOFT LANDING

22 JULY 1994

This report was prepared by the Central intelligence Agency for submission to the Joint Economic Committee, Congress of the United States.

Summary

Information available as of 18 July 1994 was used in this report

Chinese leaders are attempting to guide China's booming economy to a "soft landing" of slower, sustainable growth without precipitating a costly economic crash. Since mid- 1993 they have employed sporadic administrative measures—such as credit rationing and price controls—as they try to balance popular discontent over inflation against the risks of slowing real income gains.

China continues to score impressive economic gains amid signs of overheating. Real gross national product increased by 13.4 percent in 1993—virtually the same pace as in 1992—and continued to grow at a double-digit annual rate through June 1994. Investment spending—much of it undertaken by local authorities responding to Deng Xiaoping's two-year-old reform revival—continued to stimulate overall economic growth. Outlays on factories, housing, infrastructure, and other fixed assets increased by more than 50 percent in 1993, while direct foreign investment increased by 130 percent to nearly $26 billion. This spending sent ripple effects throughout the economy-industrial output value, for example, increased by nearly 24 percent in 1993, the highest rate in roughly 15 years of reform-driven policies. Meanwhile, surging demand for imported industrial materials and consumer goods resulted in a $ 1 2 billion merchandise trade deficit, the largest recorded since 1985.

Beijing's administrative measures to cool the economy have produced mixed results. China's investment boom eased somewhat in the first half of 1 994, for example, but inflation levels have remained stubbornly high and have been accompanied by social strains. Urban living costs increased by more than 23 percent in 1993—compared to 13 percent in 1992—and year-on-year rates remained virtually unchanged through June 1994. Beijing continues to face demands to provide new loans to help state enterprises pay workers and to fund higher grain prices for farmers. These pressures threaten the regime's hopes of achieving a soft landing and could set the stage for another round of retrenchment in China's boom-and-bust economic cycle.

Beijing's difficulties in dampening economic overheating have helped bolster demands on the part of many central policymakers for a revision in China's reform strategy. Whereas previous reforms frequently stimulated growth by giving local authorities more autonomy, a new approach implemented in early 1994 has attempted to recentralize some powers to help Beijing modulate the boom-and-bust cycles as well as to enforce financial discipline on local authorities:

- Among the program's key elements, Beijing enacted a sweeping overhaul of the tax system in January that boosts the proportion of revenues earmarked for central coffers and reduces the element of negotiation in tax payments that had contributed to local fiscal autonomy.
- Beijing has also taken steps to strengthen the ability of the central bank to implement monetary policy through indirect levers such as open-market operations and interest rate adjustments rather than through administrative credit rationing. The central bank, for example, is no longer forced to issue funds to underwrite a portion of the government's deficit.
- in steps toward currency convertibility, the regime scrapped its dual-exchange rate system in January by setting the official exchange rate at the rate formerly used at government-run swap centers and in April established a limited interbank market for foreign exchange.
- Beijing has announced plans to expand the transformation of state enterprises into limited-liability companies that use shareholding to better clarify legal claims on enterprise assets. A new company law provides an improved legal foundation for these ownership experiments.

The process of establishing economic institutions—including a strengthened central bank and a sounder regulatory framework for emerging financial markets-that are needed to support Beijing's new reform agenda will not be easy or fast. Many local leaders, for example, appear worried that Beijing will use enhanced powers gained from taxation and other centralizing reforms to stifle local development efforts. Local resistance and footdragging have already forced Beijing to compromise on some elements of the new tax system. The central government's current preoccupation with economic and social stability is also slowing progress in some market-oriented reforms—the regime, for example, has clamped down on nascent commodities and futures markets as a price control and antispeculation measure.

Chinese officials undoubtedly recognize that long-term national stability depends on continued growth to generate new jobs and to help spread reform benefits from dynamic coastal urban centers to inland areas where development has lagged behind. Further expansion of market forces within the economy—including the development of capital markets to better allocate investment resources—is probably essential to sustain these growth rates. Chinese authorities are working to erect a sounder regulatory framework for market reforms by drafting new laws to cover securities, banking, insurance, and other sectors. Coupled with reforms to improve Beijing's macroeconomic controls, these steps hold promise for smoother, sustainable development if the regime can manage the economic and political challenges it now faces.

Rapid Growth Brings Mixed Blessings

Chinese leaders are struggling with a complex economic agenda as they attempt to guide China's booming economy to a "soft landing" of slower, sustainable growth without precipitating a costly economic crash. Since mid-1993 they have initiated a series of administrative measures—such as credit rationing and price controls—as they try to balance popular discontent over inflation against the risks of sagging incomes and unemployment. At the same time, policymakers are facing the challenge of implementing a comprehensive—and sometimes controversial—set of economic reforms designed to better enable the leadership to modulate economic cycles in the future.

China's economic performance remains enviable by most standards of measurement. Real gross national product (GNP) increased by 13.4 percent in 1993 according to official Chinese statistics—virtually the same pace as in 1992—as China maintained its status as the world's fastest growing major economy.[1] When the nearly 12-percent annual growth scored in the first half of 1994 is factored in, China has increased the size of its economy by over one-third since Deng Xiaoping's visit in January 1992 to southern China that kicked off a reform revival and spurred the current economic expansion.

Investment continues to lead China's economic boom. Nominal spending on fixed assets-much of it undertaken by local officials capitalizing on Deng's call to speed development—increased by 50.6 percent in 1993, well above 1992's investment growth rate. Direct foreign investment increased by 130 percent to reach $25.8 billion, according to Chinese statistics, as foreign businesses sought access to China's beckoning domestic market and to its low-cost labor for export production. Using these figures, a United Nations report calculated that China accounted for over one-third of direct foreign investment utilized in the entire developing world in 1993. The construction and consumption boom fueled by heavy investment spending helped boost the inflation-adjusted value of industrial output by more than 23 percent last year, the fastest growth rate in the roughly 15 years of reform policies.

Chinese central policymakers, nevertheless, have found rapid growth to be a mixed blessing as signs of economic overheating—and accompanying social strains—have intensified. Urban inflation, for example, climbed to 23.9 percent in 1993—only 5 percentage points short of the peak rate in 1 988 that triggered outbreaks of panic buying.[2] Meanwhile, surging demand for imported industrial materials and consumer goods that had pushed China's trade balance into the red in the final quarter of 1992 drove the trade deficit to over $12 billion—an eight-year high. Supply bottlenecks that had worsened in 1992 persisted in 1993 as the growth in output of key raw materials and energy and the expansion of transportation services continued to lag behind overall industrial gains. A Chinese press report indicated, for example, that the number of electricity blackouts in the first six months of 1993 increased by 60 percent compared with the same period in 1992.

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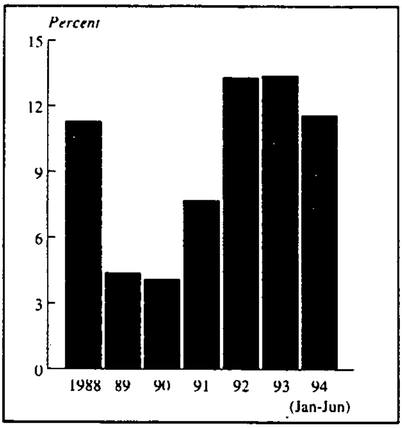
[1] China in mid-1 993 adjusted the GNP growth rate for 1992 from the preliminary figure of 12.8 percent to 13.3 percent.

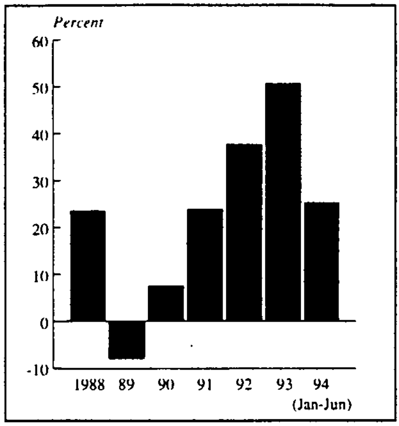
[2] Chinese inflation statistics for a particular month are year-on-year figures that record the change in price levels from the same month in the previous year. The annual inflation rates cited in this report are Chinese year-on-year figures for December. The urban inflation figures are based on cost-of-living trends in 35 major Chinese cities.

China's Economic Expansion Continues: Selected Key Indicators, 1988-94

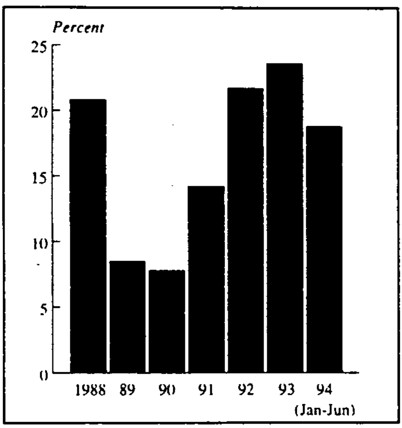
Real GNP Growth



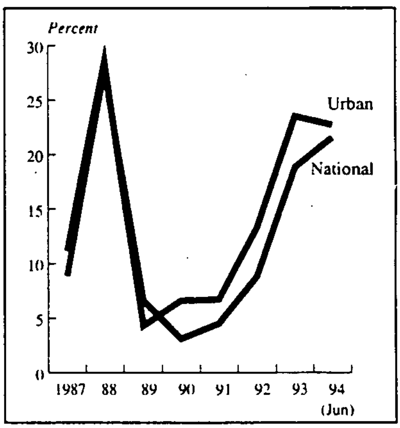
Nominal Growth in Investment in Fixed Assets



Industrial Output Growth[a]



Inflation[b]



[a] Growth in gross value of industrial output (GVIO) calculated using constant prices.

[b] Cost-of-living indexes for December of each year compared to December of the preceeding year. Urban inflation is based on cost of living for workers and staff in 35 large cities.

Source: Offical Chinese statistics.

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Buying Time: Beijing Pumps the Brakes

In a bid to cool overheating, in July 1993 Chinese leaders initiated a program—dubbed the "16 points" in Hong Kong press accounts—that targeted problems in the increasingly chaotic financial sector as a source of economic instability. Under the direction of Vice Premier Zhu Rongji—who also became governor of China's central bank in July-the program ordered state banks to recall unauthorized loans, many of which had been channeled into real estate and other speculative ventures. To slow down growth in the money supply, Zhu also demanded that local authorities quickly finish purchasing their 1993 quotas of government bonds. The regime also forced local officials to shelve plans to build hundreds of new economic zones across the country—designed to attract foreign investment but often requiring considerable infrastructure construction—thereby helping to trim investment and conserve scarce cropland.

