Office Memorandum

Confidential

TO : The Managing Director
The Deputy Managing Director

DATE: December 20, 1974

FROM : Andreas Abadjis (A.A.)

SUBJECT : Republic of China - Article XIV Consultation Discussions

A staff team comprising Messrs. W.G.L. Evers, J.B. Stepanek, B.C. Stuart, and myself visited Taipei from December 2-13, for the 1974 Article XIV Consultation discussions. The Chinese delegation was headed by Mr. S.Y. Wang, Vice Minister of Finance. The mission also had discussions with the Minister of Finance and the Governor of the Central Bank of China.

As a result of the sluggish world demand for its principal exports, such as textiles, plywood, and electrical and electronic goods and components, the economy of the Republic of China is expected to show practically no growth in the second half of this year; for the full year, real GNP is expected to grow by 3.3 per cent, compared with an increase of 11.9 per cent in 1973. Export industries have been burdened with excessive inventories of imported raw materials and exportable goods, and continuing layoffs have created an unemployment problem. Preliminary estimates indicate a reversal in the trade balance from a US$766 million surplus in 1973 to a US$800 million deficit in 1974. However, as a result of a much larger net inflow of capital, especially short-term capital, the overall balance of payments deficit is expected to be less than US$100 million this year.

In view of the foregoing difficulties, and following the recommendation of a group of Chinese professors, certain members of the Economic Committee of the Cabinet (e.g., the Minister of Finance) were in favor of floating the New Taiwan dollar. The press had given publicity to this recommendation, and upon the mission's arrival it was reported that the exchange rate would be the main topic of our discussions. However, following the depreciation of the Korean won, the Government did not take similar action, but adopted a wait-and-see attitude, apparently at the insistence of the Governor of the Central Bank. The Minister of Finance explained that they were under strong pressure to depreciate the currency since both countries competed in the same markets, and the competitiveness of the Chinese exports had been eroded by the sharp price and wage increases in 1973 and the opening months of 1974. The Minister said that the authorities were in close contact with the business community and were following the effects of the Korean action on the Chinese export industries and unemployment, and that in a month or so the Government would reappraise the appropriateness of the exchange rate of the New Taiwan dollar. He mentioned that cases had already been reported to him of foreign buyers asking Chinese exporters to lower their prices by 10 per cent or lose orders to their Korean competitors. I indicated that the decision taken was the right one, since the Chinese economy had achieved a large measure of price stability in recent months which could have been jeopardized by a devaluation: the consumer price index had increased by 2.5 per cent during eight months to October 1974, although, compared with October 1973, it was 35 per cent higher. I explained the circumstances which led to the depreciation of the won, and the fact that Korea was making substantial adjustments in the prices of petroleum products, electricity and transportation which would result in higher costs and prices; if China could maintain a relatively stable cost/price structure, especially in view of the easing of the pressure for large wage increases, the competitive edge that Korea had gained could diminish or disappear. I also discussed briefly the guidelines for floating and the possibility of an appreciation of the New Taiwan dollar thereunder, as happened in the case of the Hong Kong dollar, and certain other disadvantages that a floating rate might have for China.

On November 15, 1974, an "anti-slump" program was announced by the Government aimed at assisting the ailing export industries. It included expanded credit facilities to these industries and a reduction in the statutory reserve requirement against time and savings deposits. On December 10, further credit facilities for export industries were introduced, all bank interest rates were reduced by 0.5 per cent, and a number of minor financial incentives were given to export industries. We pointed out that although credit measures to help export industries were necessary, these could result in an appreciable expansion of total credit. Therefore, it was desirable to establish an overall credit ceiling to avoid excessive credit expansion; the ceiling should be in line with the expected growth of the economy, the balance of payments projections, price expectations and interest rate policy. Regarding fiscal policy, the budget presented to the Legislative Yuan was balanced; however, we expect that it will show a surplus, since revenues appear to have been underestimated.

The restrictions on short-term foreign borrowing by exporters and importers were substantially relaxed this year, and consequently the net inflow of short-term capital increased markedly; the inflow of direct investment and long-term capital also increased. In view of the low debt service burden, China is in a favorable position to incur additional foreign indebtedness to finance its current large infrastructure program, and for other purposes. However, the Minister of Finance pointed out that they had been effectively barred from using the resources of the IBRD and the Fund, and expressed concern regarding future access to Eximbank resources; China has been relying heavily on such resources for the financing of infrastructure and other projects.

During 1973, imports were substantially liberalized, and tariff rates were reduced both in that year and in 1974. However, the authorities indicated that in view of the difficulties experienced by domestic industries and the increase in unemployment, as well as the turnaround in the balance of payments, they had taken certain restrictive measures on imports. The importation of fully assembled cars was prohibited as were imports of color TV sets from Japan. In addition, the authorities introduced on November 15, 1974, a regulation providing that applications for licenses to import certain raw materials would be refused if locally produced goods were in excess supply and were being offered at prevailing international prices; no applications for licenses have been refused so far. Although sympathizing with the problems confronting the authorities, we explained the rationale of the Rome Communiqué, and pointed to the considerable protection that the adoption of the Voluntary Declaration concerning trade measures would provide to countries, like China, which rely heavily on exports. Regarding the Declaration, they said that they were studying the matter, and would in due course reply to the Managing Director's letter.

cc: ✓ETR
FAD
LEG
RES
TRE

Mr. Tun Thin
Mr. Ahrensdorf

INTERNATIONAL MONETARY FUND

November 20, 1974

Mr. Palmer:

Mr. Tun Thin has redrafted the covering memo and page 8 of the brief, and copies of each are attached. Please let me know if you have any comments so that I may send you the final version of the brief.

Attachment

A.A.

Andreas Abadjis

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: November 20, 1974

FROM : Tun Thin and Donald K. Palmer

SUBJECT : Republic of China - Briefing Paper for Article XIV Consultation

Attached is the briefing paper on China for your approval. It has been cleared with Messrs. Silard (LEG) and Miller (TRE). We would appreciate receiving your comments by the end of the day on November 26.

The brief has argued that on the basis of available information there is no immediate need for depreciation of the new Taiwan dollar. However, it is likely that China would react by proposing a depreciation in its exchange rate and/or a move to a floating rate system should the Korean won be depreciated later; Korea is a major competitor of China in the United States, Japan and other markets.

Attachment

REPUBLIC OF CHINA

Briefing Paper - 1974 Article XIV Consultation

Prepared by the Asian Department and the Exchange and Trade Relations Department

Approved by Tun Thin and Donald K. Palmer

November 20, 1974

I. Introduction

The 1974 Article XIV consultation discussions with China will be held in Taipei, from December 2 to December 13, 1974. The staff team will consist of Messrs. Andreas Abadjis (ASD) (head of mission), Willem G. L. Evers (ASD), Brian C. Stuart (ETR), James B. Stepanek (ASD), and a secretary.

II. Fund Relations with China

Quota:	SDR 550 million, of which SDR 59.9 million has been paid in gold.
Use of Fund Resources:	A gold tranche purchase was made on October 20, 1971.
Fund holdings of NT$:	100 per cent of quota.
Last Article XIV Consultation:	Staff discussions were held in April 1973 and the Executive Board Decision was taken on July 18, 1973. Decision No. 4013-(73/75) is attached to this paper.
SDR position:	China is a participant in the Special Drawing Account, but has opted not to receive allocations so far.
Par value, central and representative rates:	An initial par value of NT$ 40 per U.S. dollar was agreed with the Fund on September 4, 1970. On May 8, 1972, the par value was changed to NT$43.4286 per special drawing right, corresponding to NT$40 per US$1; on the same date, China availed itself of wider margins, Decision No. 3639-(72/42). On February 16, 1973, the Government established a central rate of NT$45.8413 per special drawing right, or NT$38 per US$1 (Decision No. 3875-(73/14), adopted February 17, 1973). The establishment of the central rate represented a depreciation of 5.26 per cent from the par value expressed in gold. The new Taiwan dollar has, since, been pegged to the U.S. dollar. The representative rate for Fund accounting in new Taiwan dollars is the midpoint of the buying and selling rates for the U.S. dollar as determined by the Central Bank of China.

Technical assistance:	Mr. Quinton, from the fiscal panel, assisted in the adoption of the brussels Tariff Nomenclature from May 1971 to November 1973. Mr. J.C. Duignan, from the fiscal panel, prepared a report on a value-added tax for the Republic of China in 1970 and visited Taipei in January 1974 to assist in the preparations for the introduction of the tax. A CBS mission visited Taipei during March 1974 to assist in the revision of the Central Banking Act.

III. Recent Economic Developments

The rate of growth of the economy accelerated in 1973. Real GNP increased by 12.3 per cent, compared with an average rate of growth of 11.4 per cent in the preceding three years, and an average rate of 9.5 per cent envisaged by the current Four-Year Economic Development Plan 1973-76. Per capita income at current prices increased by 20 per cent to US$446 in 1973. The population growth rate has been falling, and in 1973, for the first time, it was below 2 per cent. Preliminary estimates indicate that the rate of growth in real GDP will decline to about 8 per cent in 1974. Supply shortages, the decline in the world demand for the country's exports, and the high cost of agricultural and industrial materials, especially oil and related products would be the main factors responsible for the expected decline in the rate of growth.

As in other countries, inflation has become the principal problem confronting the authorities in Taiwan. Following a period of relative price stability, consumer prices increased by 30 per cent and wholesale prices by 40 per cent during 1973. Imported inflation was an important factor, but a strong expansion in domestic demand financed by a marked increase in credit also contributed to the price inflation. In 1973, the authorities took a number of measures to counter inflation, including increases in interest rates, the issuing, for the first time, of Treasury bills to reduce the liquidity of the banking system, and considerable tariff reductions and relaxation of import restrictions. In January 1974, the Government announced that in order to break the inflationary psychology it would permit "once for all" large price increases with the intention of subsequently stabilizing them at a higher level. Government subsidies on petroleum products, steel bars, soybeans and other key commodities were removed, and prices and rates of public utilities and other Government goods and services were increased. At the same time, Central Bank and commercial bank loan interest rates and rates on commercial bank deposits were increased by 3-4 percentage points to a range of 14.0-17.5 per cent lending rates and 10-15 per cent for deposit rates. Prices increased by 29 per cent during the first three months of 1974 but have tended to stabilize thereafter. The consumer price index in July 1974 was about 50 per cent higher than in July 1973. Additional tariff reductions were introduced in October 1974. Wage increases accelerated: in 1973, the manufacturing wage index was, on the average, 22 per cent higher than in 1972, and in May 1974, it was 44 per cent higher than the 1973 average.

