Paper presented at the Conference on the Impact of the Underground Economy, Fraser Institute, 21-22 April 1994, Vancouver, Canada.

# REFORM AND CHINA'S UNDERGROUND ECONOMY

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## Progress of Economic Reform

Between 1978 and 1993, China liberalized its economy incrementally and achieved extraordinarily rapid output growth. Real GNP expanded at an average annual rate of 9.5%.[1] The reforms started in agriculture with the replacement of the communes by a system of household farming with land leased from the state. Between 1979 and 1983, with over three quarters of the population still in agriculture, farm output surged by 8-10% per year.[2] The commune system was not consciously dismantled as a matter of policy or design. The process started when local leaders in Sichuan province decided to experiment with the household responsibility system without official approval from the central authorities. The experiment turned out to be a great economic success and was rapidly emulated throughout the country. Within a year the commune system had collapsed and the agricultural sector became semi-privatised. The reforms were legitimized by the central authorities in ex post fashion.

By 1984, the engine of rapid economic growth had shifted to rural light industry, which began to absorb much of the labour force released by productivity gains in agriculture. Small scale private traders flourished alongside numerous new manufacturing enterprises owned largely by townships and villages. These became the backbone of the new market driven non-state sector. Most of the enterprises in the non-state sector are collectively owned and operated by local governments. These enterprises operate outside the system of official price, output, and financial controls that were still applicable to the state owned enterprises. Industrial output produced by the non-state sector rose from 26.65% of total output in 1983 to 51.91% in 1992. The central government provided little support to the non-state sector. In fact the state banking system has been very reluctant in extending bank credit to the non-state sector. Total loans extended to the non-state sector by the state banks as a percentage of total outstanding state bank loans remained around 12-14% between 1983 and 1992. Most of the growth of the non-state enterprises had relied on self-financing.

Foreign trade was liberalized gradually by setting up special economic zones that were somewhat outside the control of the traditional state trading monopolies. The first and most

[1] All figures quoted in this paper are derived from various issues of the **China Statistical Yearbook**.

[2] See Johnson, D.G. (1990) **The People's Republic of China: 1978-1990**, ICS Press, San Francisco.

important ones were in the Pearl River Delta area in connection with the Hong Kong trade.[3] These then became progressively more numerous and broader in scope. In time an export (and import) boom had become China's new engine of economic growth. Exports as a share of GNP rose from 5.31% in 1979 to 18.76% in 1993. Over time the distinction between special economic zones and the rest of the economy was blurred. A wide range of state owned enterprises, township and village enterprises, and private enterprises were able to have more or less equal access to foreign trade and to foreign exchange through the swap centres, where enterprises could buy and sell foreign exchange to finance transactions not included in the state plan. Until the establishment of a unified foreign exchange market in April 1993, the volume of foreign exchange transactions in the swap centres was reported to be almost 80% of the total transactions in China. The official exchange rate depreciated significantly from RMB 2.5 yuan to US$1 in 1979 to RMB 8.7 yuan to US$1 in 1993. The depreciation reflected a gradual move towards market levels from an initial position of overvaluation. The process of foreign trade and foreign exchange liberalization was again incremental, responding to the most urgent needs of enterprises as they arose.

**Incrementalism and the Underground Economy**

The Chinese economic reforms were aimed at promoting economic growth and revitalizing economic performance. The Chinese leadership recognized that their political legitimacy depended on delivering a better standard of living. But within the leadership disagreements over the ultimate goals of economic reform and strategies to achieve those goals continue to rage. It was not until 1993 that the goal of creating a socialist market economy was formally adopted by the government. Even then the socialist rider was apparently retained because of the lack of consensus on goals and strategies.

The Chinese economy was on a dual track system, where the traditional system co-existed with the new. This dualism reflects the lack of consensus within the leadership. The debates over price reforms, foreign exchange reforms, enterprise reforms, and the piecemeal nature of the reforms mirrored the on-going conflicts within the leadership. The market expanded by diverting resources away from the state sector. It was a process of growing out of the state plan. The Chinese economic reforms did not strip away the rents captured by major interest groups, but merely altered the way in which those rents can be secured. This evolutionary approach explains why reform has been incremental. One can discern a pattern of starting with the easy tasks and gradually progressing to more difficult tasks. This was not, however, a conscious strategy as is sometimes implied by those who claim that the Chinese reform strategy is gradualist. A more appropriate way of characterizing the process of economic reforms in China is as a sequence of breakthroughs in the traditional system at points that offered the least political resistance from the establishment.