Coupled with two hikes in bank interest rates—one in May and one in mid-July—these measures began to show results, as urban year-on-year inflation dropped by nearly 3 percentage points from July's peak to 20.7 percent by September 1993. Investments in fixed assets, which had increased by 61 percent in the first half of 1993 compared with the same period in 1992, dropped by 10.4 percent in August compared with July. The rate of industrial output growth also began to ease—real industrial output value in July was up by 25.1 percent over July 1992, but by September the growth rate had dropped to 16.4 percent

State enterprises and local officials whose construction projects were pinched by credit controls by late summer began to pressure Beijing to ease the anti-inflation drive. Local branches of state banks—which claimed to be recovering tens of billion of yuan in unauthorized loans—were also denying new loans that state enterprises needed to cover their operating expenses, according to Chinese press accounts. Signs of financial distress at these firms—along with other economic and political pressures—forced the regime to ease up on credit controls. State banks increased their loan portfolios substantially in the final quarter of 1993—lending increased by over 110 billion yuan in December alone—pushing total new lending for the year to 484 billion yuan, or roughly 100 billion yuan above 1992's level.[3]

This aggressive bank lending helped to revive state projects and provided funds to purchase crops from farmers, but it also fueled inflationary pressures that pushed urban living costs up again late in 1993 and to even higher levels in the first months of 1994. Food prices, in particular, increased substantially in key urban areas beginning in November—grain prices in some cities jumped by more than 30 percent within the space of a few weeks in December—in part because farmers and traders hoarded grain in expectation of even higher prices in 1 994. Chinese press accounts also blamed some of the price hikes on industrial development that took crop land near major coastal cities out of production and drove up urban prices of fresh vegetables and fruits.

As a result of concern over rising prices, Chinese leaders renewed their efforts in early 1994 to reduce inflation and ensure economic and social stability. At the National People's Congress session in March, for example, Chinese leaders promised to hold annual inflation to 10 percent or less in 1994. They also lowered targets for fixed-asset investment and called for growth in lending from state banks to be held to roughly the same increase registered in 1993, implying a renewed emphasis on limiting the expansion of the money supply.

[3] Because Beijing administratively changed China's official exchange rate from roughly 5.4 yuan to the dollar in December 1993 to 8.7 yuan to the dollar in January, we are not converting Chinese currency into dollar equivalents in this report.

The cornerstone of Beijing's renewed anti-inflation effort was a high-profile campaign to reimpose price ceilings on key consumer items- Central authorities in early March issued a directive instructing local officials to use various administrative means to stabilize prices of 20 daily necessities such as staple foods, some consumer durables and textile products, utilities, and services. Some localities began issuing grain coupons to urban residents, according to a Hong Kong press account, at least temporarily reinstituting a rationing program that had been largely scrapped during the preceding year. The regime launched price inspections to enforce the guidelines and cracked down on tens of thousands of retailers caught selling goods at prices higher than official ceilings. Underscoring the regime's prerogative to reimpose price controls, Vice Premier Zou Jiahua stated in early June that it would be a "total misunderstanding" to assume that the government would allow producers and retailers to freely set prices even after price reforms were in place.

As of mid-1994 Beijing's efforts to deal with the strains of overheated growth with price controls and other administrative measures were producing uneven results. Nominal spending on fixed assets increased 25.2 percent in the first half of 1994 compared with the same period in 1993, higher than Beijing's target rate but less than half the nominal growth in investment posted in the first half of 1993 and down even more sharply when spending is adjusted for inflation. China's trade deficit also eased in the first half of 1994—exports were up 30 percent compared with the same period in 1993, while the growth rate of imports slowed to 21 percent in June, China registered its first monthly trade surplus since late 1992, narrowing the trade deficit in the first six months to only $820 million. Inflation, however, remained stubbornly high—with urban year-on-year living costs up 22.7 percent in June—as the effects of earlier money supply growth and price reforms continued to work through the economy. Industrial production also continued to increase substantially, with real gross output in the first half of 1994 up nearly 19 percent compared with the same period in 1993.

Responding to these uneven results, Beijing cracked down on dozens of newly established futures and commodities markets as a further price control and antispeculation measure. Earlier in the year, the regime had shut down petroleum futures markets by reimposing central control over the distribution and pricing of crude oil and gasoline. Beijing apparently intended to help the state-run oil industry sell domestically produced petroleum products in the face of growing competition from imports, along with combating speculation with this policy. Beijing extended the crackdown on futures trading to other commodities in June. Beijing in May also clamped down on unauthorized sales or transfers of state-owned property, effectively shutting down dozens of newly established local property markets.

Meanwhile, the regime is under pressure from sectors of the economy pinched by the anti-inflation drive to again ease up on credit and investment restraints. Efforts to slow growth are adding to urban unemployment—one recent Chinese press report noted that the rate at which unemployed Chinese find new jobs is down sharply. Chinese press reports also recently indicated that many workers who had given up secure but low-paying jobs in state offices and enterprises to start entrepreneurial ventures-a practice characterized in Chinese press reports in 1992 and 1993 as "swimming in the sea" of the marketplace—are now trying to return to their old jobs. Furthermore, Beijing's efforts to trim investment spending are slowing sales of some industrial products and stockpiles of unsold goods at many state enterprises are rising, according to recent Chinese press reports.

New Reforms Mark Shift in Strategy

Beijing's difficulties in dampening growth without precipitating a painful economic slowdown have helped to bolster demands on the part of many central policymakers for a key revision in the reform strategy. The new reform agenda emerged at a key Central Committee meeting in November 1993 that approved a document touted as a concrete blueprint for realizing Deng's vision of a socialist market economy. Whereas previous reforms frequently stimulated growth by giving local authorities more autonomy, the document called for steps that would recentralize some powers to help Beijing smooth out economic boom-and-bust cycles as well as to enforce financial discipline on local authorities. Specific elements of this approach—such as overhauling the tax system and strengthening the role of the central bank—have been proposed previously but stymied by resistance from local officials.

Aggressive lobbying by Vice Premier Zhu Rongji and other central leaders helped tip the balance, enabling Beijing in January to implement key tax reform measures, replacing the negotiated revenue-sharing deals that had bolstered the fiscal independence of key coastal provinces with a system earmarking specific taxes for central or local coffers. In a compromise to gain local support, central authorities agreed to temporarily transfer funds to offset shortfalls localities may experience under the new system. This offset agreement will gradually be phased out over the next three years, enabling Beijing to eventually collect about 60 percent of total tax revenues—up from about 30 percent—to help boost funding for national infrastructure development.

Beijing's efforts to revamp its banking system—the second major element in the new approach—include two broad initiatives:

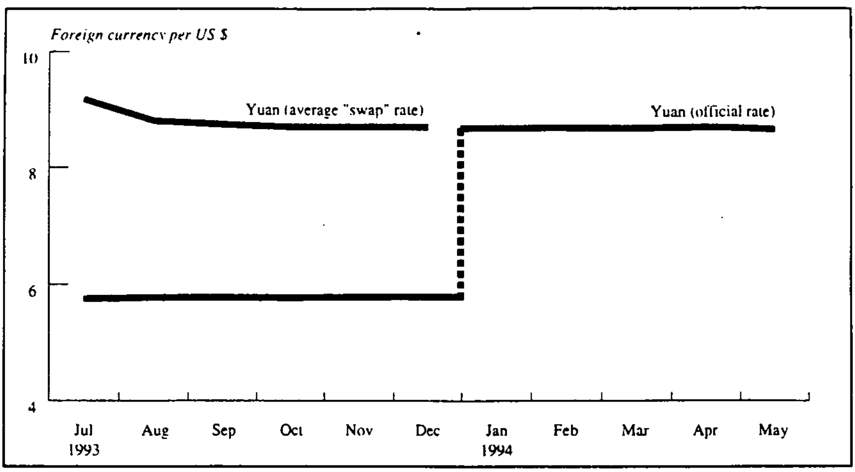
- The leadership plans to strengthen the ability of the central bank to implement monetary policy through indirect levers such as open-market operations and interest rate adjustments rather than through administrative credit rationing. Beijing has already moved to delink the People's Bank of China (PBOC)—the central bank—from the Ministry of Finance, which formerly covered part of the government deficit through bank overdrafts. Instead, Beijing more than doubled the issuance of government bonds in early 1994 compared with 1993 to underwrite the deficit. Shifting to bond financing should also help reduce the inflationary impact of deficits and eventually better establish a national bond market that the central bank can tap to help regulate the money supply.

- The central government is also taking steps to separate policy and commercial lending in a bid to rely more heavily on economic criteria in allocating investment funds. In March and April 1994, Beijing established three new policy lending banks to support major domestic infrastructure projects, agriculture, and foreign trade. Under this policy, Beijing will gradually transform the existing state-owned banks—which have handled much of the regime's policy-directed, low-interest lending—into commercial banks responsible for managing their own portfolios.

Third, the reform agenda calls for restructuring the foreign exchange regime to make China's currency completely convertible within several years. Beijing is under pressure from its major trading partners to move forward on these reforms as part of its GATT accession process. On January 1 China eliminated its dual exchange rate system by unifying its official and foreign exchange center currency rates. In April, Beijing established an interbank market for foreign exchange, creating a new channel for domestic enterprises to obtain hard currency. Progress toward full currency convertibility continues to be slowed by Beijing's efforts to retain control of foreign exchange and to prevent capital flight. For example, new regulations have reinforced Beijing's stipulations that most foreign-invested firms must obtain the foreign exchange they need through exporting.

Fourth, the central government is attempting to form what it calls a "modern enterprise system" by transforming many state-owned enterprises into limited-liability or joint-stock companies with more clearly defined rights and obligations, particularly with regard to the management and disposal of enterprise assets. Central leaders announced they would select 100 large and medium state firms for conversion into joint-stock companies as a focal point for the "modern enterprise system" effort in 1994 and that hundreds of other firms would incorporate elements of the reform such as establishing corporate boards to oversee state property. Beijing has also promulgated a new company law that took effect in July 1994 to help shore up the legal foundation for these reforms. These measures are basically designed to increase the efficiency of state enterprise operations and help make them responsible for losses rather than dependent on such government assistance as low-interest loans and subsidies.