Little information is available on the 1973/74 (July 1-June 30) and 1974/75 budgets, because they are not published. Money supply increased at a more rapid rate in 1973 (47 per cent) than in 1972 (35 per cent) and 1971 (19 per cent). This increase was associated principally with the large expansion in credit to the private and public enterprise sector (45 per cent), and also with the increase in net foreign assets (22 per cent). On the other hand, net credit to Government declined substantially in 1973. Quasi-money rose at a lower rate (22 per cent) in 1973 than in 1972 (32 per cent), possibly because of the decline in real rates of interest and a shift in liquidity preference. During the first eight months of 1974, money supply decreased by 3 per cent. Net foreign assets recorded a decline equivalent to 11 per cent of money supply at the end of 1973. Credit to the private sector and public enterprises rose by 26 per cent compared with a 32 per cent increase during the first eight months of 1973, but the decline in net credit to Government was approximately one half of the decline during the same period in 1973. The rate of increase in quasi-money (23 per cent) was approximately the same as in the first eight months of 1973.

During 1973, China's balance of payments continued its strong performance of earlier years: the fifth consecutive surplus was registered amounting to SDR 323 million. Export earnings increased sharply by 51 per cent and, although import payments increased at an even higher rate, the net result was a further improvement in the trade balance. Exports to the United States and Japan accounted for 38 and 19 per cent, respectively, of total exports while imports from these countries accounted for 25 and 38 per cent, respectively, of total imports. Despite substantial increases in receipts from long-term loans and direct investment, the capital account showed a deficit during 1973 owing to a large increase in short-term export financing.

During the first six months of 1974, China's balance of payments moved into deficit, owing mainly to a large rise in imports; exports were 56 per cent higher than in the first half of 1973. The trade balance showed a deficit of US$262 million, in contrast to a surplus of US$357 million during the first six months of 1973. The capital account showed a surplus during the first half of 1974 owing to a reflow of short-term capital as well as to a rise in receipts from long-term loans. The balance of payments showed an overall deficit of US$271 million, in contrast to a surplus of US$323 million in the first half of 1973.

Imports of crude oil increased from 3.4 million tons in 1971 to 11.2 million tons in 1972, partly in order to build up stocks. In 1973, they declined to 5.4 million tons, but increased again to 10.7 million tons during the first six months of 1974.

Gross official international reserves increased by SDR 70 million during 1973, and by SDR 42 million during the first eight months of 1974. At the end of August 1974, they amounted to SDR 978 million, equal to about two months of imports.

The exchange and trade control systems continue to involve restrictions. However, since 1970, imports have been gradually liberalized by shifting commodities from the controlled to the permissible list. In March 1973, 2,000 items were added to the permissible list, which now includes some 15,000 items versus 460 on the controlled list. In July 1974, imports of automobiles and color TV sets from Japan were suspended while the number of color TV sets imported from the United States and Europe was restricted. Since February 1973, China's trade-weighted effective exchange rate has appreciated by about 3 per cent. During 1974, the effective exchange rate has remained relatively stable. At the end of October the rate was virtually unchanged from the May 1971 level.

IV. Topics for Discussion

In 1973, the Chinese economy recorded again a rapid rate of growth, but, in contrast to previous experience, it was accompanied by a sharp rise in prices which continued during the opening months of 1974. The balance of payments showed an overall deficit during the first half of 1974, and the rate of growth of real GNP is estimated at about two thirds of that in 1973, owing principally to the adverse impact of the slowdown in world economic activity on China's export industries.

Currently, inflation is the most important problem confronting the authorities. In an economy as open as the Chinese economy where both exports and imports of goods and services exceed 50 per cent of GNP, external factors have a marked influence on price developments. However, the large credit expansion has contributed to demand pressures. The staff team will review the measures taken so far to curb inflation; following the upsurge at the beginning of 1974, prices have declined slightly. The staff will inquire about price prospects and the future role of fiscal and credit policies in relation to the Government's balance of payments and growth objectives. Recent developments in time and savings deposits and interest rate policy will be examined, and developments in the long-term capital market will be assessed.

The Government has recently announced a program for large capital expenditures on infrastructure, the development of which had not kept pace with industrial expansion. The adoption of this program may also be related to the recent decline in economic growth and the deterioration in export prospects. The staff team will inquire whether the objectives of the Four-Year Development Plan (1973-76) have been amended, especially with regard to the role that had been assigned to exports of providing the main impetus to economic growth; the implications of such a change for the balance of payments prospects will be discussed.

The reasons for the reversal of the trade balance from a surplus to a deficit in the first half of this year will be examined. Recent developments and prospects for Taiwan's exports of manufactured goods, including textiles, will be assessed in the context of the recessionary trends in the country's major markets, and the restrictions placed on certain Chinese exports in these markets. The factors behind the sharp increase in imports in the first half of 1974, and import prospects for 1975 will be discussed; import liberalization measures taken in 1973 were, of course, one of the factors behind the large increase in imports. The staff team will request information about any recent foreign borrowings, as well as any special arrangements made for financing oil imports. The outlook for foreign investment will be discussed, and, more generally, the overall balance of payments prospects for 1975 will be assessed. The mission will also obtain latest data on outstanding external debt and the debt profile.

China's prorated maximum access to the oil facility amounts to SDR 272.95 million under Option D (SM/74/220, Table 5). In view of the deteriorating balance of payments position, the Chinese authorities may raise the question of using the Fund's oil facility. The staff team will, of course, have to examine whether a balance of payments need exists, on the basis of more recent data; the latest data show that gross international reserves had actually increased during the first eight months of 1974. However, in the case of China, there is another consideration that should be taken into account, viz., that a request for a purchase under the oil facility may raise broader issues in the Board discussion of such a request, and the mission should point this out to the authorities.

Since February 1973 when the new Taiwan dollar depreciated by 5.26 per cent in terms of gold, the trade-weighted effective exchange rate has appreciated by 3 per cent. At the request of the Government, Chinese professors of economics in U.S. universities made a study last summer in which they recommended that the new Taiwan dollar should be allowed to float in order to improve the trade balance. The staff feels that in the case of China where speculative capital flows are not important, floating the rate may not be an appropriate solution. Although there was a sharp deterioration in the trade balance in the first half of this year, this was due principally to a sharp increase in imports reflecting partly restocking in various commodities including oil. Exports of manufactured goods, such as textiles and plywood, have been encountering difficulties, owing mainly to the slowdown in the world demand for such products; the prospects in this regard are, of course, unclear. The extent to which China can borrow abroad next year is uncertain, but its low debt service ratio at present suggests that it may be able to do so at an adequate scale. On the basis of available information, the staff believes that there is no immediate need for depreciating the exchange rate, but will, of course, examine recent balance of payments developments and prospects, and adjustment policies with the Chinese authorities. The staff team will also explain to the Chinese authorities the implications of the guidelines for floating.

China continues to maintain comprehensive exchange and trade controls, some of which are applied restrictively. Although a substantial liberalization of imports was implemented in 1973, 463 items, or 3 per cent by number, still remain on the controlled list. In July 1974, imports of automobiles and color TV sets from Japan were suspended, and imports of color TV sets from the United States and Europe were restricted. The staff team will inquire about the reasons and nature of these restrictions, and will draw the attention of the authorities to the importance of avoiding measures to restrict trade and current payments in meeting the balance of payments problem. The staff team will examine existing exchange and trade restrictions and their implementation, and will explore the scope for liberalization. The authorities' positive response to the "Voluntary Declaration on Trade Measures" contained in the C-20 Communique of June 13, 1974, will be encouraged.

INTERNATIONAL MONETARY FUND

China - 1973 Article XIV Consultation

Executive Board Decision - July 18, 1973

1. This decision is taken by the Executive Directors in concluding the 1973 consultation with the Republic of China pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. During 1972 economic growth continued at a high rate. Since about mid-1972 price increases tended to accelerate and toward the end of the year became a matter of concern. Both cost-push factors related mainly to external developments and demand pull factors due to substantial monetary expansion generated in large part by the external sector played a role. The Fund welcomes the authorities' efforts to restrain the growth of liquidity, including the more active use of debt management and monetary policy and to take other measures to curb price increases, and recommends further strengthening of such policies.

3. The balance of payments strengthened further in 1972 with a growing current account surplus and some revival of net capital inflow, and exports and imports significantly exceeded expectations. Developments in the first part of 1973 suggest a continuation of these trends. Some of the policies adopted recently should have some countervailing effects. The Fund welcomes the authorities' continuing intention to adapt policies in the light of changing circumstances.

4. Both internal and external developments facilitated the recent substantial liberalization of restrictions on imports and some relaxation of restrictions on current payments. The Fund believes there still remains scope for moves in this direction, and that further liberalization would be conducive to achievement of internal and external policy objectives.

Mr. Abadjis November 18, 1974

Donald K. Palmer

China - Consultation Briefing Paper

I have two comments to make on the briefing paper, both relating to page 8.

1. In discussing possible use of the oil facility, you appear to refer to a decline of net international reserves in the first half of 1974. However, the criterion for use of the oil facility is gross international reserves. On the basis of the fact that gross international reserves rose by SDR 42 million during the first 8 months of 1974 (page 5), China would not qualify for the use of the oil facility.

2. Perhaps unintentionally, the briefing paper gives the impression that the staff has no position as to the preferred form of the exchange rate system. While, in present circumstances, the staff might have to go along with a floating exchange rate system, if one were introduced, I would still think it would be our preference that the Chinese continue with the existing system. If there is agreement on this view, I think the briefing paper should reflect it.

cc: Mr. Evans

Mr. Palmer

November 16, 1974

MEMORANDUM

Comments by me 11/18

To: ETR
FAD
LEG
TRE

From: Andreas Abadjis A.A.

Subject: China - Briefing Paper for Article XIV Consultation

May we please have your comments by Tuesday, November 19, at 4.30 p.m.

Attachment

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Exchange and Trade Relations Department

Approved by Tun Thin and Donald K. Palmer

November , 1974

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Technical Assistance: Mr. Quinton, from the fiscal panel, assisted in the adoption of the Brussels Tariff Nomenclature from May 1971 to November 1973. Mr. J. C. Duignan, from the fiscal panel, prepared a report on a value-added tax for the Republic of China in 1970 and visited Taipei in January 1974 to assist in the preparations for the introduction of the tax. A CBS mission visited Taipei during March 1974 to assist in the revision of the Central Banking Act.