The massive shift of resources from the state sector to the non-state sector in agriculture and industry and the growing importance of foreign trade created a vibrant economy with more or less rational prices that started to reflect economic scarcity. At the beginning of the reform almost all prices were controlled, today less than 5% of the prices are still controlled.

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[3] See Sung, Y.W., P.W. Liu, Y.C.R. Wong, and P.K. Lau (1994) **The Fifth Dragon: Emergence of the Pearl River Delta**, Addison Wesley Publishers.

These impressive achievements notwithstanding, China remains a semi-reformed economy. The state owned enterprises continue to produce almost half the industrial output. One third of the state owned enterprises are suffering losses that have to be covered by the state. Another third of these enterprises are sustained by state banks through low interest rate loans. The state owned enterprises have become a major fiscal burden. Reforming the state sector is the most difficult task that China has to complete before its economy can become truly efficient. Over time there is a growing recognition within China that it is not sufficient to undertake reforms without fundamentally changing the system. The endorsement of a socialist market economy represents a significant step towards recognising this point, although it stops short of making a clean break to embrace a market economy without "ifs" and "buts".

It is clear that local governments have been the most innovative force in experimenting with new reform measures and policy initiatives. Perhaps the further one is away from the political centre the weaker is the political resistance to reforms. The success of local initiatives were subsequently supported by the central government and therefore gained political legitimacy. The role of the central government in legitimizing local initiatives is significant because it enhances the chance that the reform measures would survive a change of local leadership. The policy environment in China during the reform period was a peculiar one. The central bureaucracy, often identified with the interest of the state sector, was naturally hesitant about pushing forward the reformist agenda with great speed. The local governments, who were identified with the interests of the non-state sector, were far more enthusiastic because they had the incentive to do so. Senior leaders in the political centre would forge political alliances sometimes with the central bureaucracy and sometimes with local leaders. Such a reform process resulted in great regional variations and was reinforced by the policy of creating special economic areas with greater freedom to experiment with and implement more liberal reform measures.

Defining the scope of the underground or informal economy in China is a daunting task. In China the system of law is in a state of permanent flux because of on-going reforms. New legislation and regulations are constantly being drafted and institutions are being created to implement and enforce new laws and regulations. As power has been devolved from the centre, enterprises and local authorities are often engaged in practices that have not been approved by the central authorities. If they had asked for permission ahead of time there is the risk that it might not be approved or be subjected to long approval delays. As a consequence there is an unavoidable element of ambiguity about the legality of all local reform measures when they are introduced. Indeed local officials often seek to enhance the legitimacy of their initiatives by lobbying senior leaders for gestures of support.

Regional and local variations imply that reform measures that are considered acceptable and legitimate in one area may not be so in another area. Provincial and local authorities have frequently approved or condoned practices that contravene policy regulations stipulated by and even legislated by the central government. The best example is that large amounts of Hong Kong currency circulate in Guangdong province with almost no restriction, but this is in direct violation of central government regulations.

Using the taxonomy advanced by Feige (1990), China's underground economy has the features of being: illegal, unreported, unrecorded, and informal.[4] Some of them are illegal because it violates legal statutes. The growth of crime in many areas, including organised crime, is evident in most cities. Some of the activities are unreported because they violate fiscal statutes. Tax evasion is pervasive as a consequence of the introduction of the fiscal contract responsibility system, whereby the central government engages in annual bargaining exercises to determine the level of taxes that local governments and selected state owned enterprises should pay the government. The distortions in the economy and the changing accounting system also makes it difficult to measure the scale of economic activity. Even the size of China's GNP has a margin of error that is as large as 500-600% depending on whether one use the conventional exchange rate conversion factor versus the purchasing power parity measures.[5] But perhaps the most important form of underground economic activity is the informal economy. Individuals and enterprises engage in widespread violation of legal and administrative rules. As in most developing countries, full compliance with these rules would make economic activity impossible.[6]

China today is a transitional economy where private property rights are poorly defined and enforced. Regulations are pervasive but enforcement is not always effective. The coexistence of the state and the non-state sector under such conditions creates enormous opportunities for rent seeking and corruption. These activities take many forms, but an important characteristic is the incentive to divert resources from the state sector to the non-state sector. The state sector typically have low private and social rates of return and the non-state sector have high private and social rates of return. Liberalization have allowed bureaucrats and managers greater freedom to capture the profits that should accrue to the state and to divert funds and resources of the state owned enterprises and banks into non-state enterprises they themselves control or own. Some of the enterprises may even be incorporated overseas. The managers and bureaucrats are motivated by the differential in private rates of return between the two sectors. For the economy as a whole diverting resources from the state sector is economically efficient to the extent that it results in a higher social rate of return. In China this is still largely true so that we do not have perverse consequences for the economy.

