China's Economic Reform: The Next Step

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Introduction

Between 1979 and 1993, China liberalized its economy incrementally and achieved extraordinarily rapid output growth. The reforms started in agriculture with the replacement of the communes by a system of household farming with land leased from the state. With over three quarters of the population still in agriculture, farm output surged by 8-10% per year between 1979 and 1983 (See Johnson, 1990). The commune system was not consciously dismantled as a matter of policy or design. The process started when provincial leaders in Sichuan province permitted local experimentation with the household responsibility system without first seeking 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-privatized. The reforms were endorsed by the central authorities *ex post*.

By 1984, the engine of rapid economic growth had shifted to rural light industry, which began to absorb much of the labor 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 58.60% in 1993. The central government provided little support to the non-state sector. Indeed the state banking system had been very reluctant to extend bank credit to the non-state sector. Total loans extended to the non-state sector by state banks as a percentage of total outstanding state bank loans remained around 12-14% between 1983 and 1993. Most of the non-state enterprises had relied on self-financing for growth.

Foreign trade was liberalized gradually by setting up special economic zones that were largely outside the control of the traditional state trading monopolies. The first and most important ones were in the Pearl River Delta area in connection with the Hong Kong trade (See Sung, 1991). 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 centers, 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 1994, the volume of foreign exchange transactions in the swap centers was reported to be almost 80% of the total transactions in China. The official exchange rate of the RMB against the US Dollar depreciated significantly from 2.5 in 1979 to 8.7 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.

The story of China's economic success since reform started in 1978 is now well known. Even the harshest critics find difficulty in belittling an economic record of 9.3% average annual rate of growth since reforms began. The coastal provinces and especially the Pearl River Delta economy made even more spectacular gains. Nevertheless, despite such an impressive record, China still has to wrestle with the myriad of economic and political problems in a transitional economy and the success of the economic reforms in the near term are not a foregone conclusion.

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Indeed, China's high growth rates have been accompanied by large boom and bust cycles of about four-year intervals. These cycles are uncomfortably frequent and politically convulsive that time and again one wonders how and if the reform agenda can be further advanced. So far China has surprised many with the persistence of its reform efforts. Inflation in China as measured by the general retail price level rose at an average annual rate of 10 percent, although it has risen above 20% in the current overheated economy. This is a modest record when compared with the other transitional socialist economies in Eastern and Central Europe and the former Soviet Union.

Characteristics of China's Economic Reforms

The Chinese reforms were aimed at promoting growth and revitalizing economic performance. The Chinese leadership recognized that their political legitimacy depended on delivering a rising standard of living to the people. But within the leadership, disagreements over the ultimate goals of economic reform and the 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.

The main thrust of the Chinese reforms was to decentralize economic decisions to enterprises and to provinces and localities. This permitted the non-state sector to emerge alongside the state sector. Indeed the share of industrial output produced by state owned enterprises declined from over 75% in 1979 to 41.40% in 1993. The massive shift of economic activity from low to high productivity activities and from low to high efficiency organizational forms is the source of China's rapid economic growth. This has led some analysts to observe that China's experience with gradual reform provides useful lessons about how to *grow out of the state plan*. It is often argued that such an approach is attractive because it reduces social instability and political uncertainty. Whether China's reforms can succeed by growing out of the state plan is the main subject of my remarks today.

The emergence of the new non-state sector and the declining importance of the old state sector was an unintended consequence of the reform. The leadership had originally envisaged that the productivity and profitability of the state owned enterprises would improve following decentralization of decision making authority. They did not expect to see the development of a vibrant economy outside the state plan. Over time, there is a growing awareness within the Chinese leadership that their system has to be fundamentally altered and not merely tinkered with. The endorsement of a socialist market economy represents a significant step towards recognizing this point, although it stops short of embracing a market economy with private property rights. Current hesitation probably has more to do with on-going conflicts within the leadership over economic and political interests, rather than genuine ideological concerns.

The Chinese reforms were incremental and evolved under a relatively relaxed policy environment that permitted new initiatives and experiments to take place. It was not the unfolding of some preconceived master plan. One can think of the process as a series of experimental breakthroughs that occurred in areas where political resistance to change was weak and where reforms provided an opportunity for rents to be captured by various interest groups. A pattern of starting with the easy changes and gradually progressing towards more difficult ones can be discerned. It was certainly not a conscious development as is sometimes implied by those who claim that the Chinese reform strategy is gradualist. The political debates about where the reform was to be heading gives the deceiving appearance of a pro-active gradualist strategy when it was in fact the outcome of numerous unplanned experiments that had survived the dual test of economic utility and political acceptance.