China: Foreign Exchange Rates, 1993-94



Source: Derived from Chinese press reports.

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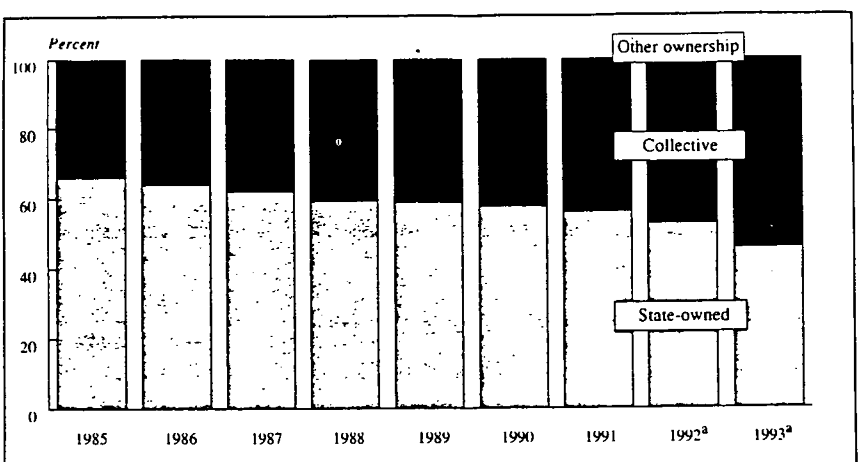
China's Economic Sectors: Gains Marred by Tough Problems

State industries Fall Further Behind. The regime's sporadic attempts to cool the economy and the initial implementation of Beijing's reform agenda created an uncertain environment for virtually every sector of the economy. China's industrial sector was at the forefront of the economic expansion in 1993, registering a 23.6-percent increase in the gross value of industrial output (GVIO) measured in constant prices. As in recent years, performance at non-state firms far outstripped growth at state-owned industries—where GVIO increased by 8.9 percent according to preliminary statistics. In contrast, collectively owned firms—including rapidly growing rural enterprises—boosted their output value by 39.8 percent. Industries of other ownership categories—dominated by over 80,000 foreign-funded enterprises now operating in China—registered a 64.4 percent increase.

Industrial growth continued to be concentrated at factories producing consumer and export goods—where fewer price controls mean greater profits —rather than at basic industries such as energy that require hefty investments. The result was continuing bottlenecks and shortages of key commodities and services. Production of coal—China's primary energy source—increased by only 2.2 percent to reach 1,141 million metric tons, and crude oil production increased by only 1.3 percent to 144 million metric tons. In 1993 China became a net petroleum importer for the first time in decades as domestic demand for gasoline and other petroleum-based products continued to outstrip production gains. Heavy state investment in generating plants boosted electricity production by 8.8 percent to 820 billion kilowatt hours, but Chinese officials still estimated that power output was running up to 20 percent short of demand at prevailing state-set prices. Freight volume on China's already strained railway system increased by only 3.1 percent, substantially below the rate of overall economic growth.

China: Shares of Industrial Output by Ownership, 1985-93



[a] Figures for 1992 and 1993 are estimates calculated using official Chinese industrial growth rate statistics.

Note: Excludes output from individually owned firms and collective firms operated by villages. Other ownership primarily consists of foreign-invested enterprises.

Sources: Derived from official Chinese gross value of industrial output statistics.

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Sluggish progress in improving economic efficiency at state-owned enterprises became starkly apparent when new figures released in April 1994 showed that nearly one-half were running deficits, a jump from roughly one-third in mid-1993. Reforms ironically helped to make some state-sector problems more evident:

- Tighter accounting standards in force since mid-1993, for example, reduced managers ability to hide losses by underreporting depreciation costs, counting loans as revenues, and through other bookkeeping sleight of hand.
- Price reforms in recent years for energy and some raw materials trimmed deficits at key centrally run state enterprises—such as coal mines and oilfields—but drove up costs for many intermediate producers—such as textile plants and other light industrial enterprises.

Beijing's attempts to dampen economic overheating by tightening credit also exacerbated financial problems at some state enterprises. Controls over new bank lending—one of Beijing's few effective tools to force local officials to trim spending—hits the state sector hard because many firms depend on loans for working capital to meet payrolls and to pay suppliers. Indeed, a recent Chinese press report suggests that state firms now provide only about 7 percent of their working capital from retained enterprise profits—down from 25 percent in 1984—and rely primarily on bank loans for the remainder. Restrictive credit controls hurt even economically viable firms in the beginning months of 1994 by adding to interenterprise "triangle debts," as firms were unable to pay suppliers because their own accounts receivable were rising.

In a trend particularly troublesome for regime hopes of maintaining social stability, increasing numbers of cash-strapped firms failed to meet their payrolls or sent workers home on part pay beginning in late 1993. Although a senior Chinese official claimed in May 1994 that only about 10 percent of state-owned firms were experiencing slowdowns, Hong Kong press accounts have cited reports that the figure may be twice as high. By either estimate, millions of state enterprise workers have probably been affected by pay cuts.[4] Although the introduction of new state enterprise pay scales in late 1993 and early 1994 helped incomes of fully employed state enterprise workers keep pace with inflation, workers receiving only partial pay and China's growing population of retirees were particularly hard hit by price increases. Hong Kong press accounts have claimed that labor disputes and the formation of independent trade unions are on the rise in Chinese factories.

Agriculture's Mixed Harvest The record grain harvest in 1993 of 456.4 million metric tons—up by nearly 14 million metric tons compared with 1992—helped boost overall agricultural sector output by 4 percent.[5] The strong harvest, however, was one of the few bright spots in an increasingly troubled sector. Stagnant economic returns from basic agriculture resulted in both peasants and government units marshaling fewer resources in support of farming. Although nominal investment in fertilizer and other agricultural production materials increased in 1993, for example, when adjusted for inflation real investment in these goods dropped by 7.8 percent compared with 1992. Recent Chinese press reports also noted that government spending on farming science and technology declined by one-third and that roughly one-sixth of China's

[4] State enterprises employed more than 95 million workers at the end of 1993, or nearly 70 percent of the total urban work force.

[5] A Chinese official agricultural report issued in May 1994 indicated that the grain harvest may have been somewhat below the initial statistic, although still slightly ahead of 1990's 442 million-metric-ton harvest.

local-level rural technology centers were closed because of budget cuts in 1993.

The effect of these trends was particularly evident in cotton production in 1993 as low state-set prices and inadequate efforts to combat insect damage contributed to a 17-percent drop in output and the smallest cotton crop China has harvested since 1986. Although Beijing tightened state controls over the allocation of cotton from major producing regions in China's far west, cotton supplies in the government's hands declined by more than one-third compared with 1992, according to one Chinese press account Hoarding and profiteering undoubtedly exacerbated distribution problems that sent the price of cotton available through limited market channels soaring. As of early 1994, cotton shortages were idling many state textile mills, adding to the problem of worker layoffs in urban areas.

Rural areas are also experiencing persistent social tensions. Mounting frictions between peasants and local government and party officials over taxes, land-use rights, and corruption have weakened the administrative structure Beijing relies on to ensure crop production and to maintain rural social order. One recent Chinese publication claimed that roughly 100 farmers were killed and 1,000 were injured in various clashes last year, most of which were probably rooted in local clan disputes or in arguments over property rights. Farmers anxious to boost meager incomes have also been blamed for erecting roadblocks and collecting "tolls" along roadways, interfering with China's already strained road transportation system.

Sluggish growth in rural incomes—particularly in comparison with income gains scored in dynamic coastal cities—is an important contributor to rural unrest Although reforms in the early 1980s—such as the breaking up of the commune system—helped boost rural per capita income to over one-half that of urban incomes by mid-decade, the proportion slipped to below 40 percent in 1993. Per capita rural incomes increased by only 3.2 percent in 1993 when adjusted for inflation—compared to over 10 percent income growth in urban areas—and real farming incomes were virtually flat or even fell in some localities if income gains at rural enterprises are deducted. The government increased prices paid to farmers for grain and other commodities in 1993, but these adjustments were barely enough to offset even faster price increases for fertilizer and other agricultural production materials. Meanwhile, the strong grain harvest helped keep free market food prices stable for much of 1993—a benefit for urban consumers but a hardship for producers. Food price hikes at urban markets beginning in November benefited primarily grain traders and other middlemen rather than farmers, according to Chinese press accounts.

The pressure of surplus rural labor is evident in both rural and urban areas. Beijing is promoting the development of village- and township-run industries and household enterprises—particularly in hinterland areas—to create jobs for underemployed farm workers away from increasingly overcrowded cities. But although employment at these rural firms increased by roughly 6 million last year—and is now roughly 110 million strong—this still lagged behind the overall growth in the rural labor pool; Chinese officials conservatively estimate more than 10 million new rural workers are entering the labor force every year, and that over 130 million rural workers are now surplus. Rural-to-urban migration became more pronounced in 1993 as a growing army of unemployed rural laborers left their villages in search of better employment opportunities. These migrant rural laborers—including young women seeking temporary jobs in coastal exporting factories—provide a ready pool of cheap labor, but also can strain urban social services, overwhelm transportation facilities such as railway stations, and contribute to rising urban crime rates.

Mindful of the rising costs and threats to social stability from these problems, central authorities held repeated work conferences devoted to agriculture in 1993 and 1994 and continued to tout the sector as the regime's number-one priority. They pledged to boost real rural incomes by 5 percent in 1994 —nearly double 1993's rate—and took a difficult policy step in early June by boosting grain purchase prices by as much as 40 percent to help ensure a good crop and ease peasant discontent and by passing the price increases on to urban consumers. Beijing has also moved to increase state investment in agriculture and to rebuild the civil administrative system in rural areas. Leaders also urged local officials to use administrative measures to strive for self-sufficiency in grain production, to protect cropland that supplies vegetables and other products to major cities, and to boost acreage devoted to cotton in 1994.