**Underground Labour Market**

Before the reforms China had a rigid system of controlling population movements tied to a system of rationing essential consumption goods. They have collapsed with the reforms. There is now a growing floating population of individuals and households estimated to be in excess of 80 million who reside in the major growth cities without residency rights.[7] They are urban squatters in search of jobs. They have no access to social welfare, housing, education by virtue of the fact that they do not have residential rights, but are tolerated by the local governments because economic growth has created tight labour markets in many coastal cities.

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[4]Feige, E.L., (1990) "Defining and Estimating Underground and Informal Economies: The New Institutional Economics Approach", **World Development**, Vol 18, No. 7, July.

[5]See "Chinese Puzzles", **Economist**, 15 May 1993, pg. 79.

[6]This problem is highlighted in De Soto, H. (1990) **The Other Path**, Harper & Row Publishers, New York.

[7]Figure cited by Xuejin Zuo, "Socioeconomic Impacts of Floating Population in China: An Assessment and Policy Issues", Research Proposal, Shanghai Academy of Social Sciences, 1994.

One of the consequences of labour migration is that population control policies have ceased to be effective for this population, since they operate outside the regime of state institutions.

Workers in state owned enterprises who have attractive housing and welfare benefits but poor salaries are taking on secondary jobs with non-state enterprises while holding on to the benefits provided by their state owned enterprises. The magnitude of these labour markets is unknown but is probably quite sizeable and will continue to grow over time.

**Underground Foreign Trade and Investment**

Despite trade liberalization, tariff and non-tariff barriers are quite high. This has given rise to a huge smuggling problem. Statistics are difficult to obtain, but it is likely that Hong Kong is a major conduit because of its proximity to China. It is reported that about 10% of all luxury cars in Hong Kong are stolen and smuggled into China. According to an industry source, the amount of cigarettes smuggled into China is twice the amount that is officially imported. It has been estimated on the basis of import and consumption figure in Hong Kong, that half the television sets imported into Hong Kong are subsequently smuggled into China. Smuggling between Hong Kong and China had become so serious that the Hong Kong government was compelled to license high powered speed boats in a bid to stem the flow of smuggled goods.

Taiwan fishermen routinely conduct barter trade with Chinese fishermen in the open seas. In a bid to regulate such trade activities, the authorities in Fujian province have legalized them as "minor trade" in 1985 and stipulated that they take place in designated coastal mainland ports managed by customs officers. But from Taiwan's point of view this is still smuggling because Taiwan authorities bans direct trade with China. The Taiwan policy has created an elaborate trading system involving, Taiwan, Hong Kong and China. Taiwan does not ban indirect trade with China so long as such trade go through a third party. Hong Kong re-exports from Taiwan to China considered as indirect trade amounted to US$6.3 billion in 1992.

In addition to smuggling Taiwan also conducts three different forms of direct trade: transhipment, transit shipment or cargo-in-transit, and illegal direct shipment.[8] These three sources of direct trade amounted to US$4.7 billion in 1992. In principle Taiwan businesses cannot openly export to the mainland by transhipping via Hong Kong because transhipment usually involves a through bill of lading and therefore constitutes direct trade. Taiwan customs, however, allow exporters to leave the final destination open and specify Hong Kong as the port of discharge, where the goods are to be shipped elsewhere. On arrival in Hong Kong, the shipping companies can specify a mainland port as the final destination and the Hong Kong government usually allows such cases to pass as transhipment and exempts the goods from the import and export tax. Such cases are known as "switch bill" because another bill of lading, a bill consigning the goods from Hong Kong to a mainland port, replaces the original bill consigning the goods from Taiwan to Hong Kong. Transit shipment or cargo-in-transit involves those cases where ships carrying goods from Taiwan to China makes a stopover in Hong Kong. Taiwan exporters claim their goods are destined for Hong Kong when their goods left Taiwan. On arrival in Hong Kong, the shipping company claims that the goods are destined for the

[8]See Y.W. Sung (1994) "The Economics of the Illegal Trade between Taiwan and Mainland China", Department of Economics, Chinese University of Hong Kong.

mainland. The Hong Kong government treats these goods as cargo-in-transit.