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As in other countries, inflation has become the principal problem confronting the authorities in Taiwan. Following a period of relative price stability, consumer prices increased by 30 per cent and wholesale prices by 40 per cent during 1973. Imported inflation was an important factor, but a strong expansion in domestic demand financed by a marked increase in credit also contributed to the price inflation. The authorities took a number of measures to counter inflation. Short-term foreign borrowing was restricted in April 1973 and the reserve requirement on savings deposits was increased in July of that year. Increases totaling 4.0-5.5 percentage points in interest rates on loans of the Central Bank and loans and deposits of commercial banks were introduced in July and October. Savings certificates and Treasury bills were issued for the first time to reduce liquidity of the banking system. In April 1973, a price freeze was imposed on government enterprises, and subsidies for certain essential commodities were introduced. In addition, export controls on certain products in short supply were announced in September and October. Imports of many products were liberalized in March of 1973, and country of origin restrictions for many products were dropped during the second half of the year. Tariff reductions of up to 50 per cent for certain foodstuffs and raw materials were effected at various times throughout the year. In January 1974, the Government announced that in order to break the inflationary psychology it would permit "once for all" large price increases with the intention of subsequently stabilizing them at a higher level. Government subsidies on petroleum products, steel bars, soybeans and other key commodities were removed, and prices and rates of public utilities and other Government goods and services were increased. At the same time, Central Bank and commercial bank loan interest rates and rates on commercial bank deposits were increased by 3-4 percentage points. Prices increased by 29 per cent during the first three months of 1974 but have tended to stabilize thereafter. The consumer price index in July 1974 was about 50 per cent higher than in July 1973. Additional tariff reductions were introduced in October 1974. Wage increases accelerated: in 1973, the manufacturing wage index was, on the average, 22 per cent higher than in 1972, and in May 1974, it was 44 per cent higher than the 1973 average.

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During 1973, China's balance of payments continued its strong performance of earlier years: the fifth consecutive surplus was registered amounting to SDR 323 million. Export earnings increased sharply by 51 per cent and, although import payments increased at an even higher rate, the net result was a further improvement in the trade balance. Exports to the United States and Japan accounted for 38 and 19 per cent, respectively, of total exports while imports from these countries accounted for 25 and 38 per cent, respectively, of total imports. The trade surplus with the United States increased by SDR 188 million to SDR 603 million in 1973, while the trade deficit with Japan declined by SDR 111 million to SDR 511 million in 1973. Despite substantial increases in receipts from long-term loans and direct investment, the capital account showed a deficit during 1973 owing to a large increase in short-term export financing.

During the first six months of 1974, China's balance of payments moved into deficit, owing mainly to a large rise in imports; exports were 56 per cent higher than in the first half of 1973. The trade balance showed a deficit of US$262 million, in contrast to a surplus of US$357 million during the first six months of 1973. The capital account showed a surplus during the first half of 1974 owing to a reflow of short-term capital as well as to a rise in receipts from long-term loans. The balance of payments showed an overall deficit of US$271 million, in contrast to a surplus of US$323 million in the first half of 1973.

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15,000 items versus 460 on the controlled list. In July 1974, imports of automobiles and color TV sets from Japan were suspended while the number of color TV sets imported from the United States and Europe was restricted. Since February 1973, China's trade-weighted effective exchange rate has appreciated by about 3 per cent. During 1974, the effective exchange rate has remained relatively stable. At the end of October the rate was virtually unchanged from the May 1971 level.

IV. Topics for Discussion

In 1973, the Chinese economy recorded again a rapid rate of growth, but, in contrast to previous experience, it was accompanied by a sharp rise in prices which continued during the opening months of 1974. The balance of payments showed an overall deficit during the first half of 1974, and the rate of growth of real GNP is estimated at about two thirds of that in 1973, owing principally to the adverse impact of the slowdown in world economic activity on China's export industries. 8%?

Currently, inflation is the most important problem confronting the authorities. In an economy as open as the Chinese economy where both exports and imports of goods and services exceed 50 per cent of GNP, external factors have a marked influence on price developments. However, the large credit expansion has contributed to demand pressures. The staff team will review the measures taken so far to curb inflation; the credit measures have been successful in slowing down the rate of credit expansion, and, following the upsurge at the beginning of 1974, prices have declined slightly. The staff will inquire about price prospects and the future role of fiscal and credit policies in relation to the Government's balance of payments and growth objectives. Recent developments in time and savings deposits and interest rate policy will be examined, and developments in the long-term capital market will be assessed.

The Government has recently announced a program for large capital expenditures on infrastructure, the development of which had not kept pace with industrial expansion. The adoption of this program may also be related to the recent decline in economic growth and the deterioration in export prospects. The staff team will inquire whether the objectives of the Four-Year Development Plan (1973-76) have been amended, especially with regard to the role that had been assigned to exports of providing the main impetus to economic growth; the implications of such a change for the balance of payments prospects will be discussed.

The reasons for the reversal of the trade balance from a surplus to a deficit in the first half of this year will be examined. Recent developments and prospects for Taiwan's exports of manufactured goods, including textiles, will be assessed in the context of the recessionary trends in the country's major markets, and the restrictions placed on certain Chinese exports in these markets. The factors behind the sharp increase in imports in the first half of 1974, and import prospects for 1975 will be discussed; import liberalization measures taken in 1973 were, of course, one of the factors behind the large increase in imports. The staff team will request information about any recent foreign borrowings, as well as any special arrangements made for financing oil imports. The outlook for foreign investment will be discussed, and, more generally, the overall balance of payments prospects for 1975 will be assessed. The mission will also obtain latest data on outstanding external debt and the debt profile.

China's prorated maximum access to the oil facility amounts to SDR 272.95 million under Option D (SM/74/220, Table 5). Although balance of payments projections for 1974 are not available, there was an overall deficit of US$271 million in the first half of the year. In view of this and the uncertain export outlook, the Chinese authorities may bring up the question of using the Fund's oil facility in their discussions with the mission. Besides the question of balance of payments need which the staff could examine, in the case of China, a request for a purchase under the oil facility may raise broader issues in the Board discussion of such a request. Therefore, the mission should point out these considerations to the authorities.

[illegible]

At the request of the Government, Chinese professors of economics in U.S. universities made a study last summer in which they recommended, inter alia, that the new Taiwan dollar should be allowed to float. Recent newspaper reports indicate that the authorities are considering implementing this recommendation. The study stated that floating would have a favorable effect on the trade balance, would guard against present uncertainties regarding other currencies in the area, and would reduce fluctuations in the external balance and hence facilitate the management of domestic liquidity.

If the Chinese authorities indicate that they wish to introduce a floating exchange rate system, the staff team would state that, from the beginning, the rate should be allowed to float freely, and that Central Bank intervention should essentially be limited to smoothing out erratic fluctuations

shouldn't we argue for keeping a peg

in the rate and to guiding the rate within a range which would be consonant with balance of payments viability and reserve objectives discussed with the Fund. The staff team will also point out that the system will be subject to Fund surveillance in terms of the guidelines for floating, and that this would involve frequent consultations between the Fund and the authorities in implementing the guidelines; also that the trade-weighted effective rate of exchange should be the relevant measure for evaluating the exchange rate movements from month to month and quarter to quarter.

China continues to maintain comprehensive exchange and trade controls, some of which are applied restrictively. Although a substantial liberalization of imports was implemented in 1973, 463 items, or 3 per cent by number, still remain on the controlled list. In July 1974, imports of automobiles and color TV sets from Japan were suspended, and imports of color TV sets from the United States and Europe were restricted. The staff team will inquire about the reasons and nature of these restrictions, and will draw the attention of the authorities to the importance of avoiding measures to restrict trade and current payments in meeting the balance of payments problem. The staff team will examine existing exchange and trade restrictions and their implementation, and will explore the scope for liberalization. The authorities' response to the "Voluntary Declaration on Trade Measures" contained in the C-20 Communique of June 13, 1974, will be sought.

V. Proposed Decision

The following draft decision is submitted for consideration by the Executive Directors:

1. This decision is taken by the Executive Directors in concluding the 1973 consultation with the Republic of China pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. During 1972 economic growth continued at a high rate. Since about mid-1972 price increases tended to accelerate and toward the end of the year became a matter of concern. Both cost-push factors related mainly to external developments and demand pull factors due to substantial monetary expansion generated in large part by the external sector played a role. The Fund welcomes the authorities' efforts to restrain the growth of liquidity, including the more active use of debt management and monetary policy and to take other measures to curb price increases, and recommends further strengthening of such policies.

3. The balance of payments strengthened further in 1972 with a growing current account surplus and some revival of net capital inflow, and exports and imports significantly exceeded expectations. Developments in the first part of 1973 suggest a continuation of these trends. Some of the policies adopted recently should have some countervailing effects. The Fund welcomes the authorities' continuing intention to adapt policies in the light of changing circumstances.

4. Both internal and external developments facilitated the recent substantial liberalization of restrictions on imports and some relaxation of restrictions on current payments. The Fund believes there still remains scope for moves in this direction, and that further liberalization would be conducive to achievement of internal and external policy objectives.

<u>China: Factors Relating to the Exchange Rate</u>

1. Net foreign assets of the banking system increased by US$342 million. in 1973 During the first nine months of 1974 they declined by US$224 million. At the end of September they amounted to US$1,653 billion. Official reserves, as recorded in IFS, increased by US$84 million in 1973 and by a further US$51 million during the first eight months of 1974. Movements in official reserves are not compatable with changes in net foreign assets of the banking system; there is a long-standing discrepancy between official reserves as reported to IFS in US dollars, and the net reserves in new Taiwan dollars of the Central Bank.

2. The trade balance moved from a surplus of US$587 million in 1973 to a deficit of US$589 million during the first six months of 1974. During the first ten months of 1973 the trade deficit amounted ot US$1,105 million. The deterioration in the trade balance resulted from the fact that import payments rose faster than export receipts. Import prices during the first six months of 1974 were 33 per cent higher than in 1973 whereas export prices increased by 28 per cent. The terms of trade declined by 4 per cent between 1973 and the first half of 1974. The most important factor responsible for the reversal of the trade balance was, however, the fast increase in import volume while the export volume tended to stagnate. The import volume index rose by 31 per cent between 1973 and the first six months of 1974 while the export volume index declined by 1 per cent. The sharp increase in imports payments for the first ten months of 1974 indicate a continuation in the increase in volume. Import payments during this period were 98 per cent higher than compared with the same period in 1973. Export earnings, by contrast, rose only by 36 per cent. Part of the increase in import payments between 1973 and 1974 is due to higher volume

and prices of oil imports. The volume of oil imports amounted to 10.7 million tons during the first six months of 1974 as against 5.4 million tons for all of 1973. Payments for oil imports amounted ot US$352 million or 11.9 per cent of total imports payments during the first six months of 1974 as against US$99 million or 2.6 per cent of total import payments during 1973.

3. The appreciation in the trade weighted exchange rate of about 3 per cent since February 1973 can hardly be held responsible for the deterioration in the trade balance, particularly as the appreciation of this rate took a more permanent character only after May 1974. During the same period, i.e., since February 1973, Japan's trade weighted exchange rate depreciated by about 11 per cent while Korea's trade weighted exchange rate appreciated by about 3 per cent. Imports to Japan during the first ten months of 1974 comprised 19 per cent of total exports, i.e., the same percentage as in 1973. Imports from Japan declined from 38 per cent of the total to 33 per cent. Exports to the United States, China's most important trading partner declined from 38 per cent to 33 per cent of the total; imports from the United States remained unchanged at 25 per cent.