Policy Shifts Buffet China's Financial Sector. Beijing's efforts to cool speculation in real estate and enterprise shares in early 1993 encouraged Chinese investors to seek more secure savings options but also slowed capital market experiments. The regime had a tough time selling state treasury bonds in the face of competition from more attractive investment opportunities, and in March 1993 bank savings deposits registered only the second monthly decline since 1978. Beijing's orders in July 1993 that state banks withdraw unauthorized loans, however, shrank the capital pool that was helping to underwrite the booming real estate market Beijing also cracked down on real estate companies—which had increased from 6,200 in early 1992 to about 20,000 by mid-1993—with tougher regulations. In the spring of 1993, authorities also charged a large shareholding venture with raising nearly a billion yuan through illegal methods such as promising investors returns substantially higher than bank interest rates. The case underscored the risks of capital market experiments when effective regulatory controls are lacking and government policies are still evolving.

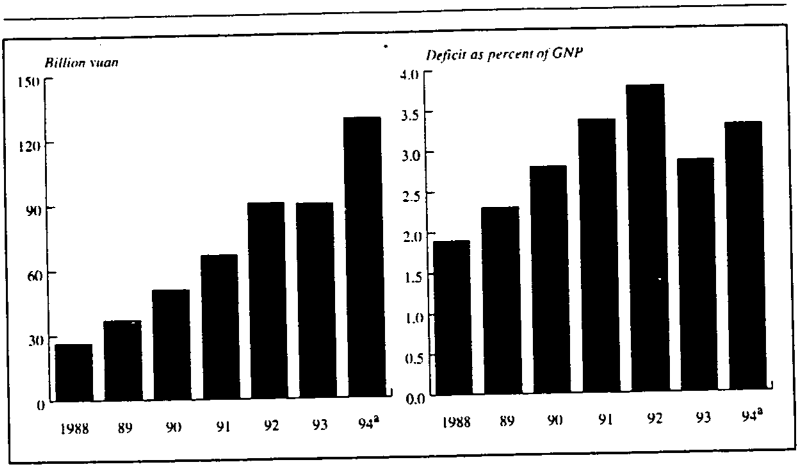
Investor caution in the wake of these developments depressed share prices on China's authorized stock markets. Indexes for domestic shares at the Shanghai and Shenzhen stock markets dropped by roughly 50 percent between late 1993 and the spring of 1994 in stark contrast to the bull market through mid-1993 that had even triggered riots in Shenzhen in August 1992 when investors were denied a chance to purchase new issues. Recognizing that additional stocks would only glut the market, Beijing in mid-1994 shelved plans to issue new state enterprise shares in the second half of the year.

With stock markets falling and many local real estate schemes on hold, Chinese savers appeared willing to accept negative real interest rates offered by bank deposits and government bonds. Savings deposits in Chinese banks began increasing sharply in mid-1993 and ended the year at 2.3 trillion yuan, an increase of 23 percent. In contrast to sluggish bond sales in previous years, financial officials recently reported that Beijing had succeeded in selling the new issue of 100 billion yuan in government bonds by early July.

Beijing's Budget Deficits Set To Climb. Even before Beijing's new tax system came into effect in January 1994, the reforms were affecting the government's budget deficit, which actually declined slightly in 1993. Because central authorities had pledged to make up any revenue shortfalls localities experienced in 1994 compared to their actual 1993 tax receipts, local officials had an incentive to boost their reported tax income in 1993. Some localities went so far as to collect 1994 taxes in advance, according to Chinese financial officials, which helped raise overall government tax revenues by more than 25 percent in 1993. Expenditures also grew but at a slightly lower rate—increasing by about 20 percent compared to 1992—allowing Beijing to post a nominal budget deficit of 89 billion yuan compared with 90 billion yuan in 1992.[6] Because of the rapid growth in the economy, the deficit as a proportion of GNP actually declined from 1992's peak of 3.8 percent to 2.9 percent in 1993.

The deficit relief is likely to be short lived, however, as Beijing's 1994 budget calls for the deficit to increase by 45 percent to 129 billion yuan or roughly 3.3 percent of GNP.[7] The budget projects that total state revenues—including local government taxes—will increase by 7.7 percent Central tax revenues are projected to rise roughly 50 percent over the target set for 1993 as the proportion of taxes earmarked for central coffers increases under the new tax system, but transfers from the central treasury to localities are also up sharply under the new budget, reflecting Beijing's commitment that funding for local governments will not decrease from the 1993 base.

China: State Budget Deficit, 1988-94



[a]Projected.
Source: Derived from Chinese budget and GNP statistics.

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[6] The hard budget deficit includes foreign and domestic borrowing, whereas Beijing's official budget deficit last year—20.5 billion yuan—represents only the unfinanced portion of the government's deficit

[7] Beijing has introduced a new budget accounting system for 1994 that includes a portion of the deficit financed by foreign and domestic borrowing. Beijing's targeted budget deficit for 1994—66.9 billion yuan—is nearly three times 1993's official deficit figure as a result. Under the new system, however, the regime has apparently stopped including spending on some construction projects financed with foreign loans and some debt service costs in the official deficit figures. The 129-billion-yuan deficit projection includes these items. The estimated proportion of GNP for 1994 is based on growth and inflation rates for the first six months.

Total state expenditures, including debt service costs and spending on projects funded through foreign borrowing, are projected to grow by 13.8 percent in 1994. Among specific expenditures, spending on various social services—including health care, education, and pensions—is projected to increase by 17 percent Beijing's 1994 budget also calls for military spending—which had increased by 14.5 percent to 43.2 billion yuan in 1993—to grow another 20 percent to reach 52 billion yuan. Chinese authorities claim part of the increase is the result of inflation and higher salaries for military personnel. China's military has numerous additional sources of income—including earnings from plants and corporations run by military organizations—that together equal and probably exceed budgeted funding support. Together with budgeted funds, these off-budget revenue sources are helping to fund military modernization efforts.

Growth Pressures Evident in Foreign Trade. The problems associated with overheated growth and partial reforms elsewhere in the economy were evident as well in China's trade performance in 1993. China increased its exports in 1993 by 8 percent—down more than half from the growth rate posted in 1992—to $91.8 billion. Imports, however, surged by 29 percent to $104 billion, resulting in a merchandise trade deficit of $12.2 billion, China's first deficit since 1989 and the largest the country has recorded since 1985.

Much of the slowdown in China's export performance in 1993 can be traced to surging domestic demand and domestic price increases that encouraged China's trade corporations—now responsible for their own profits and losses—to shift sales to the domestic market. Chinese trade officials have also cited the cutthroat export pricing practices of Chinese trading corporations vying to capture a share of increasingly tight foreign markets for the lackluster increase in export revenues last year.

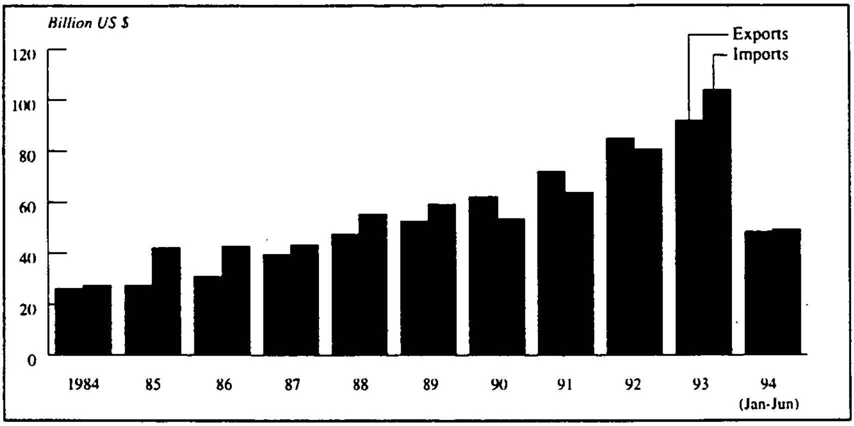
On the import side, the combination of relaxed import controls and the rapid domestic economic expansion—which bolstered demand for imported production materials to make up for domestic production shortfalls—added to the trade deficit. Iron and steel imports, for example, more than tripled in 1993. Dramatic increases were also seen in imports of machinery and electrical equipment, which last year accounted for more than one-third of total Chinese imports; China is now the world's second-largest importer of machine tools after the United States. Looser import controls also sparked increased purchases of such big-ticket consumer goods as automobiles, imports of which expanded at nearly a 52-percent pace.

The continuing boom in foreign investment also contributed to China's trade deficit. Imports by foreign invested enterprises (FIEs) accounted for more than 40 percent of total Chinese imports in 1993 and grew more than twice as fast as imports overall. According to official Chinese statistics, nearly $17 billion of FIE imports last year represented equipment and materials supplied by foreign investors as part of their equity stake in mainland projects. The remaining $25 billion imported by FIEs last year represents materials and semifinished goods that are processed for export—FIEs produced over 27 percent of total Chinese exports in 1993—as well as items imported for use in FIE operations.

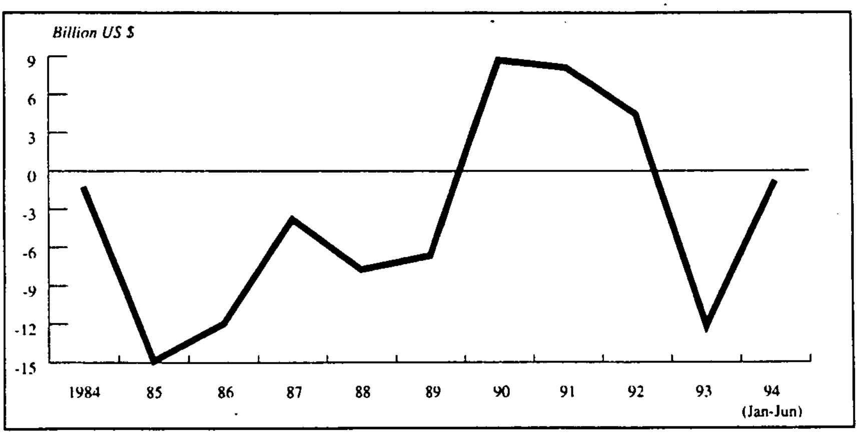
Earlier this year, Beijing began unveiling policies designed to alleviate the trade deficit. In addition to unifying China's dual exchange rated—effectively devaluing the currency and boosting the price competitiveness of some exports —Beijing:

Foreign Trade, 1984-94

Imports and Exports



Trade Balance



Source: Offical Chinese statistics.

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- Promoted the establishment of trade associations and industrial chambers of commerce whose roles include the ability to set minimum prices for key export commodities, minimizing the earnings losses caused by price competition between Chinese exporters.
- Established the China Export-Import Bank in late May to boost funding available for export credits, particularly to support sales of machinery and similar high-value-added goods that Beijing has targeted for export growth.