Chinese re-exports to Taiwan via Hong Kong was US$1.1 billion and direct exports to Taiwan was US$1.2 billion. Chinese exports to Taiwan are much smaller relative to what she imports from Taiwan.

Total trade between Hong Kong and China was about US$9.6 billion in 1993. This has served as a major conduit for capital flight from China through transfer pricing. Profits that accrue to Chinese entities are therefore deposited in companies in Hong Kong controlled by Chinese officials and entrepreneurs. Since these companies are incorporated in Hong Kong they are treated as foreign companies by China. In reality these are of course Chinese capital, not foreign capital. The Chinese call these companies the "false foreign devils". When these companies invest in China they enjoy preferential tax benefits accorded to foreign investors. The tax rate on profits for foreign and joint venture companies is 15%, but can be as high as 50% for domestic companies. This simple mechanism provides a way for diverting and transforming Chinese government funds into foreign private funds controlled by Chinese officials and entrepreneurs. The proportion of foreign investments in China that is really domestic investments is unknown.

It is estimated that at least 15% of the currency issue in Hong Kong amounting to US$1.5 billion circulates within China. They can be deposited in Chinese banks as foreign currency deposits. Since Chinese banks are not allowed to make foreign currency loans these deposits are recycled into Hong Kong. It is reported that Chinese enterprises who make deposits in China have loan facilities extended to them in Hong Kong indirectly, thereby facilitating their financial transactions in Hong Kong and elsewhere.

Many state owned enterprises in China are trying to raise funds by selling shares. If they are authorised to place those shares with foreign investors they become foreign joint venture companies. They can then enjoy preferential tax treatment. These state companies have a huge incentive to sell their company shares and assets at a discounted value in order to obtain those tax advantages. Bribes can further sweeten the pie. A further twist emerges if the foreign investor is in fact a "false foreign devil".

**Financial Reforms, Underground Loans and Macroeconomic Instability**

Prior to the economic reforms, banks were virtually the sole financial institution in the economy. They were charged with meeting the objectives of the planning authorities, and they essentially passively allocated credit in accordance with the economic plan and relied on the government to cover any loan losses. The People's Bank of China was charged with the task of mobilizing resources from sectors that ran a surplus, largely households, and passed them on for central allocation to industry and agriculture. The banking system was essentially an accounting mechanism. It had little role in selecting firms to finance, assessing their creditworthiness, or monitoring them. Loan collection was of little concern since the state would routinely cover any losses. Under such a system non-bank financial services were of little use. The situation began to change with economic reform and the growth of the non-state sector and the growing volume of foreign trade.

In 1984, China started to reform its monobank system. The People's Bank of China was transformed into a central bank and handed over its day-to-day business of deposit taking and loan granting to four specialized banks: The Agricultural Bank, the Industrial and Commercial Bank, the Bank of China, and the Construction Bank. While there was a change in the structure of the banking system, the process of credit creation remained unchanged. Banks loans were still regulated through a rigid system of quotas set by the central authorities to fulfil planning requirements. Interest rates on deposits and loans were also set uniformly. To attract deposits the People's Bank of China would set interest rates at levels above the prevailing rate of inflation, but loan rates was often set at very low levels so as to keep the balance sheets of loss making state-owned enterprises appear solvent.

As economic decision making power was devolved to the provinces and enterprises, the centre began to lose effective political control over the expansion of credit. Bank credit was dominated by enterprise expansion of bonuses and wage payments with local authorities putting pressure on branch banks to extend loans in their locality for investment projects. In periods when the centre called for speeding up economic reforms, the pressure applied by enterprise managers and local authorities on banks to expand credit increased. Banks would exhaust their lending quotas by mid-year, and the central government would be forced to seek monetary accommodation to meet its fiscal obligations.

A more significant change occurred in 1986 with the legalisation of the interbank lending market. The market was originally developed for short-term lending among the state banks to solve their liquidity problems so that banks serving fast growing regions and sectors where there was a high demand for loans could borrow from other banks where there was an excess supply of loans. The imbalance between loans and deposits among banks was a consequence of maintaining a system of rigid bank credit quotas when the economy was becoming increasingly liberalized. China's interbank lending market was intended to be a mechanism for permitting limited short term financial flows to occur across regions and sectors outside the plan.