4. One factor that may have had an important impact on the deterioration of the trade balance is a possible reversal of the stock cycle. National accounts data show a decline in stocks of US$82 million in 1972 and of US$41 million in 1973. During the first six months of 1974, raw materials accounted for 61 per cent of total imports and capital goods for another 33 per cent.

5. Traditionally, export growth has been the most important contributing factor to overall economic growth and investments in export industries have been relatively more important than investments in infrastructure. Inadequate infrastructure facilities have recently become a bottleneck for further growth

In early 1974 the authorities announced a major program of infrastructural investments invisaging expenditures of US$1.9 billion. The shift in the investment pattern toward more infrastructural projects may have had some detrimental effect on the balance of trade. This effect is likely to be more pronounced in 1975 than it was in 1974. These investments may, in the short run, hamper export growth and require an increase in imports. The effect on the balance of payments could be offset by an increase in savings or, more likely, by an increase in long term foreign borrowings. The low debt service ratio (about 5 per cent) would indicate that such additional foreign borrowing is feasible.

6. Net domestic credit increased by 25.1 per cent during the first eight months of 1975, as against 22.3 per cent during the similar period in 1974. These rates of credit expansion appear inconsistent with the delicate balance of payments position and the decline in growth during 1974. However, to some extent, these figures should also be judged against the increase in prices particularly of imported commodities, as well as changes in stocks.

Conclusions

On the basis of the developments mentioned above, it would appear that the major emphasis for balance of payments adjustments would have to fall on internal policies and that there is little prima facie evidence for a major change in the exchange rate. However, the balance of payments outlook for 1975, on which little is known at present, may warrant some modification of this judgment. While a major change in the rate would thus seem immature at present, the Chinese authorities may want to float the new Taiwan dollar because of uncertainties with regard to other currencies in the area.

Table . China: Foreign Trade Jan.-Oct. 1974

(In millions of U.S. dollars)

		In Per cent
Industrial products	4,039.7	85.4
Processed agricultural products	450.1	9.5
Agricultural products	241.0	5.1
Total exports	4,730.8	100
Raw materials	3,588.2	61.5
Capital goods	1,901.5	32.6
Consumer goods	346.4	5.9
Total imports	5,836.1	100
United States	1,708.7	36
Japan	921.5	19
Other	2,100.6	45
Total exports	4,730.8	100
United States	1,472.6	25
Japan	1,916.3	33
Other	2,447.2	42
Total imports	5,836.1	100

China. Trade Balance

	1973	January-October 1973	January-October 1974
Exports	4,405	3,473	4,731
Imports	3,818	2,951	5,836
Trade balance	587	522	-1,105

REPUBLIC OF CHINA

Briefing Paper - 1973 Article XIV Consultation

Prepared by the Asian Department and the Exchange and Trade Relations Department

Approved by Tun Thin and Donald K. Palmer

March , 1973

I. Introduction

The 1973 Article XIV staff consultation discussions with China will be held in Taipei, Taiwan, from April 11 to April 20, 1973. The staff team will consist of Messrs. Joachim Ahrensdorf (head of mission), John B. McLenaghan, Mrs. Hui-Chen Wu Yang, and a secretary. Two members and secretary of the team will arrive in Taipei on April 8, 1973 to initiate the work.

II. Fund Relations with China

Quota:	SDR 550 million; of this SDR 59.9 million has been paid in gold.
Use of Fund Resources:	A gold tranche purchase was made on October 20, 1971.
Fund holdings of NT$:	100 per cent of quota.
Last Article XIV Consultation:	Staff discussions held in March 1972 and Executive Board Decision taken in June 1972, Decision No. 3679-(72/53).
SDR position:	No allocation was made.
Par value and central rate:	An initial par value of NT$40 per U.S. dollar was agreed with the Fund on September 4, 1970. On May 8, 1972, the par value was changed to NT$43.4286 per special drawing right and corresponded to NT$40 per US$1. At the same time, China availed itself of wider margins, Decision No. 3639-(72/42). On February 16, 1973, the Government established a central rate of NT$45.8413 per special drawing right, or NT$38 per U.S. dollar. Decision No. 3875-(73/14, February 17, 1973).

Technical assistance:	Mr. S. G. Quinton from the fiscal panel was assigned for a term of one year to assist the Chinese Customs in the adoption of the Brussels Tariff Nomenclature, beginning in May 1971. His services have been extended for another term of one year with effect from May 4, 1972.

III. Recent Economic Developments

In 1972, the economy continued its rapid growth of recent years. Preliminary estimates show that GNP in constant prices rose by 11.0 per cent compared with an average annual growth rate of 10.4 per cent in the preceding three years. Per capita income in current prices is estimated to have increased from the equivalent of US$329 in 1971 to US$372 in 1972. The targets set in the Fifth Four-Year Economic Development Plan (1969-72) were either met or surpassed. In January 1973, the Government launched the Sixth Four-Year Economic Development Plan (1973-76) which envisages that real GNP will grow at an annual rate of slightly above 9.0 per cent during the Plan period.

Money supply increased by 33 per cent in 1972, considerably higher than the average annual rate of increase in 1967-71. The rapid increase in the net foreign assets of the banking system and the continued expansion of bank credit to the private sector were the main factors responsible for the rapid monetary expansion in 1972. These expansionary forces were offset to a large extent by a rapid increase in time and savings deposits and a considerable decline in net bank credit to the public sector reflecting improved budgetary performance of the Government. The price rise in 1972 was the highest in recent years; wholesale and consumer prices rose by 7 per cent and 4 per cent, respectively, due partly to higher costs of imported goods. In January 1973, money supply rose by nearly 10 per cent, while wholesale prices rose by another 4 per cent.

The overall balance of payments which registered substantial surpluses in 1970 and 1971 is estimated to have recorded a surplus of the order of $200 million in 1972. Exports increased by 46 per cent and imports increased by 43 per cent, and as a result, there was a further substantial increase in the trade surplus. Exports to the United States and Japan accounted for 41 per cent and 13 per cent, respectively, of total exports. The shares of these countries in imports were 29 per cent and 38 per cent, respectively. The trade surplus with the United States increased to $450 million in 1972 while the trade deficit with Japan increased to $675 million in 1972 (on exchange settlement basis). Based on data for the first half of 1972 (latest available), net direct investment was somewhat higher than in the corresponding period of 1971, while there was a sharp increase in private short-term capital, mainly trade credits. Capital inflow (net) on account of the government sector was insignificant in both periods.

Official holdings of international reserves totaled $738 million at the end of 1972, of which $87 million was in gold and $651 million in foreign exchange. They increased by $212 million during the year. The foreign exchange holdings were equal to about three-months imports at the level of 1972.

The exchange and trade control systems continue to involve some restrictions. Beginning in mid-1970, the authorities embarked on a major import liberalization program which envisaged gradual shifting of a large number of commodities from the controlled list to the permissible list. An automatic approval system was introduced, and a general licensing system was established for imports by large manufacturers and other direct users. From September 1972, imports from Japan were limited to $20,000 per order while imports from sources other than Japan were eased and facilitated considerably. Additional measures to liberalize imports have just been announced,

IV. Issues for Discussion

1972 was another year of sustained economic growth attended by the third successive, sizable surplus in the balance of payments. This outcome, however, was not without some offsets on the domestic side in the form of increasing difficulty in containing the liquidity creating effects of the rise of foreign assets and a rapid expansion in domestic credit, and a sharp upturn in the rate of price increase. In the context of reviewing with the authorities their internal and external policy objectives over the short- to medium-term, the staff team will direct its attention to the following specific issues.

1. The sixth Four-Year Economic Development Plan which was launched recently provided the overall growth objectives over the period 1973-76. The Plan envisages an annual rate of growth in GNP of approximately 9.0 to 9.5 per cent over the next four years, a rate that is somewhat less than that achieved during the previous Plan. The Plan, not yet available to the staff in full seems to opt for a continuation of seek ~~to~~ continue the successful development strategy adopted in the preceding Plan, with continued emphasis on the growth of export oriented manufacturing industries. The staff team will explore whether adaptations are being made in the Plan, as well as for the long-range plan, in the light of developments since their formulation. It will try to assess if the targets seem feasible and to what extent adaptations may be warranted. This assessment will focus in particular on the balance of payments objectives.

2. While the overall fiscal performance has been sound in recent years, the growth in banking system credit to the private sector, which has averaged 23 per cent a year for the past five years, coupled with rising

external surpluses since 1969, has produced increasingly large additions to the money supply. This pattern was repeated in 1972 despite a decline in credit to the public sector and despite the assistance of leakages from the system through transfers of time deposits to the Central Bank. At the same time, after many years of modest price increases, there was a marked deterioration in price performance in the twelve-month period ~~year~~ ended January 1973 partly as certain cost-push factors, e.g. increasing international prices of primary products and the yen revaluation, exerted additional pressures on prices; on the other hand liquid asset holdings ~~liquidity ratios for the economy~~ continued to increase ~~decline~~. These developments indicate the need for a critical review of credit and other policies and their application~~s~~, and the possible need for more effective policy instruments. Progress and plans for adaptations in fiscal policies will be reviewed. The long-term objective of lowering interest rates will be examined in the context of its appropriateness for short-term policy objectives. In addition, the staff team will discuss the operation of the securities market, as well as the development of the long-term capital market and the degree of specialization among financial intermediaries.

3. The balance of payments recorded another impressive surplus in 1972. Despite an adverse movement in the terms of trade, the trade surplus rose by 34 per cent compared with the previous year while net capital inflow appears to have increased compared with the previous year when there was a marked decline. These developments occurred despite ~~the~~ adverse influences of the revaluation of the yen in December 1971, and the less favorable climate for inward foreign investment during 1972.

The staff team will assess the balance of payments prospects against the background of the recent change in the relationship between the new Taiwan dollar and the currencies of China's major trading partners, the influences of commercial policy in China and of restrictions on Chinese
outlook
goods in important export markets, and the climate for foreign investment.

4. There were important developments in 1972 with respect to China's economic relations with Japan, particularly the limitation placed on the size of individual import orders from that country as a means of reducing China's chronic trade deficit with Japan. With respect to official borrowing from Japan, the Chinese authorities have announced that they will make no further borrowings. The staff team will assess the scope for diversification of imports and the impact on the internal cost structure of alternative sources of supply of raw materials and intermediate goods, especially in view of the increasing price competition being experienced by Chinese manufactures in markets abroad.