Local governments often spearheaded new reform measures and policy initiatives. Often times the further one is from the political center the weaker is the resistance to reforms. Successful local initiatives were often endorsed retrospectively by the central government and therefore gained political legitimacy. The role of the central government in legitimizing local initiatives is relevant because it enhances the probability that the reform measures would survive a change of local leadership. The policy environment in China during the reform period was a shifting one. The central bureaucracy, often identified with the interest of the state sector, was naturally hesitant about pushing forward a thorough reformist agenda with serious commitment. The local governments, who were identified with the interests of the non-state sector, were far more enthusiastic. Senior leaders in the political center would forge political alliances sometimes with the central bureaucracy and sometimes with local leaders (See Shirk, 1993). Such a reform process resulted in episodes of rapid development alternating with retrenchment and also great regional variations. The latter was reinforced by the policy of creating special economic zones which allowed greater freedom to experiment with and implement more liberal reform measures.

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. One good example is the large amounts of Hong Kong currency that circulate in Guangdong province with almost no restriction, but this is supposedly in violation of central government regulations.

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 devolved from the center, 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.

China today is a transitional economy where private property rights are poorly defined and unevenly 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 has low private and social rates of return and the non-state sector has high private and social rates of return. Liberalization has allowed bureaucrats and managers greater freedom to capture the profits that would otherwise accrue to the state. They are able to divert the funds and resources in many state owned enterprises and banks into the non-state enterprises they control, and even into overseas companies. 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 perverse consequences for the economy are not dominant.

Structural Aspects of Macroeconomic Imbalance

To date economic reform has not improved the productivity of the state owned enterprises (Woo and Fan, 1994). Furthermore, losses have increased as state owned enterprises are able to divert profits into wages after economic decisions became more decentralized. As a consequence, enterprises could now keep the profits, but the state continues to be responsible for the losses. 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 has probably exceeded 10% of GNP in 1993.

Macroeconomic instability is a direct consequence of the growing fiscal deficit, which is in turn caused by the huge losses of the state owned enterprises. At the heart of the problem is the soft budget constraint of the state owned enterprises. When liberalization policies are emphasized, state owned enterprises would begin to bid for bank credit to finance its capital investment program. Because of their political influence they are able to obtain extremely favorable credit lines. They also receive priority allocation of materials and obtain implicit subsidies from a distorted price system. The economy will soon become overheated and control measures had to be imposed. State policies have alternated between control and decontrol phases with predictable regularity.

In the early stages of the reform, macroeconomic stability in China was maintained by relying on the state banks to mobilize household savings and the surplus accumulated by the non-state sector to finance fiscal deficits and the deficits of state owned enterprises. The rapid growth of the dynamic non-state sector and the willingness of the public to keep their savings in bank deposits made it possible for the state to finance the losses of the state sector. This is needless to say a precarious condition to rely on for macroeconomic stability.

Macroeconomic stability has become increasingly difficult to maintain over time. Periodic episodes of open inflation have to be managed by employing draconian measures to cool off the economy. Macroeconomic instability in China is a structural problem and stems from the failure to reform the state sector. Since the transition to a market economy is incomplete, 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 and the political will to curb credit expansion.

An important issue is whether China can continue to grow by allowing the state sector to gradually wither away to be replaced by the non-state sector. In practice, this is difficult without risking macroeconomic imbalance. As the non-state sector grows it will begin to compete with the state sector for funds. If the banking and financial system is liberalized, more credit and capital will flow to the profitable non-state sector. But the state owned enterprises will be squeezed and, in the short run, many may collapse unless the government bails them out. In the long run, the state owned enterprises will have to be privatized or restructured. In the interim, the government will have to assume responsibility for making social security payments to displaced workers. And unless a broad based tax system is already in place, the government will be compelled to monetize the growing fiscal deficit.

The solution is not difficult in principle, however, unless China is prepared to tackle them, macroeconomic instability and economic stagnation of the state sector cannot be averted. If China succeeds, her spectacular economic performance in the recent past would become self sustaining. It may not be easy to grow out of the state plan. Financing non-state sector growth will depend on implementing banking and financial reforms. But these reforms cannot be pursued independently of tax reforms and enterprise reforms if macroeconomic stability is to be maintained. In other words, one has to have a thought out reform plan and not simply a willingness to undertake experiments as is the case in the past.