The interbank lending market grew rapidly over time. Since 1992 the scale of interbank lending had increased to 300 billion yuan. This is almost one-seventh of the total volume of outstanding state bank loans in 1992. Interbank loans became an important cause of the overheating of the Chinese economy in 1993 as banks sought to circumvent credit quotas by operating in the interbank lending market.

The overheating of the Chinese economy in 1993 can be traced to the enhanced pace of economic reform that gathered momentum following Deng Xiaoping's trip to southern China in early 1992. In 1992, real GDP rose by 12.8%, industrial output rose by 21.7%, fixed asset investment rose by 37.6%, general retail price index rose by 5.4%, and the cost of living index in 35 major cities rose by 10.9%. In the first six months of 1993, real GDP rose by 13.9%, industrial output rose by 25.1%, fixed asset investment rose by 61.0%, general retail price index rose by 10.8%, and the cost of living index in 35 major cities rose by 17.4%; all rates have been annually adjusted.

It is worth noting that fixed asset investment by state owned enterprises rose by only 33% in 1992, but shot up to 70.7% in the first six months of 1993. The surge of fixed asset investments in general, and in state owned enterprises in particular, were the prime cause of the overheated economy in 1993. In June 1993 it was reported that unauthorized interbank lending had risen to 200 billion yuan. State banking funds were being diverted through the interbank market into investment projects or for speculative purposes in the emerging securities and properties market. In some instances even influential state owned enterprises were able to have direct access to the interbank lending market. The involvement of numerous banks and state owned enterprises in property development channelled much needed resources from key infrastructure projects into speculative pursuits and gave rise to vast opportunities for corruption.

Many problems can be identified. At the most superficial level one can blame the poor state of banking regulation and supervision for the diversion of bank funds. The fact that banks suffer from undue political influence by powerful groups in society that impinge not only on credit allocation but also monetary control decisions is a more serious indictment of the inadequacies of China's monetary and banking system. The lack of central bank independence, the arbitrariness of the credit allocation process, and the conflicting pressures derived from government support for state owned enterprises and market demands of the non-state sector are key policy matters that have yet to be addressed.

Since the mid-1980s, the financial sector began to develop rapidly with a more diversified structure and a broader menu of financial instruments. Some state owned commercial and development banks were established first in the special economic zones but later spread throughout the country. Rural and urban credit cooperatives became more aggressive in extending loans to the non-state sector. Numerous non-bank financial institutions including trust and investment companies, insurance companies, finance companies, financial leasing companies, and securities companies were created. These non-bank financial institutions were mainly subsidiaries of the state owned banks, of state owned enterprises, and of the central and provincial government offices.

Since these institutions operated outside the state plan they had little incentive to lend to or invest in loss making state owned enterprises. Loans extended to the non-state sector as a percentage of total outstanding bank loans grew rapidly. Loans extended by rural credit cooperatives as a percentage of total bank loans rose from 2.33% in 1979 to 11.35% in 1992. The percentage for urban credit cooperatives rose from 0.25% in 1986 to 1.75% in 1991. The increase of loans made by non-bank financial institutions rose even more rapidly from 2.87% in 1986 to 6.71% in 1991.

These non-bank financial institutions undoubtedly played an important role in channelling resources to the more efficient non-state sector and contributed to the rapid growth of the more productive sector of society. The near monopoly control the state banking system had over loans was weakened, but that also compounded the problem of macroeconomic control. In theory these non-bank financial institutions are not part of the banking system and do not issue credit that constitutes money in the usual sense. But given the rudimentary regulatory framework in China, the real situation can be very different. It is clear that the non-bank financial institutions have access to the interbank lending market and have diverted these loans into investment projects or for other speculative purposes.

## Corruption

Corruption has emerged as a pervasive feature of the Chinese economy because the reforms have created a dual track system with state and non-state sectors. Economic liberalization has shifted decision making rights and the residual claimant from the central bureaucrats to managers, entrepreneurs, and local bureaucrats. One consequence of this change is to make corruption easier because it has become more difficult to monitor the behaviour of so many agents.

