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EXTERNAL SHOCKS AND STRUCTURAL ADJUSTMENT
IN THE POST-REFORM CHINESE ECONOMY
— THE CASE OF THE 1986 OIL PRICE FALL

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by

Zhaoyang Peng

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The University of Adelaide

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ABSTRACT

This is a theoretical and empirical study of the structural adjustment to external shocks in the post-reform Chinese economy, focusing on the case of the 1986 oil price fall. Macroeconomic adjustment to the 1986 oil price shock was a crucial section in the path of China's economic development in the 1980s. Depending on how China was able to cope with the unfavourable external shocks, the transition of the economy under reforms could be imperiled or proceed as intended.

The significance of the 1986 oil price shock to China is highlighted in the beginning of the thesis. Oil exports are an important source of foreign exchange to China. In 1985, one quarter of China's total export revenues was generated by oil exports. The 60% fall of the world oil prices in 1986 caused substantial losses to the economy. More importantly, the shock arrived at a time when the economy was facing "structural contradiction" and "economic overheating". The shock reinforced both the structural and inflationary problems in the Chinese economy.

The adjustment is analysed in the theoretical framework of the booming sector model. The theory is applied to the case of a slump, in both real and monetary aspects. The study emphasises the institutional arrangements in the post-reform Chinese economy which alter the results of the standard theoretical model. The analysis shows that the 1986 oil price shock was transmitted to the Chinese economy mainly through a spending effect. The resource movement effect was small as the oil industry was an "enclave" under government protections.

The adjustment in the quantity-constrained Chinese economy was driven by government intervention. In an attempt to sterilise the effect of the slump, the government offset the spending effect through its fiscal deficit. But actions on other controlled variables, such as money supply and exchange rate depreciation

were inconsistent with the sterilisation policy. This made the adjustment more difficult.

To gain an understanding of the adjustment mechanisms in the Chinese model, the study moves to assess the effects of market oriented economic reforms on resource allocation in the Chinese economy, which cover not only the reforms' qualitative impact on economic agents, but also the quantitative significance of the markets. The results show that the evolution of the "two-tier price system" and the expanding role of markets in the allocation of resources greatly improved the flexibility of the economy.

Building on this foundation, a computable general equilibrium model is developed using a market price input-output table as the data base. The specifications of the model captures the "stylised facts" in the Chinese economy, and is specially adapted to reflect the booming sector phenomena considered in the study.

The model is used to provide some insights in the adjustment of the Chinese economy to the 1986 oil price shock. The results of the model are consistent with the booming sector theory. Policy responses are simulated which show that an appropriate combination of real absorption manipulation, exchange rate depreciation and a cut in money supply are the preferred policy options to achieve the structural adjustment in the Chinese economy after the 1986 oil price shock.