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 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. Financial arrangements affecting major investments cannot be successfully concluded without a more clear delineation of property rights. Privatization through the back door has its limits. Muddling through as has happened in the past is not an adequate policy response. For this to happen the state must withdraw itself entirely from enterprise decisions in the state sector.

Second, if social and economic disruption due to enterprise reforms are to be avoided, one needs to adopt interim measures to create a social security net for discharged workers when enterprise reforms take place. Resources spent on caring for displaced workers is socially less costly than trying to keep unprofitable enterprises running. It is most unlikely that a national social security net can be established, given the precarious fiscal condition of the central government and its eroding ability to mobilize local and provincial resources, any feasible social security net has to be based on local or provincial initiatives and resources. This means that places which have the highest concentration of state owned enterprises, where enterprise reforms are most needed, are also the slow growth areas and will have the most difficulty financing a social security net.

The non-state sector has been the engine of rapid economic growth in China, but future growth of this sector will be hampered by the absence of a well functioning banking and financial system to serve as an efficient conduit for channeling investment capital. The engine of economic growth in some of the coastal areas are externally oriented non-state and foreign or joint venture enterprises. Many of them benefited from having access to the financial market in Hong Kong and elsewhere. But as the scope and activities of these enterprises begin to grow inside China, their economic activities will become increasingly constrained by the failure of the banking and financial system in China to develop in step with their needs. Although the future development of the Chinese economy has its own momentum, it cannot be entirely insulated from the effects of overall macroeconomic instability, where the risk of stalled reforms is still present and is likely to increase as macroeconomic imbalance continues.

The benefits of an efficient allocation of investment loans can be very substantial in China because of the high rate of capital accumulation. According to 1991 statistics, the value of fixed capital assets in state owned enterprises was RMB 1987.2 billion and the value of gross fixed capital formation was RMB 355.8 billion. In the same year, total gross fixed capital formation was RMB 527.85 billion. Since state enterprises are usually more capital intensive, it is reasonable to project on the basis of the capital to investment ratio in the state enterprises to obtain an upper bound estimate of the total value of fixed capital assets in 1991. The value cannot exceed RMB 2948.4 billion. Gross fixed capital formation includes bank loans, but also transfers from the state, enterprise funds, and local government investments. A significant improvement in the efficient use of savings and of funds from various sources would have been achieved if bank loans were to be extended to productive enterprises at market determined interest rates to reflect the true opportunity cost of funds. At the high levels of investment prevailing in China, it would not take many years to renew the entire stock of capital.

Financial Reforms and Macroeconomic Instability

Although the banking and financial system remains tightly controlled for fear of jeopardizing the state owned enterprises, funds have been drained from the banking system clandestinely in order to finance non-state sector growth. This has exacerbated macroeconomic instability in recent years and the state has reacted by introducing *ad hoc* control measures to curb financial market developments.

Before 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 allocated credit passively in accordance with the economic plan and relied on the government to cover any loan losses. The People's Bank of China (PBOC) 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.

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 fulfill 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 center 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 center 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 legalization 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 RMB 300 billion. This is almost one-seventh of the total volume of outstanding state bank loans in 1992.

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 channeling 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.

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. The following table presents figures on relevant macroeconomic statistics since 1992.

Table: Annualized Percentage Growth Rates

	1992	1993:Q1-Q2	1993:Q3-Q4	1994:Q1-Q2
GDP	12.8	13.9		
Industrial Output	21.7	25.1		
Total Fixed Asset Investment	37.6	61.0		
State Sector	33.0	70.7		
Non-State Sector				
Retail Price Index	5.4	10.8		
Cost Living Index 35 Cities	10.9	17.4		

Source: China Economic News, EIA Information & Consultancy Ltd., Hong Kong

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 RMB 218 billion. 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 channeled 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.

China needs a central bank that has the requisite authority and tools to control money supply growth. Banking reform is also needed because an efficient commercial banking system is a prerequisite for effective channeling of funds to productive sectors. But such a bank system can only function if there is the political will to privatize and restructure the state owned enterprises. The rampant expansion of credit to finance fixed asset investments in state owned enterprises and real estate development projects on the one hand and the shortage of funds in infrastructure, industrial, and agricultural sectors on the other also indicate the difficulty of implementing a rational credit and sound monetary policy.