5. China has long maintained comprehensive exchange and trade controls, some of which are applied restrictively, although in the view of the staff there appears to be little justification on balance of payments grounds for their retention. The import liberalization program which was introduced in 1970 was suspended for a time from late 1971 as a result of economic and other uncertainties. It was subsequently resumed on a more modest scale. However, on March 15, 1973, a further substantial liberalization of imports was announced, with the transfer of 2,367 items from the controlled list of imports to the permissible list, leaving only 463 items or 3 per cent by number on the controlled list. The removal of these impediments to imports is regarded as timely. Although the staff has only

limited information of the latest measures, it appears that imports still on the controlled list are largely comprised of imports controlled as a matter of course in developed countries. In view of the effective depreciation of the new Taiwan dollar in February 1973, the staff team will explore the scope for a further relaxation of exchange and trade restrictions. In this respect, the staff team will be mindful of the sentiments expressed by Executive Directors on the occasion of their consideration of the establishment by China of a Central Rate (EBM/73/14--February 17, 1973).

6. With respect to external indebtedness, the long-term debt profile appears to remain favorable. Aside from a review of prospects for long-term loans, discussion in this area will therefore focus on the shorter end, both in terms of import financing arrangements and on the policy with respect to short-term financial credits. The outlook for direct foreign investment in China will also be reviewed.

7. In November 1972 international reserves as reported in IFS totalled US$826 million, while on the monetary survey basis net foreign assets at that date amounted to about US$1.4 billion. The staff team will follow up the efforts of last year's mission to reconcile the discrepancy between the two series.

8. The staff team will review any changes since the last consultation in the gold market, including exports and imports, domestic nonmonetary uses, and regulations governing private ownership. In view of recent developments in the price of gold in world markets, there is special interest in the working of the open tender marketing system through the Central Trust of China which was adopted in November 1971, and trends in domestic prices.

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: April 24, 1973

FROM : J. Ahrensdorf

SUBJECT : China - 1973 Article XIV Consultation

Discussions were held in Taipei from April 11 to April 20. The mission included Mrs. Yang and Mr. McLenaghan.

The Chinese authorities have become increasingly concerned about financial and related price developments. In 1972 real GNP grew at a rate of about 11 per cent, exceeding considerably the Plan target and expectations at the beginning of the year. The overall balance of payments surplus was US$537 million and the trade surplus was US$592 million. This generated a considerable increase in domestic liquidity which was slightly larger than the one generated by bank credit to private and public enterprises. As a result, the money supply increased by 33 per cent in 1972 and apparently by nearly 40 per cent in the 12-month period ended March 1973. These rates are considerably in excess of those experienced in recent years. Associated price increases were by and large accelerating since last fall and reached an annual rate of about 13 per cent by February 1973. In the last decade or so, prices had increased at an average annual rate of less than 2 per cent. In the light of these developments the authorities introduced a number of measures since around mid-1972 to restrain financial expansion and to mitigate the cost-push effects of the general rise of world market prices of primary products and of the revaluation of the yen. These measures included steps to reduce Central Bank lending and the placement of newly created certificates of deposit with banks as a substitute for increases in legal reserve requirements against deposits which are by and large at their statutory limits. Noteworthy is that for the first time fiscal policy has been used in a truly compensatory sense by issuing government bonds in a situation of fairly strong budgetary surplus in order to mop up excess liquidity. Steps were also taken to restrain liquidity increases by curbing inflows of short-term capital for conversion into domestic currency and generally restraining foreign short-term borrowings. Not very long after the Board discussion on the proposed new central rate for China in mid-February, a rather wide-ranging liberalization of import restrictions was announced. Some relaxations in restrictions in invisible transactions were made or are under consideration. Also, some steps were taken to restrain exports of certain key commodities temporarily and, more broadly, to simplify and reduce the rather elaborate system of financial export incentives.

The staff team endorsed the changes in the direction of financial and other policies taken in recent months as appropriate under the emerging circumstances. Considering the projection of another large overall balance of payments surplus for 1973, the team plead for a continuation and strengthening of the policies pursued in the recent past in order to restrain financial expansion originating both from the current as well as the capital account of

the balance of payments, and to liberalize restrictions on current payments and transfers. In particular, it urged caution as to further reductions in nominal interest rates in view of the likely adverse effects of the recent sharp drop in real interest rates on savings habits and willingness to hold liquid assets.

Toward the end of the mission, I had occasion to discuss at considerable length the whole spectrum of financial policies in the present situation with the Governor of the Central Bank. In this context he raised thoughts, apparently put forth in certain circles, of issuing negotiable foreign exchange certificates to exporters in lieu of foreign exchange proper, or of introducing an exchange rate policy along the lines of crawling pegs. I referred to the observations of a number of Executive Directors at the discussion of China's proposed new central rate, which implied some uncertainties as to the adequacy of the new proposed central rate. The draft minutes of that Board meeting had been made available to the Chinese authorities. At that Board meeting there was a fair degree of unanimity that assessment of the adequacy of the exchange rate adjustment of February should be deferred for at least six months. Subsequent to that Board discussion, China had liberalized its restrictions on imports to a significant extent, and also those on some invisible transactions and took a number of measures to restrain the influx of liquidity from abroad. Against this background, I expressed the view that the impact of these measures on the balance of payments would be felt only after a certain lag and that, therefore, for the time being the merits of modifications of the exchange system appeared doubtful.

cc: ETRD
LEG
TREAS
RES
FAD
CBS
INST
Mr. Woodley
Mrs. Yang
Mr. McLenaghan
Far Eastern Division

Mr. Palmer April 27, 1973

John B. McLenaghan

China: 1973 Article XIV Consultation

As a supplement to Mr. Ahrensdorf's Back-to-Office Report of April 24, 1973, the following additional comments may be of interest in the light of the special attention focused by the mission on the exchange rate and the exchange and trade system. The presence in Taipei as an advisor to the Chinese delegation of the Economic Minister in Washington (Mr. Martin Wong), who had been informed by Mr. Hebbard of the main points of the Executive Board's discussion on the new central rate for the new Taiwan dollar on February 17, 1973, indicated that the Chinese authorities were fully cognizant of the mission's effort to assess the adequacy of the exchange rate and the exchange and trade system.

During the discussions, considerable emphasis was placed by the Chinese representatives on the import liberalization effected in March when some 2,360 items were transferred from the controlled to the permissible list of imports. The authorities referred on several occasions to the present import regime as one "completely free of restrictions." Although some 400 items remained on the controlled list of imports, they include items which were said to be those kept under control in most countries, e.g., silver, gold, military equipment, drugs, etc. In some other respects it seemed that moves in the direction of a more liberal trade and exchange system had been taken recently as a direct result of the strengthening balance of payments position and of the growing difficulties for domestic monetary management of a large influx of foreign exchange. While limits continued to be placed (and enforced) on exchange allowances for certain payments for invisibles, the scope of the allowances had been broadened in certain areas, and consideration was being given to a further relaxation, e.g., the provision of exchange for tourist travel. With respect to exports, the Chinese representatives indicated that they were planning to use their administrative discretion to reduce the extent and the impact of fiscal incentives for exports, without in any way departing from the basic approach of active encouragement of export industries. In this context, however, it was significant that they were troubled by the question of what should be the optimum ratio for Taiwan of exports to GNP which on present forecasts was expected to exceed 45 per cent in 1973. There were also some interesting developments with respect to capital inflows and their influence for domestic monetary management. Certain measures had been taken in recent weeks in order to reduce the destabilizing effects of unwanted short-term capital inflows. These measures included the abolition of the right of repatriation of capital acquired in future in the form of short-term foreign borrowing, as well as steps to avoid or reduce reliance on deferred payments for imports. With respect to the last mentioned measures, it was pointed out that while nearly 85 per cent of exports were on a cash settlement basis, imports increasingly had been financed on a deferred payments basis; given the rapid growth in foreign trade in recent years, the leads and lags involved had been a significant factor in adding to domestic liquidity.

With respect to efforts to reduce the imbalances in trade with major trading partners, the Chinese representatives indicated that a major concern was the reduction of the by now very large trade surplus with the United States. Some fears were held that a continued growth in the surplus would result in the imposition of stringent quotas on exports from Taiwan. In the context of trade with Japan, the mission was told that there had been some relaxation of the measure imposed in September 1972 limiting imports from that country. The original measure had placed a limit of US$20,000 in individual orders of machinery from Japan. The limit was subsequently increased to US$200,000. The mission was told that the measure was administered flexibly in the light of the needs of individual industries. In its preliminary appraisal the staff team pointed out that it was not necessarily in the interests of any one country, nor of the world economy to seek to achieve a balancing of trade on a strictly bilateral basis.

As indicated in the Back-to-Office Report, the exchange rate had been given considerable attention within the Government and, we understand, in academic circles as well. While the authorities had moved a good deal in the direction of liberalizing the exchange and trade system, it was equally clear that considerable scope remained. In the light of the moves so recently taken, however, it seemed appropriate that some time should lapse before/a reasoned assessment could be made of their significance for the existing exchange rate.

cc: Mr. de Looper

JBM:mo

INTERNATIONAL MONETARY FUND

~~Mr. Palmer~~

5/1/73

Mr. Sturc:

I think you will be interested in the attached additional report by John McLenaghan.

Attachments

Donald K. Palmer

DKP

By how much did the real income of workers rise in course of last few years?

ES

Office Memorandum

Mr. Mc J -

TO : Mr. Palmer

DATE: April 27, 1973

FROM : John B. McLenaghan

SUBJECT : China: 1973 Article XIV Consultation

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With respect to efforts to reduce the imbalances in trade with major trading partners, the Chinese representatives indicated that a major concern was the reduction of the by now very large trade surplus with the United States. Some fears were held that a continued growth in the surplus would result in the imposition of stringent quotas on exports from Taiwan. In the context of trade with Japan, the mission was told that there had been some relaxation of the measure imposed in September 1972 limiting imports from that country. The original measure had placed a limit of US$20,000 in individual orders of machinery from Japan. The limit was subsequently increased to US$200,000. The mission was told that the measure was administered flexibly in the light of the needs of individual industries. In its preliminary appraisal the staff team pointed out that it was not necessarily in the interests of any one country, nor of the world economy to seek to achieve a balancing of trade on a strictly bilateral basis.

As indicated in the Back-to-Office Report, the exchange rate had been given considerable attention within the Government and, we understand, in academic circles as well. While the authorities had moved a good deal in the direction of liberalizing the exchange and trade system, it was equally clear that considerable scope remained. In the light of the moves so recently taken, however, it seemed appropriate that some time should lapse before/a reasoned assessment could be made of their significance for the existing exchange rate.

cc: Mr. de Looper

Mr. Sturc May 15, 1973

J.B. McLenaghan

China: Real wages

The following table may be of some assistance in assessing recent trends in real wages. Note that the data relate only to wages in the manufacturing sector.

Index of Real Wages in the Manufacturing Sector

(Jan. 1968 = 100)

		Increase (Per cent)
December 1968	109	9.0
December 1969	112	2.8
December 1970	123	9.8
December 1971	126	2.4
December 1972	132	4.8

Source: Data provided by the Chinese authorities during the 1973 Article XIV Consultation.