Such corruption has improved incentives for bureaucrats and managers to improve the profitability and performance of their enterprises, especially those enterprise in the non-state sector. Corruption has also improved the overall allocation of resources in the economy by diverting resources from the low yield state sector to the high yield non-state sector. As resources flow into producing commodities with a higher social rate of return the economy grows faster.

Given that most state owned enterprises are losing money and have to be financed by the state banking system, the advent of growing corruption in the financial sector further complicates the problem of controlling macroeconomic stability. They in turn threaten the momentum for reform.

Pervasive corruption is socially disruptive and breeds discontent. As law enforcement agencies themselves become corrupted it becomes increasingly difficult to maintain law and order in society. When corruption becomes institutionalized it may be very difficult to maintain open and competitive markets.

## Prospect of Economic Reform

From 1978 to 1993, central government revenue as a proportion of GNP fell from 35 to 15%. The fiscal deficit as a percentage of GNP was relatively small and did not exceed 4% of GNP. However, the ambiguous financial position of loss making state owned enterprises makes the true fiscal deficit difficult to calculate. Since policy loans are forced lending to state owned enterprises, often made at very low interest rates, they should be included as part of the fiscal deficit in China. The consolidated fiscal deficit that includes these loans is much larger and in all likelihood had exceeded 10% of GNP in 1993. Fiscal deterioration in China is a growing problem.

More than a decade of economic reform has failed to improve the productivity and profitability of state owned enterprises. Many of them continue to rely on the state to cover their losses. Increasing open and hidden fiscal deficits have largely been financed by borrowing from the state banking system. Macroeconomic instability has become increasingly difficult to handle and has from time to time resulted in open inflation and exchange rate crises that had to be managed through draconian measures to cool off the economy.

Macroeconomic instability in China is a structural problem and is a direct result of the failure to reform the state sector. Since the transition to a market economy has yet to be completed, rising inflation and exchange rate crises complicate the process of economic reform by making it politically necessary to reintroduce price and exchange controls in the absence of an effective mechanism or the lack of a political will to curb credit expansion. Loss making state owned enterprises is the source of China's macroeconomic instability and puts further economic reforms at risk.

The solution is not difficult conceptually. Unless the Chinese government is prepared to move quickly and boldly to prepare for the open privatization and restructuring of the state owned enterprises economic stagnation in the state sector cannot be averted. Interim measures to create a social security net for discharged workers are obviously necessary to avoid widespread social discontent. Resources spent on caring for displaced workers is clearly socially less costly than trying to prop up these unprofitable enterprises. It will also create an opportunity to rationalize the banking and financial system so that the problem of macroeconomic instability can be resolved. This in turn will scarce financial capital available to the vibrant non-state sector instead of being wasted on the inefficient state sector. China's spectacular success in the recent past would then become sustainable.

The current situation in China is best summarized with reference to recent figures on industrial output in the period January-April 1994.[9]

| | Total RMB billion | Change (%) over same 1993 period |
|---|---|---|
| Total industrial output | 1224 | 18.35 |
| of which: | | |
| State enterprises | 579 | 4.72 |
| Collective enterprises | 457 | 31.58 |
| Other enterprises | 188 | 39.65 |

In this period, state enterprises produced 47.5% of total industrial output, but its year-on-year growth rate was a mere 4.72%. The non-state sector comprising both the collective and private, joint venture, and foreign owned enterprises grew at a year-on-year rate of between 30-40%. The non-state sector is forging ahead leaving the state sector lagging behind.

Will the state sector quietly wither away?

This is most unlikely. First, one has to recognize that the state sector includes many heavy and infrastructure industries that are state monopolies. One can bleed the state sector to death by simply diverting resources away into the non-state sector, but one cannot create the same industries in the non-state sector without a shift in policy. Privatizing major state enterprises and opening them up to competition has to be an explicit policy, not an implicit one. Financial arrangements affecting major investments cannot be successfully concluded without a more clear delineation of property rights. Privatization through the back door simply cannot work.

[9]**China Economic News**, Vol 15, No. 20, 30 May 1994.

Second, if widespread social and economic disruption and macroeconomic instability is to be avoided, one needs to adopt a feasible strategic plan to reform that includes the establishment of social security nets for displaced workers in order to move the economy successfully towards the goal of creating a market system. Muddling through as has happened in the past is not an adequate policy response. The state has to embrace the private enterprise system and a market economy without "ifs" and "buts". For this to take place political reforms are almost inevitable.