While Beijing has sought to combat the deficit primarily through an expansion of exports, it has also turned to the limited use of import restrictions. For example, simultaneous with announcement in January 1994 that it was lowering tariffs on automobiles, Beijing reduced quota levels on auto imports. In June, Beijing publicly released an industrial policy document calling for continued protection for the domestic auto industry from imports. In an apparent step away from liberalizing access to the domestic market that China's major trading partners are seeking, the document stipulated that auto imports will be controlled and that automotive joint ventures with foreign producers must meet specific domestic content targets or face higher tariff rates on imported auto components. Chinese officials have also initiated an import tendering system for 171 products they claim are still in the initial stages of development—and thus require continued protection—including textiles, telecommunications gear, and machine tools. Although the net effect of the tendering system differs little from earlier import substitution policies that served to reduce the competition from imported goods, it is, nonetheless, a more transparent system.

Indeed, Beijing is taking care in crafting these measures not to jeopardize its efforts to gain entry to the GATT or to the World Trade Organization that is slated to replace GATT early next year. Chinese officials continue to tout measures taken to increase foreign access to the Chinese market and bring the economy into conformity with GATT standards. The regime, for example, lowered tariffs on nearly 3,000 items at the end of 1993 and eliminated quotas and licenses for over 200 products in June 1994. In some cases, it has removed restrictions faster and on more goods than required under the market access agreement it signed with the United States. Beijing also published a new foreign trade law in May 1994 that has increased the transparency of China's trade regime, although senior trade officials have indicated that China will need several years to establish a comprehensive foreign trade legal system.

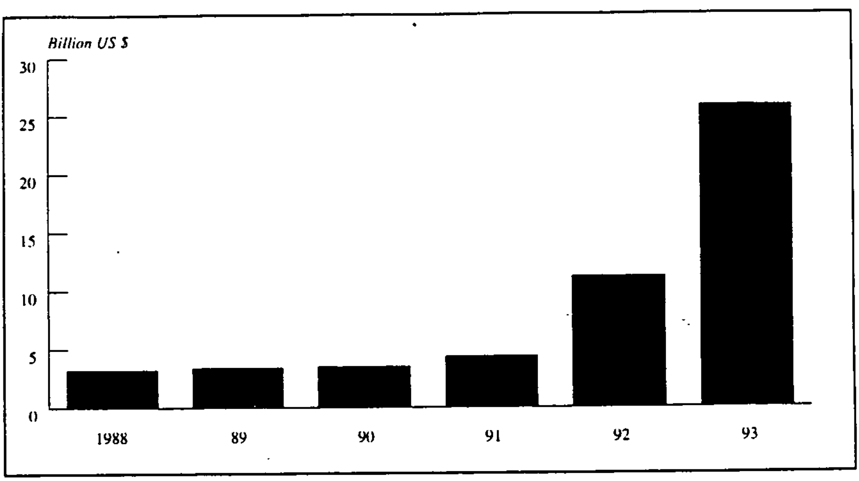
Foreign Investment Surge Continues. Foreign investors anxious to capitalize on China's rapidly expanding economy continued to flood China with investment dollars last year. In 1993, China absorbed $25.8 billion in new direct foreign investment, making China second only to the United States in tapping this source of funds according to Chinese officials. Foreign investment accounted for 13 percent of China's total investment in fixed assets in 1993—up from 8 percent in 1 992—according to Chinese officials. The number of investment contracts approved last year alone—more than 83,000—is roughly equivalent to the total number approved since 1980. Chinese statistics underscore the increasingly large role FIEs are playing in the Chinese economy:

- The output generated by FIEs accounted for 11 percent of total industrial output value in 1993.
- The trade generated by FIEs in 1993 totaled $67 billion, roughly equivalent to China's total only eight years earlier.

- FIEs are China's fastest growing job market outside of rural enterprises and now employ nearly 10 million Chinese workers.

Last year's investment picture was notable not only for the large increase in the number of investment commitments, but also for the willingness of investors to transfer technology and move into higher-value-added production. Most dramatic, perhaps, was the growing stake of *Japanese* investors in mainland projects. Last year, industrial giant Sony announced its first mainland investment project while other leading Japanese companies initiated projects requiring greater technology transfer. Hitachi, for example, signed a contract to produce the control systems for thermonuclear power stations, while NEC joined with a Chinese manufacturer to become the largest manufacturer of integrated circuit boards in China. *Taiwan* manufacturers have also stepped up to more sophisticated investments, in part because Taiwan authorities are easing constraints on cross-straits investments, including allowing Taiwan firms to invest in auto parts manufacturing plants in China and conditionally lifting bans on building and engineering consulting operations on the mainland. *US* investors were also active in 1993; Chinese statistics indicate that US businesses delivered over $2 billion in investment capital last year alone, representing 40 percent of all US investment in China since 1980.

China: Utilized Direct Foreign Investment, 1988-93



Source: Official Chinese statistics.

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Beijing's success in attracting foreign investment funds—and the increased role these projects are now playing in the Chinese economy—has encouraged the leadership to try to influence investment flows. Specifically, authorities are revamping investment policies in an effort to more directly support China's industrial policy goals, a marked change from previous preferential investment policies that focused on regions, rather than on industrial sectors. Targeted areas for investment include the energy, transportation, raw materials, and agricultural sectors. In addition, in an effort to attract more investment by large multinational corporations—which Chinese authorities believe are more likely to transfer technology and produce higher-value-added goods—Beijing has decided to offer these firms greater access to the domestic Chinese market than is available to other foreign investment partners. Chinese authorities are also gradually opening up the country's services market to limited participation by foreign firms. For example, in late June, Beijing announced that foreign firms could begin handling cargo at some Chinese ports and operate some inland and coastal shipping routes.

Beijing's efforts to strengthen its oversight of foreign investment activity, however, does appear to be having a dampening effect on the number of new investment contracts being signed this year. Although preliminary statistics indicate that paid-in investment capital continues to show healthy growth above 1993 levels, statistics released by China's State Administration for industry and Commerce indicate that the number of new approvals during the first three months of 1994 dropped nearly 44 percent when compared to the same period in 1993. Investor concern about the ramifications of ongoing tax and foreign exchange reforms is probably behind the dropoff. In Guangdong Province, however, a distinct difference has emerged between new commitments between the investment activity of US, European, and other firms—which continue to show strong growth—and projects initialed by Hong Kong and Taiwan investors—which Chinese statistics indicate have dropped. Although the exact reasons remain unclear, this suggests Beijing's efforts to discourage low-value-added investments may be taking hold. In particular, tax changes and other policies designed to halt excessive real estate speculation in south China may be behind the slowdown; Chinese statistics indicate that foreign investment absorbed through the transfer of land-use rights currently accounts for roughly 40 percent of foreign capital utilized in Guangdong.

The Elusive Soft Landing

The mixed results from efforts to cool overheated growth—particularly stubbornly high inflation rates—mean that Beijing cannot yet declare victory in its search for a "soft landing" of manageable growth levels. Beijing's efforts to restrain new bank lending—a key element of its anti-inflation drive—will probably face an important test later this year. In addition to demands to selectively relax credit controls to enable state enterprises to meet payrolls and to avoid further layoffs, the grain price hikes Beijing approved in June will add to pressures on state banks to issue more loans to ensure the purchase of fall crops. Even a plan reported in the Hong Kong press to bankrupt several dozen large, deficit-ridden state enterprises in major cities later this year would cost the regime an additional 7 billion yuan to settle enterprise debts and pay compensation to workers who lose their jobs.

Apparently in view of these factors, the central bank in July issued a report stating that banks should try to hold growth in new lending this year to no more than 20 percent above the amount of new loans issued in 1993, according to Chinese press reports, tacitly admitting that China is unlikely to keep credit growth to 1993 levels. Easing anti-inflation efforts in response to domestic pressures for additional credit, however, would further prolong Beijing's search for a soft economic landing. China's current inflation, of course, remains far below the hyperinflation experienced by some other developing and transforming economies. But a failure to reduce inflation could erode public confidence in the regime and set the stage for another boom-and- bust economic cycle.

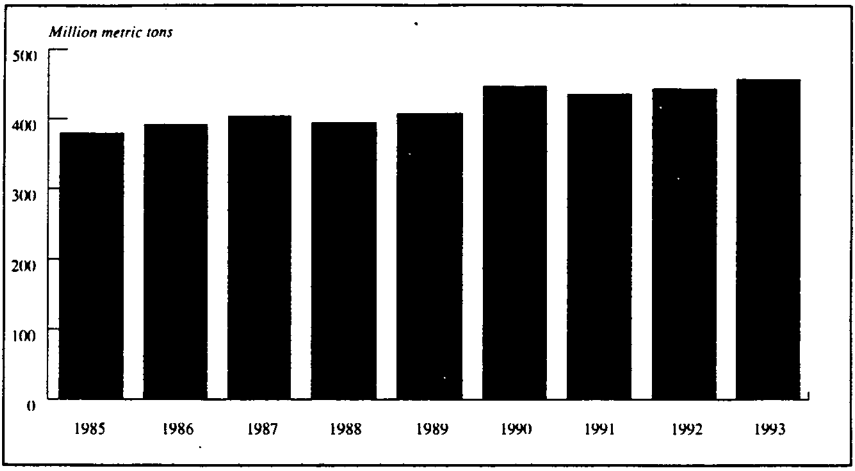
Beijing still appears committed to building economic institutions—including a strengthened central bank and a sounder regulatory framework for emerging financial markets—in a bid to improve its ability to regulate the economy. This commitment is evident, for example, in Beijing's continuing effort to promulgate new economic legislation. Along with the new company and foreign trade laws that have been promulgated recently, Chinese officials are working on new laws to cover emerging securities markets, along with banking, insurance, and other sectors.

In an effort to ease the introduction of key state enterprise reforms, Beijing is also beefing up social welfare services to reduce the hardships faced by state enterprise workers who lose their jobs. Localities, for example, are speeding up the introduction of unemployment insurance and old-age pension systems. The regime is also working to establish health care insurance systems and to commercialize housing so that workers—who now depend on their employers to provide these benefits at little or no cost—will be able to obtain housing and other needs independently. By reducing the trauma of job loss, these reforms should enable the regime to cut the bloated state enterprise work force and proceed with bankrupting state firms that have little hope of recovery.

