

Background of China's Cancellation of Plant Import Contracts

by Keitaro Hasegawa, economist

In January 1981, the Chinese Government informed plant exporters mainly in Japan that it would cancel contracts for plant imports. This came as a big shock to the Japanese business community, although it had already been expected for some time. The view spread fast that Beijing's action virtually amounted to abrogation of a long-term trade agreement signed between the two countries in 1978, deepening pessimism about future prospects for Sino-Japanese economic relations. Not only that, an increasing number of people displayed anxiety about China's political system.

Vacillating Policy

The total value of the contracts affected by the cancellation notices, involving the Baoshan steel mill and petrochemical complexes in Nanjing, Beijing and Shengli, amounted to \$1,541.4 million.

In February 1980, China had notified Japanese businesses involved that it would hold off implementation of plant import contracts because they had yet to obtain the approval of the Chinese governmental authorities concerned. This incident showed that China's policy on plant imports was still vacillating. After all, China said the contracts had been approved, and construction work got under way according to the contracts.

As to the reason for the January 1981 cancellation notice, the Chinese side explained it as part of the adjustment of the domestic economy, as there was an evident shortage of domestic funds necessary for construction work. With this in mind, the Japanese side offered ¥300 billion in yen credits, which led to agreement on the continuation of plant construction.

Susumu Nikaido, chairman of the Liberal-Democratic Party's Executive Council, conveyed the Japanese Government's intentions to the Chinese side. But formal negotiations have yet to be completed, with the signing of an accord expected when Chinese Vice Premier Gu Mu visits Japan. The yen credit consists of ¥30 billion in commodity credits, ¥70 billion in lendings by city banks and ¥100 billion in supplier's credits (deferred payment). Thus it does not include a loan by the

Export-Import Bank of Japan, which had been strongly requested by China. The commodity credit represents a diversion from the earlier-agreed credits for the Wuqiangxi hydraulic power station and the Dayaoshan tunnel, so it is not a new credit.

Covered by the yen credit are the first phase of the Baoshan steel mill project and the Daqing petrochemical plant project. Of the former project, the contract for a hot strip mill was canceled and Mitsubishi Heavy Industries, Ltd. (MHI), the prime contractor involved, accepted a settlement regarding compensation late in August 1981. As to the petrochemical complex projects affected by the cancellation notice, it was decided to continue construction work as scheduled on the Shengli and Beijing projects, for which shipments of equipment from Japan had already made considerable progress.

Japan's increased economic aid thus led to the partial restoration of the canceled plant projects. Behind this, however, was a major change in the Chinese political scene. In June 1981, Hua Guofeng resigned as Chairman and was replaced by Hu Yaobang, a protege of Vice Chairman Deng Xiaoping, at the sixth plenary session of the Chinese Communist Party's Central Committee.

This change had leaked to the outside world from around the summer of 1980, and therefore, was taken for granted by all people both within and outside China. But there is no doubt that this represented one step forward for the Deng Xiaoping faction and one step backward for the Cultural Revolution group. But the problem remained that the balance of power within the party underwent no fundamental change. The Deng Xiaoping faction had to pay a price of major concession to the People's Liberation Army, which supported Hua Guofeng.

This major concession and compromise took the form of the reassessment of the "Mao Zedong thought" in the ideological aspect, the criticism of the movie "Kulian" (Bitter Love) in the sphere of art and literature, "readjustment" in the economy, and a policy of introduction of advanced military techniques and full-scale promotion of modernization in the



military field. All these represented a policy shift in the military-desired direction.

As part of a wholesale spending cut in the fiscal 1981 budget, the military expenditures were drastically curtailed, forcing the Liberation Army to discharge 400,000 men mainly in the rear units from its total strength of 3.6 million men. Since China, suffering from chronic unemployment, cannot provide new jobs to those discharged soldiers, part of them reportedly staged a demonstration in suburban Beijing, demanding jobs.

No wonder, therefore, that the Liberation Army reacted strongly to the threat of unemployment for discharged soldiers. And to seek such Liberation Army support for a drive to oust Hua Guofeng, the Deng Xiaoping faction had no alternative but to make a drastic concession in the form of a policy shift.

The seemingly mysterious economic "readjustment," if analyzed from this angle, may provide a clue to understanding realities in China. China's "press campaign," first carried in outgoing news dispatches and then "reimported" into China, is aimed at elevating Vice Chairman Deng to the chairmanship. This indicates that the ongoing economic "readjustment" forms part of a struggle for power within the Chinese leadership. Vacillations over policy reflect the intensity of this struggle.

"Readjustment"

After the end of a national conference of industrial and transport enterprises held on Sept. 1, 1981, internal directives laying emphasis on heavy industry again were issued in quick succession. Meanwhile, a policy of stepping up induction of foreign capital began to be publicized and an attitude of introducing advanced technologies, including military related ones, became clear. Acceptance of a yen credit from Japan and the decision to continue the construction of the Baoshan steel mill form an integral part of this drive.