The staff team was told that the increase in real wages over the last four years was probably fairly close to, if not in excess of, the increase in productivity, at least in some sectors. In contrast, over the period 1952-68, the increase in real wages had been a good deal less than the rise in productivity.

An interesting comment provided outside of the consultation discussions was that maintaining a high rate of growth in the medium- to longer-term may depend to some extent on the policy towards increasing real income. On the basis of this argument, given that recent rates of growth in exports may not be sustained, it may be more appropriate for the authorities to seek to increase demand in the domestic market.

cc: Mr. Palmer
Mr. de Looper

cc: Mr. Palmer

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: April 24, 1973

FROM : J. Ahrensdorf

SUBJECT : China - 1973 Article XIV Consultation

RECEIVED
APR 25 1973
EXCHANGE & TRADE RELATIONS DEPARTMENT

Discussions were held in Taipei from April 11 to April 20. The mission included Mrs. Yang and Mr. McLenaghan.

The Chinese authorities have become increasingly concerned about financial and related price developments. In 1972 real GNP grew at a rate of about 11 per cent, exceeding considerably the Plan target and expectations at the beginning of the year. The overall balance of payments surplus was US$537 million and the trade surplus was US$592 million. This generated a considerable increase in domestic liquidity which was slightly larger than the one generated by bank credit to private and public enterprises. As a result, the money supply increased by 33 per cent in 1972 and apparently by nearly 40 per cent in the 12-month period ended March 1973. These rates are considerably in excess of those experienced in recent years. Associated price increases were by and large accelerating since last fall and reached an annual rate of about 13 per cent by February 1973. In the last decade or so, prices had increased at an average annual rate of less than 2 per cent. In the light of these developments the authorities introduced a number of measures since around mid-1972 to restrain financial expansion and to mitigate the cost-push effects of the general rise of world market prices of primary products and of the revaluation of the yen. These measures included steps to reduce Central Bank lending and the placement of newly created certificates of deposit with banks as a substitute for increases in legal reserve requirements against deposits which are by and large at their statutory limits. Noteworthy is that for the first time fiscal policy has been used in a truly compensatory sense by issuing government bonds in a situation of fairly strong budgetary surplus in order to mop up excess liquidity. Steps were also taken to restrain liquidity increases by curbing inflows of short-term capital for conversion into domestic currency and generally restraining foreign short-term borrowings. Not very long after the Board discussion on the proposed new central rate for China in mid-February, a rather wide-ranging liberalization of import restrictions was announced. Some relaxations in restrictions in invisible transactions were made or are under consideration. Also, some steps were taken to restrain exports of certain key commodities temporarily and, more broadly, to simplify and reduce the rather elaborate system of financial export incentives.

The staff team endorsed the changes in the direction of financial and other policies taken in recent months as appropriate under the emerging circumstances. Considering the projection of another large overall balance of payments surplus for 1973, the team plead for a continuation and strengthening of the policies pursued in the recent past in order to restrain financial expansion originating both from the current as well as the capital account of

the balance of payments, and to liberalize restrictions on current payments and transfers. In particular, it urged caution as to further reductions in nominal interest rates in view of the likely adverse effects of the recent sharp drop in real interest rates on savings habits and willingness to hold liquid assets.

Toward the end of the mission, I had occasion to discuss at considerable length the whole spectrum of financial policies in the present situation with the Governor of the Central Bank. In this context he raised thoughts, apparently put forth in certain circles, of issuing negotiable foreign exchange certificates to exporters in lieu of foreign exchange proper, or of introducing an exchange rate policy along the lines of crawling pegs. I referred to the observations of a number of Executive Directors at the discussion of China's proposed new central rate, which implied some uncertainties as to the adequacy of the new proposed central rate. The draft minutes of that Board meeting had been made available to the Chinese authorities. At that Board meeting there was a fair degree of unanimity that assessment of the adequacy of the exchange rate adjustment of February should be deferred for at least six months. Subsequent to that Board discussion, China had liberalized its restrictions on imports to a significant extent, and also those on some invisible transactions and took a number of measures to restrain the influx of liquidity from abroad. Against this background, I expressed the view that the impact of these measures on the balance of payments would be felt only after a certain lag and that, therefore, for the time being the merits of modifications of the exchange system appeared doubtful.

cc: ETRD
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CBS
INST
Mr. Woodley
Mrs. Yang
Mr. McLenaghan
Far Eastern Division

cc: [illegible]

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

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cc: ETRD
LEG
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INST
Mr. Woodley
Mrs. Yang
Mr. McLenaghan
Far Eastern Division

REPUBLIC OF CHINA

Briefing Paper - 1973 Article XIV Consultation

Prepared by the Asian Department and the
Exchange and Trade Relations Department

Approved by W. John R. Woodley and Donald K. Palmer

March 28, 1973

K. S.

I. Introduction

The 1973 Article XIV staff consultation discussions with China will be held in Taipei, Taiwan, from April 11 to April 20, 1973. The staff team will consist of Messrs. Joachim Ahrensdorf (head of mission), John B. McLenaghan, Mrs. Hui-Chen Wu Yang, and a secretary. Two members and secretary of the team will arrive in Taipei on April 8, 1973 to initiate the work.

II. Fund Relations with China

Quota:	SDR 550 million; of this SDR 59.9 million has been paid in gold.
Use of Fund Resources:	A gold tranche purchase was made on October 20, 1971.
Fund holdings of NT$:	100 per cent of quota.
Last Article XIV Consultation:	Staff discussions held in March 1972 and Executive Board Decision taken in June 1972, Decision No. 3679-(72/53).
SDR position:	China is a participant but opted not to receive an allocation.
Par value and central rate:	An initial par value of NT$40 per U.S. dollar was agreed with the Fund on September 4, 1970. On May 8, 1972, the par value was changed to NT$43.4286 per special drawing right and corresponded to NT$40 per US$1. At the same time, China availed itself of wider margins, Decision No. 3639-(72/42). On February 16, 1973, the Government established a central rate of NT$45.8413 per special drawing right, or NT$38 per U.S. dollar. Decision No. 3875-(73/14, February 17, 1973).

Technical assistance: Mr. S. G. Quinton from the fiscal panel was assigned for a term of one year to assist the Chinese Customs in the adoption of the Brussels Tariff Nomenclature, beginning in May 1971. His services have been extended for another term of one year with effect from May 4, 1972.

III. Recent Economic Developments

In 1972, the economy continued its rapid growth of recent years. Preliminary estimates show that GNP in constant prices rose by 11.0 per cent compared with an average annual growth rate of 10.4 per cent in the preceding three years. Per capita income in current prices is estimated to have increased from the equivalent of US$329 in 1971 to US$372 in 1972. The targets set in the Fifth Four-Year Economic Development Plan (1969-72) were either met or surpassed. In January 1973, the Government launched the Sixth Four-Year Economic Development Plan (1973-76) which envisages that real GNP will grow at an annual rate of slightly above 9.0 per cent during the Plan period.

Money supply increased by 33 per cent in 1972, considerably higher than the average annual rate of increase in 1967-71. The rapid increase in the net foreign assets of the banking system and the continued expansion of bank credit to the private sector were the main factors responsible for the rapid monetary expansion in 1972. These expansionary forces were partly offset by a rapid increase in time and savings deposits and a considerable decline in net bank credit to the public sector reflecting improved budgetary performance of the Government. The price rise in 1972 was the highest in recent years; wholesale and consumer prices rose by 7 per cent and 4 per cent, respectively, due partly to higher costs of improted goods. In January 1973, money supply rose by nearly 10 per cent, while wholesale prices rose by another 4 per cent.

The overall balance of payments which registered substantial surpluses in 1970 and 1971 is estimated to have recorded a surplus of the order of SDR 180 million in 1972. Exports increased by 34 per cent and imports increased by 32 per cent, and as a result, there was a further substantial increase in the trade surplus. Exports to the United States and Japan accounted for 41 per cent and 13 per cent, respectively, of total exports. The shares of these countries in imports were 29 per cent and 38 per cent, respectively. The trade surplus with the United States increased to SDR 415 million in 1972 while the trade deficit with Japan increased to SDR 622 million in 1972 (on exchange settlement basis). Based on data for the first half of 1972 (latest available), net direct investment was somewhat higher than in the corresponding period of 1971, while there was a sharp increase in inflow of private short-term capital, mainly trade credits. Capital inflow (net) on account of the government sector was insignificant in both periods.

Gold and official holdings of international reserves totaled SDR 680 million at the end of 1972, of which SDR 80 million was in gold and SDR 600 million in foreign exchange. Gold and foreign exchange holdings increased by SDR 195 million during the year. They were equal to about three-months imports at the level of 1972.

The exchange and trade control systems continue to involve some restrictions. Beginning in mid-1970, the authorities embarked on a major import liberalization program which envisaged gradual shifting of a large number of commodities from the controlled list to the permissible list. An automatic approval system was introduced, and a general licensing system was established for imports by large manufacturers and other direct users.

From September 1972, imports from Japan were limited to $20,000 per order while imports from sources other than Japan were eased and facilitated considerably.

IV. Issues for Discussion

1972 was another year of sustained economic growth attended by the third successive, sizable surplus in the balance of payments. This outcome, however, was not without some offsets on the domestic side in the form of increasing difficulty in containing the liquidity creating effects of the rise of foreign assets and a rapid expansion in domestic credit, and a sharp upturn in the rate of price increase. In the context of reviewing with the authorities their internal and external policy objectives over the short- to medium-term, the staff team will direct its attention to the following specific issues.

1. The sixth Four-Year Economic Development Plan which was launched recently provided the overall growth objectives over the period 1973-76. The Plan envisages an annual rate of growth in GNP of approximately 9.0 to 9.5 per cent over the next four years, a rate that is somewhat less than that achieved during the previous Plan. The Plan, not yet available to the staff in full seems to seek to continue the successful development strategy adopted in the preceding Plan, with continued emphasis on the growth of export oriented manufacturing industries. The staff team will explore whether adaptations are being made in the Plan, as well as for the long-range plan, in the light of developments since their formulation. It will try to assess if the targets seem feasible and to what extent adaptations may be warranted. This assessment will focus in particular on the balance of payments objectives.

2. While the overall fiscal performance has been sound in recent years, the growth in banking system credit to the private sector, which has averaged 23 per cent a year for the past five years, coupled with rising external surpluses since 1969, has produced increasingly large additions to the money supply. This pattern was repeated in 1972 despite a decline in credit to the public sector and despite the assistance of leakages from the system through transfers of time deposits to the Central Bank. At the same time, after many years of modest price increases, there was a marked deterioration in price performance in the twelve-month period ended January 1973 partly as certain cost-push factors, e.g. increasing international prices of primary products and the yen revaluation, exerted additional pressures on prices; on the other hand liquid asset holdings relative to GNP continued to increase. These developments indicate the need for a critical review of credit and other policies and their applications, and the possible need for more effective policy instruments. Progress and plans for adaptations in fiscal policies will be reviewed. The long-term objective of lowering interest rates will be examined in the context of its appropriateness for short-term policy objectives. In addition, the staff team will discuss the operation of the securities market, as well as the development of the long-term capital market and the degree of specialization among financial intermediaries.