Once a sounder regulatory framework and a more comprehensive social safety net are in place, it is probable that some central leaders would support additional, gradual experiments with financial markets and state enterprise reforms. Indeed, senior Chinese leaders have recently signaled their intention to step up the pace of state enterprise bankruptcies next year. The reform process, however, will not be easy or fast. Many local leaders, for example, probably worry that Beijing will use enhanced powers gained from taxation and other centralizing reforms to enforce developmental priorities that do not fit with local interests. Local resistance will probably result in further slippage in Beijing's reform timetable.

Chinese officials widely recognize, however, that long-term national stability depends on continued growth to generate new jobs and to help spread reform benefits from dynamic coastal urban centers to inland areas where development has lagged behind. Further expansion of market forces within the economy—including the formation of capital markets to better allocate investment resources and property markets that will boost the economic returns from state assets—is probably essential to sustained long-term growth. Beijing's challenge is to construct a sounder institutional and regulatory framework to support these markets without stifling them. The payoffs of a successful centralizing reform effort—if combined with a renewed commitment to the role of markets in the economy—could include smoother economic development, less opportunity for corruption, and improved ability by Beijing to transfer coastal resources to boost hinterland areas, ultimately benefiting the entire country.

China: Grain Harvest, 1985-93



Source: Official Chinese statistics.

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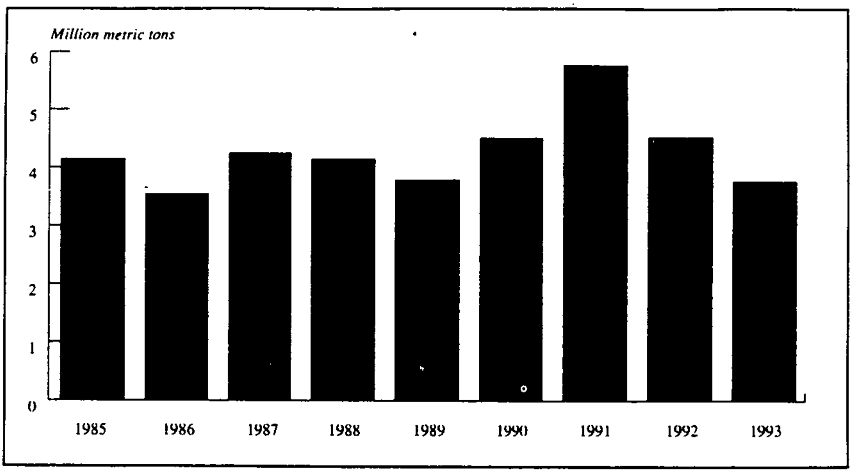
China: Cotton Production, 1985-93



Source: Official Chinese statistics.

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Appendix A

A Chronology of Economic and Political Developments, January 1993-June 1994

January 1993

Deng Xiaoping calls for faster reforms during a visit to Shanghai.

March 1993

The Eighth National People's Congress—held March 15-31—revises the state constitution to endorse Deng Xiaoping's reform ideas.

April 1993

The State Council issues a circular banning the issuance of high-interest-rate bonds by local officials to raise funds.

May 1993

State banks raise interest rates on savings deposits and loans effective May 15.

Beijing promulgates interim regulations on issuing and trading enterprise stocks.

July 1993

Vice Premier Zhu Rongji is appointed Governor of the People's Bank of China.

Zhu Rongji describes specific steps to restore financial order—the 16 points—at the National Financial Work Conference.

New accounting rules for state-owned enterprises take effect.

State banks raise interest rates on bank deposits and loans effective July 11.

Electricity prices for many consumers increase by between 18 and 38 percent, in part to help fund construction of the Three Gorges dam project.

November 1993

The Third Plenum of the Communist Party's 14th Central Committee convenes November 11-14 and approves a document outlining specific steps to form a socialist market economy in China.

December 1993

Beijing announces tariff reductions on 2,898 items effective December 31.

Chinese authorities convene a series of economic conferences, including a National Economic Work Conference, a National Planning Conference, a conference of bank managers, and a foreign trade conference, in part to develop specific plans to implement the reform document approved in November.

January 1994

Beijing unifies the official and swap center exchange rates.

Chinese authorities begin implementation of the new tax system.

March 1994

Leadership speeches at the March 10-22 National People's Congress emphasize stability.

Beijing establishes the China Development Bank and the Agricultural investment Bank to consolidate domestic policy-directed lending.

April 1994

Beijing establishes the China Export-Import Bank to provide foreign trade financing.

June 1994

Beijing releases "Outline of Industrial Policy for the Nineties" and an accompanying industrial-policy document for the automobile industry.

Appendix B

China's Bilateral Trading Relationships

In 1993, high growth in China's domestic economy spurred rapid increases in trade with most of Beijing's key trading partners, while an increased desire to improve the quality of its own production-as well as the lowering of import barriers—pushed up China's demand for imported medium- and high-technology products. At the same time, increased foreign investment helped China's trade partners boost sales across a broad range of goods, including not only the raw materials and components used in existing manufacturing operations in China, but also the machinery and equipment used to outfit new projects. In addition, Beijing's increased consideration of political factors in awarding contracts helped some countries boost exports of big-ticket items in 1993. The impact of closer economic links to its trading partners was evident as well in China's export performance—past foreign investment in medium-technology sectors came on fine, boosting China's competitiveness in a wider range of products.

The US Deficit Continues To Expand

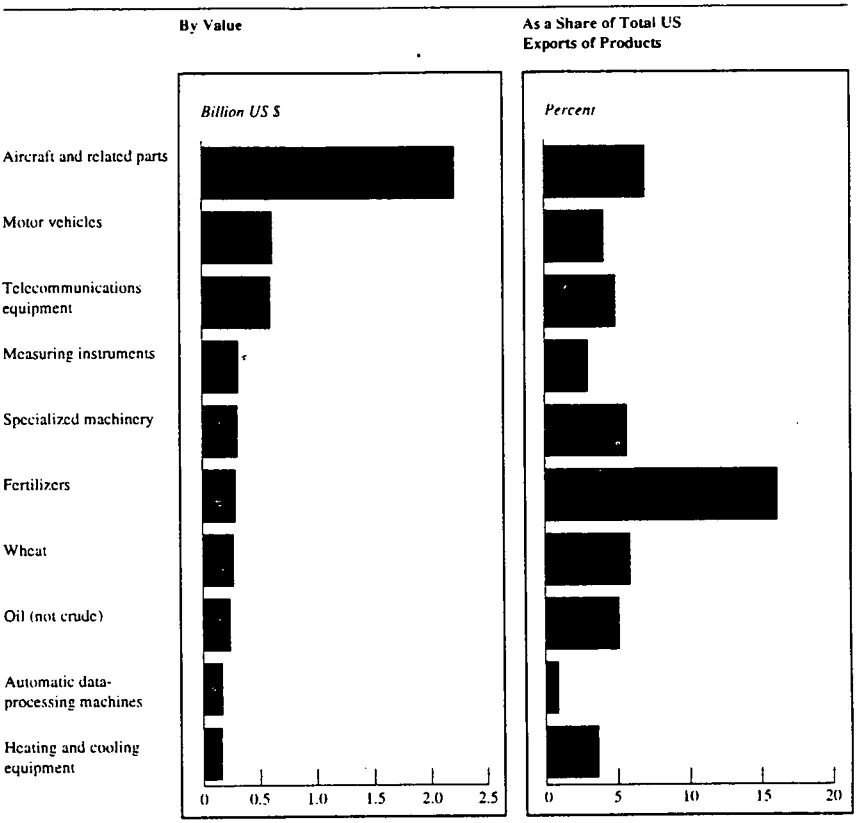
While Chinese statistics indicate the country's global trade balance moved into deficit in 1993, its surplus with the United States increased by 25 percent to reach a new high of $22.8 billion, according to US statistics.[8] Chinese exports to the United States increased by more than 22 percent to $31.5 billion. Chinese producers continued to increase their share of the US market—a key factor in the growth of the US deficit with China—and sustained their success in traditional export sectors—low-cost, labor-intensive goods. For example, gains in footwear exports to the United States—which reached a value of $4.5 billion and outpaced the growth of China's footwear sales to the world—pushed China's share of the total US market for imported footwear from about 30 percent in 1992 to 40 percent in 1993. Meanwhile, China's share of the US import market for toys, games, and various types of clothing held steady or registered modest gains.

China is also gaining ground in medium-technology sectors. Reflecting its growing competitiveness in consumer electronics products, for example, China exported nearly $1 billion worth of telecommunications equipment—probably concentrated in such product lines as telephone units and receivers—to the United States in 1993, which accounted for 6.5 percent of the total US import market for these goods.

US producers benefited last year both from the partial lowering of Chinese import barriers and from Beijing's efforts to sign highly publicized contracts with US businesses to win support for policies favoring China's interests. A Chinese trade delegation, for example, signed $800 million in contracts for aircraft and $160 million for autos from US producers in April of 1993. These purchases helped increase US sales to China by 17 percent in 1993 to a record $8.8 billion-outpacing the 3.9-percent increase in US sales to the world. US producers exported $2.2 billion worth of aircraft and related parts to China in 1993, representing the single largest category of US exports and accounting for

[8] Chinese statistics recorded a surplus with the United States totaling $6.3 billion in 1993. US and Chinese statistical experts are presently engaged in an in-depth reconciliation exercise to determine the sources of the discrepancy between US and Chinese statistics on bilateral trade. Most of the differences between the two data sets are caused by valuation differences and trade through Hong Kong and other countries. As these factors also affect China's trade with other countries, all statistics are derived from data provided by China's trading partners rather than from Chinese data unless otherwise noted.

China: Top Ten Imports From the United States, 1993



Source: US Department of Commerce statistics.