At the same time, the "energy faction" in the coal and petroleum departments, and the "investment faction" in charge of foreign investment and technological

introduction, which had been inactive since a switch to the "economic adjustment" policy in the summer of 1980, became active again. On the other hand, the name of the monetarist Vice Chairman Chen Yun, who had been advocating the elimination of a fiscal deficit and low production guidelines, is now fast disappearing from domestic newspaper reports.

The fact that a policy shift is inseparable from the rise and fall of leaders is indeed characteristic of Chinese politics. There is no denying that leaders of the above factions are attracting attention and have intensified their activities. Among them are Kang Yeen, Deputy Premier and Petroleum Industry Minister, and Yu Qiuli, Deputy Premier and Chairman of the Energy Commission, both belonging to the "energy faction," and Gu Mu, Deputy Premier and Chairman of the Foreign Investment Management Commission, and Wan Li, Deputy Premier and former Railway Minister.

A Chinese military mission to the U.S., headed by General Chief of Staff Yang Deizhi, carried a list of new military technology China wants to buy from that country, testifying to a wholesale change of attitude to the introduction of foreign equipment and knowhow.

A return to a policy of giving priority to heavy industry is closely related to the fact that the adjustment policy adopted late in 1980 is stalled. However, it was naturally expected before the start of the adjustment that a policy centering on light industry would result in a sharp drop in heavy industry production and corporate profits. There is thus little ground to consider this as a decisive factor behind a switch to readjustment.

From the start, it was not thought that the adjustment policy geared to light industry could be continued for a long time. In China, which is short of production capacity, neglect of heavy industry will immediately cause a dearth of goods and result in lowering the operation ratio of heavy industry, which in turn will sharply reduce the earnings of state-run enterprises, a major source of governmental revenues.

As already stated, the expansion of heavy industry is indispensable to make up for the shortages of transport capacity and energy, which are the biggest weakness of the Chinese economy.

From this point of view, Japanese business circles predominantly thought that the "adjustment" policy giving priority to light industry over heavy industry would not last long. Even so, the swift change in less than a year came as somewhat of a surprise.

The Chinese economy deteriorated in the first half of 1981. Although the sluggishness of heavy industry had been naturally expected, the money supply showed a drop of slightly more than 3% as of the end of June 1981, showing unprecedented

monetary rigidity. As a consequence, it has become impossible to attain the goal of eliminating the fiscal deficit through the reduction of fiscal spending mainly by sharp cuts in basic investment and military expenditures. As against the target of a balanced 1981 budget, it is now said that a deficit of 2 billion to 5 billion yuan would be allowable, indicating a major setback. The recklessness of a drastic policy seeking to totally eliminate in one year a huge deficit of 12 billion yuan registered in 1980 had already been pointed out by Japanese economists. Just as predicted Beijing has now been compelled to revise its policy.

Dissatisfaction in the Liberation Army

China's economic policy is not influenced by economic rationality alone. It is inseparably linked with struggles for power. For the power for moving the bureaucratic system in charge of guiding economic plans comes from the top leaders under a system of one-way communication only from above.

Since the People's Liberation Army having military power constitutes the foundation of authority in China, political power cannot be maintained without having army acquiescence. There can be no stable political power if there is antipathy within the army.

There is no doubt that the Liberation Army entertains deep dissatisfaction with the policy of the Deng Xiaoping faction. During the Cultural Revolution, the army could control political power on the strength of military might. After the end of the Cultural Revolution, the reconstruction of the Communist Party structure made progress on the occasion of the Lin Biao incident, resulting in the ouster of the military from political power.

The denial of the Cultural Revolution and "Mao Zedong thought" also meant a denial of the ideological foundations of the Liberation Army, maintained since its establishment, thus causing strong dissatisfaction among PLA leaders. As already

stated, the reduction of military spending under the "adjustment" policy brought added pressure to bear on the army in the form of curtailment of troop strength.

A liberalization policy in rural areas has widened the gap between the rich and the poor among peasants. Those peasants whose sons have been pressed into military service have experienced a clear drop in earnings compared with others who have no worker shortage. The progress of the liberalization policy inevitably widens the gap further. Assistance to the peasant families of Liberation Army soldiers from the people's communes is only perfunctory for the most part. Consequently, the liberalization policy has generated deep discontent among Liberation Army soldiers. This situation has added to the cogency of the old saying that "good men don't become soldiers just as good iron doesn't become nails." Viewing this as a result of the Deng Xiaoping line of denying the Mao Zedong thought, Liberation Army soldiers are getting increasingly restless.

Leaders of the Liberation Army are acutely irritated by slow progress in the



Great Hall of the People in Beijing

introduction of new military techniques, which are indispensable for the modernization of the army, to say nothing of the shrinkage of troop strength due to the reduction of military spending. Since 1978, Chinese military missions sent to the West have examined many new weapons, but not a single purchase contract has been concluded, causing the missions' activities to be derisively called "window shopping."