3. The balance of payments recorded another impressive surplus in 1972. Despite an adverse movement in the terms of trade, the trade surplus rose by 34 per cent compared with the previous year while net capital inflow appears to have increased compared with the previous year when there was a marked decline. These developments occurred despite adverse influences of the revaluation of the yen in December 1971, and the less favorable climate for inward foreign investment during 1972.

The staff team will assess the balance of payments prospects against the background of the recent change in the relationship between the new Taiwan dollar and the currencies of China's major trading partners, the influences of commercial policy in China and of restrictions on Chinese goods in important export markets, and the outlook for foreign direct investment.

4. There were important developments in 1972 with respect to China's economic relations with Japan, particularly the limitation placed on the size of individual import orders from that country as a means of reducing China's chronic trade deficit with Japan. With respect to official borrowing from Japan, the Chinese authorities have announced that they will make no further borrowings. The staff team will assess the scope for diversification of imports and the impact on the internal cost structure of alternative sources of supply of raw materials and intermediate goods, especially in view of the increasing price competition being experienced by Chinese manufactures in markets abroad.

5. China has long maintained comprehensive exchange and trade controls, some of which are applied restrictively, although in the view of the staff there appears to be little justification on balance of payments grounds for their retention. The import liberalization program which was introduced in 1970 was suspended for a time from late 1971 as a result of economic and other uncertainties. It was subsequently resumed on a more modest scale. However, on March 15, 1973, a further substantial liberalization of imports was announced, with the transfer of 2,367 items from the controlled list of imports to the permissible list leaving only 463 items or 3 per cent by number on the controlled list. The removal of these impediments to imports is regarded as timely. Although the staff has only limited information of the latest measures, it appears that imports

still on the controlled list are largely comprised of imports controlled as a matter of course in developed countries. The staff team will discuss with the Chinese authorities the considerations which bore most heavily on their decision to depreciate the new Taiwan dollar in February 1973 and will take up the question of the appropriateness of the new exchange rate in the light of recent trends and prospective developments in the balance of payments. The staff team will also examine in detail existing exchange and trade restrictions and their application, including the limitation on individual import orders from Japan, and will explore the scope for a further liberalization of restrictions. In this respect, the staff team will be mindful of the Managing Director's observations on the occasion of the establishment by China of a Central Rate (EBM/73/14-February 17, 1973) that "in the case of the Republic of China, a consultation was in any case scheduled for the spring of 1973 at which time the adequacy of the current central rate and liberalization program could be explored."

6. With respect to external indebtedness, the long-term debt profile appears to remain favorable. Aside from a review of prospects for long-term loans, discussion in this area will therefore focus on the shorter end, both in terms of import financing arrangements and on the policy with respect to short-term financial credits.

7. In November 1972 international reserves as reported in IFS totaled US$826 million, while on the monetary survey basis net foreign assets at that date amounted to about US$1.4 billion. The staff team will follow up the efforts of last year's mission to reconcile the discrepancy between the two series.

8. The staff team will review any changes since the last consultation in the gold market, including exports and imports, domestic nonmonetary uses, and regulations governing private ownership. In view of recent developments in the price of gold in world markets, there is special interest in the working of the open tender marketing system through the Central Trust of China which was adopted in November 1971, and trends in domestic prices.

The Managing Director
The Deputy Managing Director

March 21, 1972

K. Suzuki

China--1971 Article XIV Consultation

A staff team consisting of Mr. Alex Ashiabor and Mrs. Hui-Chen Wu Yang and I visited Taipei from March 2-16, 1972 for the 1971 Article XIV consultation with China. (I arrived in Taipei on March 5, 1972 following my mission to Western Samoa.)

The Chinese delegation was led by Mr. S. Y. Wang, Vice Minister of the Ministry of Finance, and included officials of the Ministries of Finance, Economic Affairs, and the Central Bank. The mission saw the Governor of the Central Bank, while the Minister of Finance was not well but I was given a chance to see him before the conclusion of the mission.

The staff team arrived in Taipei immediately after President Nixon's visit to mainland China. The country seems to have been deeply shaken by the change in the United States' China policy and the series of related developments since last year. However, the Government now appears to be recovering from the shock and is initiating more flexible policies both at home and abroad. In foreign policy, the new emphasis is on broadening trade and economic ties regardless of formal diplomatic relations. Such a change in policy is expected to include some Eastern European countries and the Soviet Union. Internally the Government is advocating self-reliance and urging the public to be prepared for further changes in the country's external relations.

The National Assembly of the Koumintang held its meetings during the mission's stay in Taipei, and nominated President Chang Kai-shek for a fifth six-year term as was expected. He will be officially elected in May and a new prime minister will be appointed by him. The new prime minister will probably be Mr. Chiang Chin-kuo, the President's son. Another expected change is that the forthcoming Cabinet and other high level appointments to be made will include an expanded number of native Taiwanese and younger persons.

In spite of the external political setbacks, a further high rate of economic growth was achieved in 1971. The GNP increased 11.4 per cent in real terms. Exports at US$2,136 million increased 36.7 per cent while imports at US$1,950 million recorded a 27.6 per cent increase. The trade surplus was US$186 million or 5.4 times that of 1970. The current account of the balance of payments showed a surplus of US$136.8 million compared with a deficit of US$12.0 million in 1970. The overall surplus was US$243.2 million as against US$190.6 million in 1970. Price stability was maintained (the consumer price index increased only 2.56 per cent and there was no increase in the wholesale price index in 1971) in spite of a considerable increase in credit and the money supply.

The main area of concern was the decline in foreign private investment. Capital inflows in 1971 were US$83.9 million compared with US$190.0 million in 1970. Direct investments by overseas Chinese and other foreign private

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EXCHANGE & TRADE RELATIONS

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The main area of concern was the decline in foreign private investment. Capital inflows in 1971 were US$63.9 million compared with US$150.0 million in 1970. Direct investments by overseas Chinese and other foreign private investors were 25 per cent below the previous year's. Japan and the U.S. were the major sources of the decline. The Chinese authorities considered the decline in private capital flows from the U.S. to be temporary. They also believed that European investors were showing an increasing interest in Taiwan and European investments are expected to fill the gap created by the hesitation of Japanese investors. Meanwhile, there were indications of an increasing pipeline of new investments--Phillips Telecommunications of Holland has decided to set up a Television Picture Tube Plant, an Austrian steel company, Voest, is cooperating with local capital to establish a new integrated steel mill and Ford Motors were reported contemplating a vehicle assembly plant.

The Chinese authorities estimate the growth rate in the next and subsequent years to be 8.5 per cent in view of an expected decline in exports. The mission felt that this estimate was too conservative. On the contrary, the mission observed that the strong and growing current surplus in balance of payments should enable the country to cope with the possible decline in foreign private investment caused by the nervousness of foreign investors in the next few years. In particular, China's dynamic industrial sector supported by comparatively low wage structure and expected adequate supply of labor in the near future should enable it to maintain its competitive position in the world market.

We observed during our discussions that the decision to maintain the exchange rate of the New Taiwan dollar at NT$40 = US$1 was based mainly on export considerations and the desire to maintain China's competitiveness in the U.S. market. The U.S. accounted for 41 per cent of Taiwan's exports in 1971.

Regarding the effects of the realignment on China's foreign trade, the Chinese authorities thought that Japanese exporters, particularly steel exporters, were absorbing the price effects of the revaluation of the yen. According to them, no adverse price effects had been observed so far. As the Japanese economy recovers, however, it is likely the adverse effects will be felt. In this connection, we impressed upon them the desirability of keeping their exchange rate policy under continuous review. They appreciated the mission's viewpoint. It is expected that the Chinese authorities will shortly avail themselves of the Fund's decision on wider margins.

In the area of banking there have been some improvements. The authorities, last year, abolished the practice of buying and selling government bonds at par. The prices of these bonds are now freely determined by the market. They are also currently considering a draft banking law in order to facilitate the efficiency and specialization of the different types of financial institutions. The mission observed that interest rates were still high and the spread between deposit and lending rates remained substantial and urged the Chinese authorities to endeavor to bring rates down and narrow further the spread so as to induce greater efficiency in the banking system. The Chinese authorities also agreed with the mission that the current practice of granting tax exemption for interest income from government bonds and savings deposits needed to be discontinued in the interests of the development of a good bond market.

Further measures were taken by the Chinese authorities to liberalize both trade and current payments in 1971. Import control on 1,583 commodities was removed last year and allowances for foreign travel and remittances to students have been raised. The mission impressed upon the Chinese authorities the need for continued review and relaxation of controls on trade and payments, particularly in the interests of the long-term efficiency of the Chinese economy. The Chinese authorities have also recently revised the rules relating to transactions in nonmonetary gold in China. As a result, the Central Bank no longer participates in trading in nonmonetary gold.

cc: CBS
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Mr. Savkar
Far Eastern Division
Mrs. Yang
Mr. Ashiabor

KS:mp

The Managing Director February 3, 1972

D. S. Savkar and Donald K. Palmer

Republic of China--1971 Article XIV Consultation - Briefing Paper

Attached hereto for approval is the Briefing Paper for the forthcoming mission to China. This has been cleared with the Departments concerned.

Attachment

cc: Mr. Smith

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

REPUBLIC OF CHINA

Staff Report for the 1971 Article XIV Consultation

Prepared by Staff Representatives for the 1971
Article XIV Consultation with the Republic of China

(Reviewed by the Committee on Article XIV Consultations)

Approved by D.S. Savkar and Donald K. Palmer

May , 1972

I. Introduction

The 1971 Article XIV consultation discussions with the Republic of China were held in Taipei during March 6-16, 1972. The Chinese delegation was headed by Mr. S.Y. Wang, Vice Minister, the Ministry of Finance, and included senior officials of the Central Bank and of the various ministries concerned with economic policy. The mission also had discussions with Mr. K.H. Yu, Governor of the Central Bank and Mr. K.T. Li, Minister of Finance. The staff team consisted of Messrs. Koji Suzuki, Alex Ashiabor and Mrs. Hui-Chen Wu Yang. Mr. P.Y. Hsu, Executive Director for the Republic of China, attended some of the meetings as an observer.

II. Report on Discussions

1. General Developments and Prospects for Growth

In spite of the adverse impact of external developments on certain areas of the economy such as the stock market and foreign private investment, the economy as a whole maintained a high growth rate accompanied by further improvement in the balance of payments and price stability. GNP in 1971 rose by 11.4 per cent in constant prices, following the 11.2 per cent increase in the previous year. The projected 7 per cent growth target in the Fifth Four-Year Plan (1969-72) and the average growth rate of about 9 per cent achieved in the past 18 years were both substantially surpassed. With the population growth rate of 2.3 per cent, the same as in the previous two years, per capita income at current prices rose to NT$13,148 (US$329), representing a 9.0 per cent increase in real terms.