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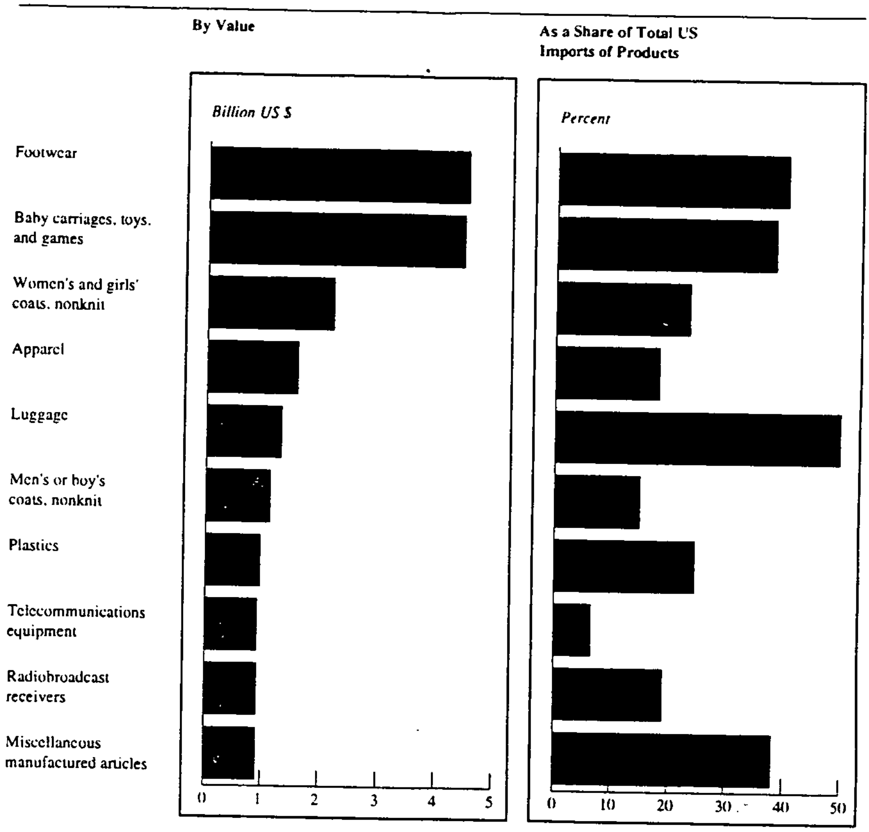
China: Top Ten Exports to the United States, 1993



Source: US Department of Commerce statistics.

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7 percent of US global exports of these items. US motor vehicle exports to China in 1993 increased by more than four times to reach $616 million; at the same time, US sales of these goods to the rest of the world were virtually stagnant.

For the second straight year, however, US producers saw their sales decline in many product lines, probably partly as a result of stiffer price competition from other suppliers. For example, US sales of finished articles of iron and steel—especially tubes and pipes—fell sharply last year—with the US share of Chinese imports of these goods falling from 10 percent to 4 percent During the same period, Italy, the United Kingdom, and Japan all saw their market shares of these finished articles increase.

US exports of capital goods to China increased last year, but the US share of China's import market still shrank. US exports of unfinished iron and steel—dominated by scrap metal—for example, grew over 40 percent but were unable to keep pace with China's global imports of iron and steel, which grew over 220 percent Similarly, although boilers, machinery, and mechanical appliance exports to China from the United States increased 30 percent, the United States still lost ground to West European and Japanese suppliers.

Trends for the first five months of 1994 suggest the US deficit with China will continue to grow. US exports to China through May were up by more than 12 percent compared to the same period in 1 993. US imports from China, however, grew 20 percent during the same period. If current trends continue, the US deficit with China will reach a new record level of $28 billion by year's end.

Japan's Economic Relationship With China Accelerates

As a result of intensified trade links to Japan, China became Japan's second-largest trading partner in 1993—up from fifth place in 1992. The trade expansion was driven largely by increased sales of Japanese goods to China last year. The increase in Chinese imports of Japanese goods surpassed even China's strong global import growth, surging nearly 45 percent to $17.3 billion in 1993. Although Japanese statistics indicate growth in exports to China helped reduce the bilateral deficit to $3.3 billion—down from a $5 billion shortfall in 1992—China's 21-percent increase in sales to the Japanese market helped keep the balance in Beijing's favor.

The rapid growth of China's domestic economy—especially last year's construction boom—stimulated Japanese sales to China in 1993. Japanese steel mills, for example, benefited from semiannual negotiations with the Chinese which paved the way for Japanese exports of steel and iron to more than double last year as Chinese demand soared.

Increased Japanese investment in China also played a part in expanded Japanese sales to the mainland. Last year, Japanese investment in China grew almost 60 percent, although China absorbed less than 5 percent of total Japanese overseas investment. New projects in China probably helped boost Japanese sales of boilers, machinery, and mechanical appliances more than 60 percent, allowing Japanese producers to pick up some market share ceded by the United States.

The foreign aid relationship Tokyo has with Beijing also continues to support Japanese sales to China. Indeed, China was the second-largest recipient of aid and accounted for 12 percent of Japan's total aid budget in 1992. Although these credits are now officially untied, Japanese firms usually perform the feasibility studies for the credits, giving Japan an advantage in the bidding process.

Chinese sales to Japan are showing the strongest growth in medium-technology fields, perhaps as a result of increased Japanese investment in these sectors for re-export back home. Chinese exports to Japan of boilers, machinery, and mechanical appliances nearly doubled last year, while sales of electrical machinery and equipment grew roughly 60 percent; both grew at nearly double the rate of sales to the United States for these products, but Japanese imports were starting from a much smaller base.

European Union Trade Results Uneven

Germany saw large gains in its sales to China last year, with exports rising more than 65 percent Germany chalked up big gains in exports of nonrailway vehicles and electrical machinery and equipment—both of which nearly doubled—and boilers, machinery, and mechanical appliances—up more than 70 percent. Some German exporters were probably helped by Bonn's decision in 1993 to cancel the sale of submarines to Taiwan, which spurred Beijing to increase contracts awarded to German firms. Overall success in the Chinese market reduced Germany's bilateral deficit from about $3.5 billion in 1992 to only $16 million in 1993.

French sales grew 15 percent in 1993, but France was the only country of China's top four trading partners in the European Union (EU)—France, Germany, Italy, and the United Kingdom—to suffer a loss in market share. Although France saw large gains in aircraft sales—an increase of more than 260 percent from 1992 as a result of contracts China signed with Airbus—French exports of organic chemicals, articles of iron and steel, electrical machinery and equipment, and measuring and surgical instruments all dropped by more than 20 percent. French producers may still be paying a cost for Paris's decision in late 1992 to sell fighter aircraft to Taiwan; estimates of losses by French officials and business leaders stemming from that decision—which drew considerable fire from Beijing—range from $500 million to $1 billion.

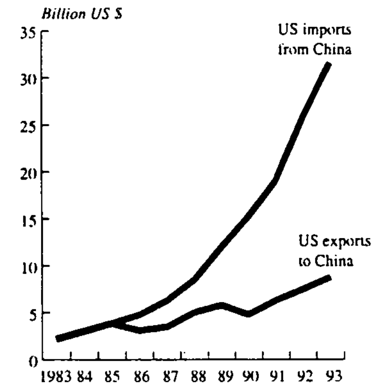
Sales by the *United Kingdom* and *Italy* to China grew more than 65 percent, but they started from much smaller bases. Exporters in both countries gained market share in articles of iron and steel; boilers, machinery, and mechanical appliances; and electrical machinery and equipment, as sales of these products to China grew between 50 and 200 percent last year.

China's sales to the EU, in contrast, fell by 4 percent last year. Exports to Germany alone fell nearly 20 percent, and Beijing lost market share in France as well. Sales of traditional export products such as apparel, footwear, and toys and games to both France and Italy declined or were stagnant. Some relief came in the form of increased sales of medium-technology goods—exports of boilers, machinery, and mechanical appliances and measuring and surgical instruments to the United Kingdom, Italy, and France grew between 15 and 35 percent—but these gains were not enough to halt the overall slide in Chinese exports to the EU market.

The success of key EU exporters and China's losses in the EU's import market allowed the EU to decrease its trade deficit with China by about half last year. Nevertheless, the EU remains concerned about the potential for a rapid influx of Chinese products—particularly labor-intensive goods—into the European market. When the EU acted to consolidate its import quota regime in March 1994, it abolished 4,700 restrictions on products from those countries whose trade is dominated by state-run companies. The consolidation, however, left quotas on seven categories of Chinese goods and placed 27 Chinese products under EU surveillance—a monitoring process that would allow the EU to impose quotas rapidly if imports from China surged. The goods targeted by the EU—such as footwear, silk, and toys—account for about one-third of Chinese exports to the EU, according to UN trade data.

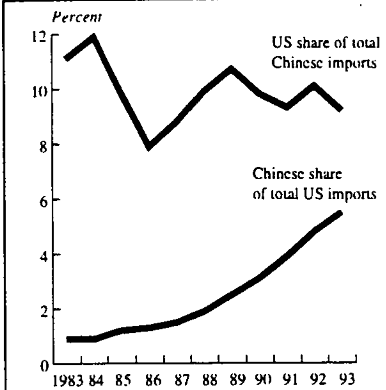
The Structure of Sino-US Trade

The US trade deficit with China...



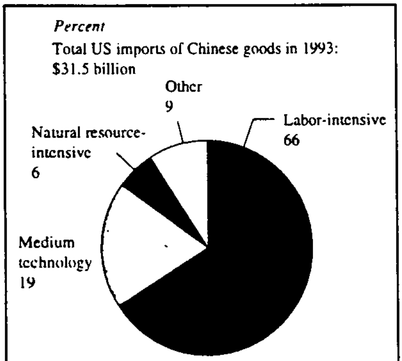
Source: US Department of Commerce statistics.

...is largely attributable to Chinese gains in the US market.



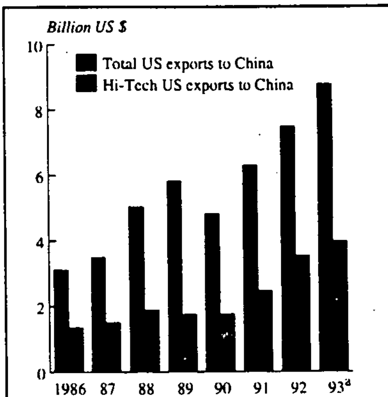
Source: US Department of Commerce and official Chinese statistics.

US imports of Chinese labor-intensive goods...



Source: UN trade data.

...complement US high-technology exports to China.



Source: UN trade data.

[a]Estimate.