In September 1981, the Liberation Army staged big military exercises in Hebei Province—the first large-scale drill in more than 20 years since the latter half of the 1950s. Under Lin Biao, who replaced Peng Tehuai as Defense Minister, the Liberation Army became a virtual composite of guerrilla units rather than a regular army and placed greater emphasis on political activities and production than on military training. The modernization of defense—one of the so-called "four modernizations"—is intended to reorganize such army into a regular defense force again. But this also spells the denial of Maoist thought. Even leaders of the Lib-



Morning "rush hour" in Beijing

MARC RIBOUD (MAGNUM) PPS.

BOB DAVIS/PPS.



Tiananmen Gate in Beijing

eration Army are divided over the contents of modernization.

For instance, the reintroduction of military ranks indispensable for a regular army, has been held off for more than a year because of strong opposition within the army itself. For the enforcement of the age limit system, inseparable from the rank system, will spell the retirement of old leaders who now control the Liberation Army, thus creating severe friction between old and young.

Despite such internal contradictions, once the interests of the Liberation Army as a whole are at stake all its personnel become closely united. The close unity of the army in opposing the Deng Xiaoping faction bears testimony to the monolithic solidary characteristic of the Liberation Army.

As already noted, the Deng faction has made big concessions to the army, which in turn has led to the economic policy readjustment.

Foreign Capital Induction

China has joined the International Monetary Fund (IMF) and the World Bank, establishing a system for fund raising in the international financial market. To cope with its balance of payments crisis in 1980, China obtained a stand-by credit of 450 million SDRs (\$552.8 million) and a trust fund of 309.5 million SDRs from the IMF in March 1981. Besides, it drew 218 million SDRs from its reserve tranche in the IMF in November 1980 and then, the remaining 150 million SDRs in January 1981. Funds China obtained from the IMF added up to 1,127.5 million SDRs (\$1,380 million), contributing largely to increasing that country's foreign exchange reserves. In 1978 and 1979, the reserves

dwindled to less than \$500 million. But the foreign currency holdings soared to \$2,260 million at the end of 1980, \$2,360 million at the end of March 1981, and \$3,810 million at the end of last June.

China is also expecting to get a total of \$1 billion in loans from the World Bank as well. Of the total, \$200 million for education will be supplied before long.

Beijing is also planning to gain large loans from the Asian Development Bank. These public loans are characterized by markedly low interests compared with the current high interest rates prevailing worldwide.

The average interest rates of the earlier-mentioned Japanese yen credit is also less than 6% a year. China is thus striving to keep interest rates as low as possible in obtaining foreign capital.

In addition to those loans of a public nature, China is assuming a positive attitude toward the introduction of private capital. China's contract for floating ¥10 billion worth of bonds for private placement under the management of Nomura Securities Co. will shortly get the approval of the Japanese Government. Besides, Fujian Province is preparing to issue ¥5 billion worth of yen-denominated bonds for private placement.

China reportedly has a policy of primarily issuing yen-denominated bonds bearing relatively low interest, since interest payments of U.S. dollars (Eurodollars)-denominated bonds would be too heavy for the current state of its economy. In the past, Beijing has followed a policy of making up for its foreign currency shortage by short-term borrowings in the Hong Kong money market. Such borrowing has rapidly intensified since early October 1981, according to local informed sources, indicating China's foreign exchange position is far from stable.

Economic "readjustment" geared to heavy industry has foreign capital induction and expanded technical cooperation with other countries as major pillars. Moreover, the successful discovery of promising reserves in offshore oil exploration projects in Bohai Bay has raised the possibility of restoring China's now-dwindling crude oil output to a great extent in the future. This is supposed to have strengthened the confidence of "energy faction" leaders and prompted them to demand a fresh policy shift.

Nonetheless, these facts alone can hardly be considered a decisive factor behind the total switch of emphasis in construction from light industry to heavy industry. The very moves of the Deng Xiaoping faction, aimed at accomplishing a process of seizing political power from the ouster of Hua Guofeng to the promotion of Vice Chairman Deng to the state chairmanship, must be regarded as decisive in the policy switchover.

Political power in China has no monolithic unity whatever. The influence of "Cultural Revolution" supporters centering on the leaders of the Liberation Army can never be ignored by the Deng Xiaoping faction, now eager to seize solid political power, because the former still control military power. There is no gain-saying that a shift from the denial to the approval of Maoist thought and a crack-down on art and literature, as witnessed recently, are due to pressure from the military. The change in the economic adjustment policy also forms part of such trend. The recent settlement of the plant contract cancellation problem, smoldering between China and Japan for some time, is, therefore, inseparable from the emergence of a new aspect in China's internal power struggle. ●