Austerity Program and Further Reforms

On 2 July 1992, Zhu Rongji announced a 16-points austerity program to cool off the economy. He emphasized that it was different from the previous program introduced in 1988-89. Zhu's program had two major aspects. First, instead of tightening credit across the board, it would recall RMB 218 billion worth of questionable interbank loans extended for speculation in properties and securities transactions, but loans to finance key infrastructure projects would be guaranteed. Second, the program was a temporary measure to stabilize the economy so as to create the conditions for a wide ranging program of enterprise reforms, banking and financial reforms, and fiscal reforms to be implemented in 1994.

By 25 August 1993 the deadline set for recalling unauthorized loans, only RMB 72.7 billion of the loans had been recovered. The deadline was extended, but even by mid-October little additional progress was made, and soon afterwards the subject was dropped. The failure to recover these loans was not surprising, since many of those loans were probably advanced to politically powerful and well connected groups that could afford to be defiant. The attempt to cool down the overheated economy was unsuccessful. Inflation continued to surge to 20.1 percent in the first quarter of 1994.

Economic overheating in the past two years highlights the drawbacks of continuing to support the loss making state owned enterprises with policy loans and cheap bank credit. It is important to recognize that this structural problem is both political and economic in nature and is the source of macroeconomic instability. The problem is no doubt also exacerbated by the devolution of power to local governments to spur growth and the partial liberalization of financial institutions while macroeconomic control mechanisms such as fiscal and monetary policy are not fully in place.

A popular view held by many observers is that local initiatives and excesses have been responsible for macroeconomic instability. The overheated economy is a result of the excessive expansion at the local level. While it is true that excesses have been committed by local authorities in making investment and financing decisions, however, the excesses of the non-state sector pales in comparison with that of the state sector, where the amount of investments in fixed assets is simply staggering. The excesses of the non-state sector reflects largely attempts to circumvent financial constraints imposed by the state. This contravenes the objective of the state to ensure that adequate funds are available to finance the fiscal deficit of the central government and the losses of the state owned enterprises.

Unless the central authorities is prepared to commit itself to a fundamental restructuring of the loss making state owned enterprises, otherwise banking and financial reforms cannot proceed very far. The state owned enterprises will continue to milk the state banking system of its funds and local authorities will seek to support the non-state sector by diverting resources from the banking system. Under such circumstances, the tax and credit control proposals will be perceived by provincial and local authorities as an attempt to reassert central control over the provinces and localities without providing in return a credible program to support the growth of the non-state sector.

The credibility of the Zhu's reform program remains in doubt, especially with a looming succession crisis after the old guards pass away. On the other hand an unstable macroeconomic environment would prevent further financial deepening, and would ultimately hold back the future growth of non-state enterprises in the coastal regions. Fortunately some of the coastal regions can still rely temporarily upon foreign investments and access to financial markets in Hong Kong for some of its funding requirements, but this is not a permanent substitute for pressing with more fundamental reforms in China.

The local economies in the coastal regions depend on their non-state sector and can potentially benefit enormously from the success of Zhu Rongji's reform package. A stable macroeconomic environment and an efficient banking and financial system will help the non-state enterprises to grow and prosper. Macroeconomic instability in China also threatens to disrupt economic growth and reform in the coastal economy because central control measures will have to be reasserted. Since most non-state enterprise are relatively new and small in comparison with the state owned enterprises, their comparative advantage is not in having access to important political connections, but rather to compete in an open and less regulated market environment.

Until now the success of China's economic reform is due largely to the partial withdrawal of the state from economic decisions. The process was essentially unplanned and uncoordinated with room for trial and error. The rise of the vibrant non-state sector shows the vitality of decentralized market forces in a more liberal policy environment. It also shows the enormous gains that can be obtained from a better allocation of resources and the relevance of organizational forms in managing incentives. The stagnant state sector, however, remains unreformed and the commitment of the state to keep supporting it with cheap policy loans is the source of recurrent macroeconomic instability. It also threatens the reform effort and the continued growth of the non-state sector. Growing out of the state plan cannot work so long as the state refuses to privatize and restructure the state owned enterprises. An economy cannot operate on a dual track system without generating fundamental contradictions. To solve the problem, China has to implement a coordinated plan for banking and financial reforms, enterprise reforms, fiscal reforms, and social security reforms. It is not enough to simply let things happen as in the early phases of the reform. Indeed the state has to become pro-active and manage the reform process. To achieve this, the leadership must have sufficient unity of purpose than was present in the past.

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