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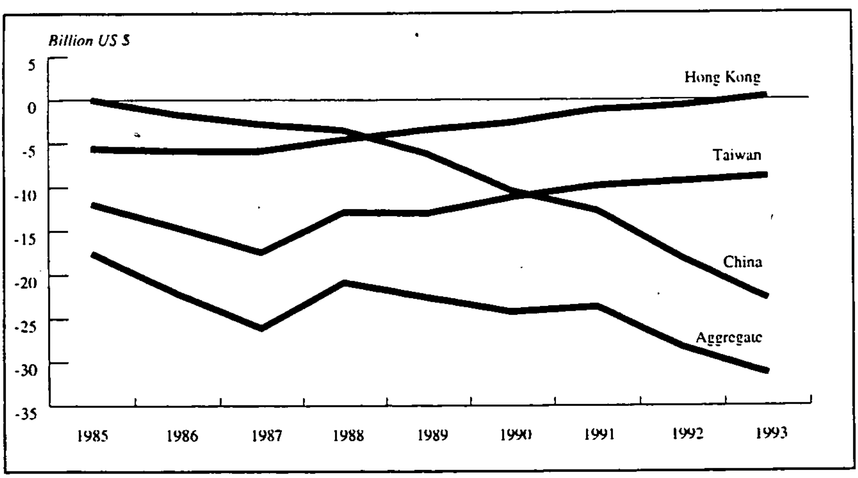
Other Key Trading Partners

Asian firms are also boosting trade with China as a result of their increased investment in China. China, for example, has become the largest recipient of *South Korean* overseas investment, accounting for nearly 60 percent of Korea's foreign outlays in 1993. These growing business ties helped Korean sales increase nearly 85 percent last year—to $4.9 billion—expanding Korea's share of Chinese imports of raw materials and inputs. Rawhide sales from Korea, for example, almost doubled, allowing Korean producers to boost their market share in this sector to nearly 20 percent

Growing Chinese domestic demand boosted Korean exports of transportation equipment last year. In September, China became the largest market for South Korean cars, overtaking the United States, and Korea's share of China's imports of nonrailway vehicles jumped from less than 1 percent to almost 12 percent Korean sales of ships and boats grew more than 400 percent, almost tripling Seoul's share of the market to more than 12 percent Chinese sales to Korea, on the other hand, fell last year—whereas China had scored a $1 billion trade surplus with South Korea in 1992, it ran a $1.7 billion deficit in 1993.

Hong Kong saw only modest growth—roughly 2 percent-in overall domestic sales to China but had large gains in some higher technology areas, probably reflecting shifting investment patterns. As Beijing seeks to direct investment into areas that will transfer technology and as wages in the coastal provinces rise—squeezing profit margins on labor-intensive goods—Hong Kong investors interested in low-cost, export-processing ventures are beginning to look elsewhere. Hong Kong exports to China of yarn and fabrics, for example, fell nearly 9 percent in 1993, indicating both a shift of Hong Kong investment to other sectors as well as increased competition from other suppliers. Sales to China of telecommunications and sound recording equipment, on the other hand, grew almost 15 percent; exports of electrical machinery increased nearly 9 percent, and sales of specialized machinery were up more than 11 percent.

US Trade Balance With China, Hong Kong, and Taiwan, 1985-93



Source: US Department of Commerce.

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Hong Kong trade statistics indicate *Taiwan* fared much better, boosting indirect exports to China by 20 percent in 1993 to $7.6 billion. Taiwan's Board of Foreign Trade, however, estimates Taiwan sales—including illegal direct shipments to the mainland—were still higher, closer to $12.7 billion. The island's sales to China continue to be concentrated in inputs for Taiwan factories on the mainland. Exports of electrical machinery, for example, grew nearly 40 percent and plastics in primary forms increased 25 percent Taiwan imports from China, on the other hand—largely raw materials sensitive to price competition from other suppliers—remained roughly $1.1 billion for the third year in a row.

Trade with *Russia* grew 30 percent last year, according to Chinese statistics. China's sales were outpaced more than 2-to-1 by its imports—doubling its deficit with Russia to $2.3 billion. Indeed, Chinese exports of textiles and apparel—China's largest category of exports to Russia-and footwear both fell last year. Raw material sales from China, on the other hand, showed healthy increases; metals and metal products in the aggregate soared 260 percent. Russian sales to China are dominated by iron and steel; boilers, machinery, and mechanical appliances; nonrailway vehicles; and aircraft These four categories alone account for more than three-quarters of Russian exports to China. Of these, only aircraft suffered a loss in sales last year; iron and steel exports nearly quadrupled.

Appendix C

Enterprise Ownership Reforms and the "Modern Enterprise System"

Under the rubric of erecting a "modern enterprise system," Beijing is pressing ahead with plans to restructure at least some state-owned enterprises into legal entities modeled on Western-style corporations. The new company law that became effective on July 1, 1994, provides terms under which Chinese firms can establish themselves as limited-liability companies or joint stock limited-liability companies. The "limited liability" designator indicates that investors in these firms cannot be held liable for company debts in excess of the amount of their investment.

Sorting Out Ownership of State Assets

The initiative broadly aims to legally define state enterprise rights and obligations, particularly with regard to the management and disposal of enterprise assets. Once state enterprise assets have been appraised and ownership rights established under this initiative, some firms will be able to issue shares to help clarify ownership among specific entities with claims on enterprise assets—including government units and other enterprises—and individual investors:

- Under terms of the law and other relevant Chinese regulations, limited-liability companies that meet specific requirements can distribute shares among units that have claims on the firm's assets, but company shares cannot be traded publicly.
- Joint-stock limited-liability companies can, with the approval of government agencies, issue shares for public trading.

Proponents hope the reforms will help clarify the status of enterprises as legal entities independent of bureaucratic interference and will also help sort out claims on assets in cases of bankruptcy. Senior Chinese economists have stated that the objective of the "modern enterprise system" is to enable state-sector firms to compete without government meddling or support. This would help encourage efficiency among promising state firms while eliminating through bankruptcies or buyouts those that cannot hold their own in the marketplace. Chinese authorities also expect that, by shoring up the sector's legal foundations, the company law and other reforms will encourage foreign and domestic investors to acquire equity shares in state firms, thereby injecting new capital to help upgrade enterprise technology.

As a focus of this initiative, the central government will soon identify 100 large state firms for conversion into limited-liability companies. The majority of shares in these firms will almost certainly remain under state control to ensure state ownership of the firms. Among the key issues confronting this initiative is determining which state agency should represent these ownership shares. The regime is also likely to use the 100 firms to experiment with different mechanisms—such as oversight boards—to allow the state to exercise control over state assets without stifling management independence. Other smaller state firms will also adopt limited liability status, but the company format will not necessarily extend to all state enterprises according to recent Chinese press reports.

Shareholding Already Widespread

The new company law and other ownership reforms, in fact, provide a sounder regulatory footing for shareholding initiatives already under way and expanding rapidly. Chinese press reports claim that nearly 3,000 joint-stock limited-liability companies were established in 1993, along with over 6,000 joint-stock firms, bringing the total number of joint-stock enterprises to roughly 13,000 by year's end. The total capital worth of these firms exceeds 200 billion yuan, divided among some 25 million shareholders. These firms apparently are primarily state owned—if rural collective firms are included, the number of shareholding firms runs into the millions, according to Chinese press reports.

Some state enterprise shareholding firms are well documented. By the end of 1993, nearly 200 Chinese state enterprises had listed shares on China's two major domestic stock exchanges. In addition, eight state enterprises had listed shares directly on the Hong Kong stock exchange, a process that generally required firms to separate the social services large state enterprises commonly provide to their workers—such as operating schools and medical facilities—from their commercial operations. Several dozen state enterprises have Beijing's approval to list on overseas stock exchanges within the next year.

Information is sparse on thousands of other joint-stock firms. A substantial portion are probably firms that have issued shares to workers that cannot be legally traded outside of the enterprise. Other new joint-stock enterprises may be entrepreneurial ventures that, in fact, have little capital or business prospects—what Chinese commentators sometimes call "briefcase companies"—or government units that have established themselves as companies. The new company law may enforce tighter standards on these firms and, by weeding out briefcase companies, enable the regime to get a better handle on the extent of share ownership in China.

Reforms—A Step Toward Privatization?

Although skirting the term "privatization," various localities—anxious to rid themselves of the burden of supporting deficit-ridden enterprises and heartened at the prospect of liquidating state assets—claimed in early 1994 that they were prepared to sell off a large portion of their locally supervised state-owned enterprises to foreign or domestic investors. Coupled with reforms beginning in the late 1980s that allowed localities to lease land to foreign and domestic investors for up to 70 years, enterprise shareholding and property ownership reforms have raised the specter of wide-scale liquidation of state-owned assets.

This process could boost efficiency by transferring operational control of these assets to investors who will work to maximize their economic returns, but the liquidation of state assets also entails thorny problems for the regime. Central leaders are concerned, for example, that local officials are pocketing the proceeds from selling state property or, at a minimum, are failing to split earnings with state banks and central government organizations that have a claim on the assets. One Chinese press account estimated that unauthorized or poorly regulated deals involving the sale of state property had already cost the regime some 30 billion yuan since the early 1980s.

Beijing's preoccupation with social stability is also a key factor tempering the pace of reforms designed to expose state firms to the survival-of-the-fittest environment of the marketplace. The regime's reluctance to cut surplus workers from state payrolls until an effective social safety net of unemployment benefits and other welfare assistance is in place remains a major stumbling block to many efficiency-enhancing reforms, including selling stakes in state firms or forcing state firms into bankruptcy. Although Chinese press accounts claim that nearly 100 state firms have gone bankrupt in recent years, almost all cases involve relatively small enterprises. Hong Kong press accounts claim central authorities hope to begin bankrupting a few large state firms in each of China's major cities as an example of the risks of continued losses to other firms, but the pace of bankruptcies will undoubtedly be moderated by popular reaction to unemployment and the costs of writing off unrecoverable enterprise debts.

In response to these concerns, Beijing tightened controls in May 1994 by forbidding the unauthorized sale of state property and demanding stricter appraisals by the regime's state asset watchdog agency—the National Administration of State-Owned Property—effectively shutting down dozens of newly established local markets dealing in state property. Central Chinese press accounts have also explicitly denied that enterprise company reforms are intended to privatize the state sector. Local officials and state enterprise managers are, nevertheless, anxious to reap the benefits of enterprise ownership reforms and will undoubtedly continue to press for further leeway in handling and liquidating state assets.

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