The mainstay of this impressive performance has been the dynamic expansion of manufacturing products which recorded a 23 per cent increase in 1971, following an 18 per cent increase in the previous year. The largest increase took place in export related items such as textiles, machines, and electrical appliances, the same pattern as in preceding years. As to the exports of textiles and related items, which rose by 45 per cent and represented 29 per cent of total exports in 1971, the Chinese representatives admitted that this increase was exceptional, and that such a large increase in production and exports was not expected in the coming years. Regarding the possible effect of the U.S. quota restrictions, however, the Chinese representatives observed that quotas were determined in quantity terms, and that the actual restrictive effect would be minimized to the extent that the textile industry can shift from low to higher value products within the stated quota. They added that there was already some indication of such a shift.

So far, China has pursued a very successful industrialization program mainly based on labor-intensive and simple assembly type industries. The Chinese authorities are confident about the future course of industrial developments in the light of the adequate supply of labor at comparatively low wages and the well-established technological base. At the same time, they were well aware of the longer term problems such as increased restrictions in advanced countries on imports from low cost countries. Also, as technology improves in other developing countries, China's products of the simple assembly type, such as television, radio sets, electrical appliances, simple electronics and textile products, will face greater competition. Based upon these prospects, the Chinese authorities are now determined to pursue more vigorously a program to establish heavier industries, including iron and steel mills, machine tools, and petrochemical complexes. These industries will be designed to provide a wider variety of capital goods and materials for the existing processing industries. In this connection, the authorities attach special significance to the integrated steel mill project recently inaugurated as a joint venture by the China Steel Corporation and a foreign steel company. Existing small steel mills and major steel consuming industries, such as shipyards and construction industries, have already started to readjust their production and investment programs, in order to coordinate with that of the integrated steel mill.

In December 1971, the Government informed the Fund that the exchange rate of NT$40 per U.S. dollar would remain unchanged. This represented a decrease in the gold value of the New Taiwan dollar of 7.89 per cent. On May 8, 1972, this rate, which corresponds to NT$43.4286 per SDR 1, was agreed with the Fund as the new par value. The Chinese representatives stated that it was too early to make a full assessment of the impact of the currency realignment on the economy. In view of the high dependency on Japanese capital goods and materials, the revaluation of the yen could cause some serious problems. However, import prices of some of the major items from Japan, particularly steel products, have not yet reflected fully the effect of the revaluation, possibly due to the prolonged recession in Japan. On the other hand, the Chinese representatives believed the yen revaluation would encourage domestic industries producing such import substitutes as machine tools and plastics, and also provide an opportunity for new types of export items such as sophisticated electronic parts. They indicated that this development was already under way.

Preliminary estimates indicate that agricultural production in 1971 rose by only 2.5 per cent, as the performance during the second half of the year was affected by damages from repeated typhoons. Production of food crops, particularly rice, suffered extensive losses, even though special crops, fisheries, forestry and livestock continued to grow satisfactorily. Rice production totaled 2,300 thousand metric tons, representing a decrease of almost 7 per cent. In addition to typhoon damage, some shifting of paddy fields to more profitable uses such as fish ponds and orchard plantation was also responsible for the decline.

Apart from the short-term difficulties due to poor weather conditions, there are also problems of a long-term nature. The economic structure has experienced a substantial transformation shifting from an agriculture-base to dominance of industry. The share of agriculture in net domestic product fell from about 35 per cent in the early fifties to less than 18 per cent in 1971, whereas that of industry rose from about 20 per cent to 34 per cent (see Chart 1). The share of agricultural employment ~~in total employment~~ in total employment declined from more than 60 per cent in the early fifties to less than 35 per cent in 1971. In view of the strategic importance of agriculture, the Chinese authorities are now confronted with the challenging problem of maintaining a reasonable growth in agricultural production and assuring a comparable income level for farmers without raising food prices. Several measures have been taken to achieve this. The main emphasis of agricultural policy is now placed on farm mechanization and further diversification of crops. Furthermore, suitable industries will be encouraged in rural areas to increase supplemental income sources for agricultural households. Taxes on farm income were reduced and the Central Government has earmarked, for the first time, special funds to be utilized for farm modernization. The Government's rice-fertilizer barter program was also revised in favor of rice growers.1/ While appreciating the problems and direction of the new emphasis in agricultural policy, the staff team suggested that similar emphasis should be placed on the marketing aspect, and that in due course the rice-fertilizer barter program should be replaced by the market mechanism with appropriate financial assistance to farmers.

The Long-Range Economic Development Plan (1971-80) provides guidelines for economic management in the context of the changing economic structure; these aim at the modernization of the economy, sustainable economic growth, and improved living standards for the people. Since the capital-output ratio is expected to rise as a result of heavier industry-oriented development, the growth rate is estimated to be 8.5 per cent, or somewhat lower than actual performance in recent years. This target rate is considered suitable by the Chinese authorities to absorb the estimated increase in

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1/ For details, see China: Recent Economic Developments, SM/72/

labor force of 1.9 million during the plan period. The Chinese authorities also envisage continuous export-oriented development in the Long-Range Plan, with the result that the ratio of exports and invisible receipts to GNP is estimated to reach 44 per cent, compared with 35 per cent in 1971.

In addition, the Sixth Four-Year Plan (1973-76) was being prepared. It was tentatively agreed to fix a growth rate target of 9 to 10 per cent per annum and an export growth rate of 14.5 per cent. The guidelines would be consistent with those in the Long-Range Plan. In response to the staff team's query the Chinese representatives said that the projected rate of exports of goods and services was in real terms, and might not be too low in view of the uncertainties in export markets.

Along with the rapid industrialization, the demand for infrastructure facilities has increased. Under the previous four-year plans, the Government had placed emphasis on the expansion of various infrastructure facilities such as electric power capacity and transportation but these were still inadequate to satisfy the growing demand. Consequently, there is an urgent need to step up the development of the infrastructure, not only to make up for existing shortages, but also to meet future requirements.

The Chinese representatives indicated that price behavior in 1971 compared favorably with that in the previous year. Consumers' prices rose by only 2.6 per cent in 1971 (monthly average) as against 3.6 per cent in 1970. The wholesale price index at the end of 1971 was 2.5 per cent higher than a year earlier, but the monthly average for 1971 showed virtually no change. The available data suggested that average wages for workers in the manufacturing industry rose by about 26 per cent in real terms during the period 1968-71. No data are available on changes in industrial productivity and unit wage costs,but plans are being formulated for the compilation of industrial productivity data. The staff team commented that, in order to keep up to date criteria for assessing the international competitiveness of exports, the development of well prepared statistical data on wages and productivity was urgently needed. The staff team also believed that the challenge which the changing structure of the economy poses for the future could be met through a well coordinated program of manpower development, adding that an expanded vocational and technical training program aimed at meeting industry's future requirements of technical and middle-level professional personnel would help eliminate future bottlenecks in this area.

2. Fiscal policy

The budget performance on a consolidated basis has shown continued improvement in recent years. The budget showed substantial surpluses from FY 1969 (July 1969-June 1969) in contrast to deficits in the previous years. The transfers of counterpart funds to the budget were discontinued from FY 1970 and the issues of government bonds were virtually limited to the redemption of previous issues. The authorities discontinued the practice of introducing a supplementary budget during the fiscal year. The budget estimates for FY 1972 provide for a small deficit of NT$114 million, in contrast to the large surpluses realized in the three previous fiscal years. Total receipts are estimated to rise by 11 per cent, and expenditures by 14 per cent.

The staff team expressed the view that the estimate of a 10 per cent increase in tax revenue for FY 1972 might be too conservative. The Chinese representatives explained that, following the revision of the income tax law in 1968, receipts from income taxes had been increasing substantially, by 40 per cent in FY 1969, 35 per cent in FY 1970, and by about 32 per cent in FY 1971. For FY 1972, it was estimated that receipts from income taxes would increase by 16 per cent. Up to February 1972, the actual collections were 40 per cent higher than those of the corresponding period of FY 1971. The major factor accounting for the increases was the raising of the tax rate applicable to the lowest taxable income bracket from 3 per cent (since 1959) to 6 per cent from 1969. In view of the 30-40 per cent increase in income tax collections since FY 1969, the estimated growth rate of 16 per cent in FY 1972 might be somewhat on the conservative side, but the estimates of revenue from other taxes were believed to be quite realistic.

With regard to the budget for FY 1973, the Chinese representatives said that the budget estimates were still under preparation. The guidelines for expenditures accord the highest priority to development expenditures, and greater emphasis will be placed on agricultural development. On the receipts side, no changes were envisaged which would increase the average tax burden of the public. Government bond issues are estimated at NT$2.6 billion, or the same as in FY 1972.

During 1971, a number of tax laws were revised. Some changes such as the reduction of taxes on farm income and research expenses were designed to meet the changing pattern of the economy and some other changes were intended to improve the distribution of the tax burden and to reduce the administrative burden on tax collecting agencies.

In March 1968, the Government appointed a Commission on Tax Reform which completed its work in July 1970. One of the Commission's recommendations was that the commodity tax, the business tax and the stamp tax be replaced by a value-added tax while retaining a number of commodity tax levies in the form of excise duties. The authorities are drafting legislation designed to implement these proposals.

The tariff law was recently revised and the Brussels Tariff Nomenclature introduced. The revised law provides that the Ministry of Finance may make recommendations for the approval of the Executive Yuan to increase or decrease tariff rates by not more than 50 per cent for a period of six months. Applying this new provision, the authorities reduced tariff rates on 14 groups of commodities, in order to mitigate the price effect of the currency realignment. With regard to tariff policy, the Chinese represen- tatives believed that some use of protective tariffs might still be necessary to assist the development of infant industries, and also to shield domestic industry against unfair competition from abroad.

The staff team noted that the rapid economic growth in recent years had led to a situation where the development of infrastructure facilities had lagged behind the needs of the economy, and that this had resulted in a number of bottlenecks. The staff team inquired whether the Government might consider it desirable to adopt less conservative budgetary policy by increasing capital expenditures on infrastructure and social overhead welfare facilities. This could be done without jeopardizing stability in view of the tendency to underestimate revenue in the budget estimates in recent years. The Chinese representatives stated that the Government's fiscal policy was determined by the principle of maintaining a balanced budget, consistent with the aim of limiting the rate of inflation to 3 per cent a year, and achieving a fairly high growth rate.

3. Monetary policies

The money supply rose by 30 per cent during 1971, compared with 21 per cent during the previous year. Time and savings deposits rose by 26 per cent, or about the same as during 1970, and the total liquidity (money supply plus time and savings deposits) rose by 27 per cent (Chart 2). The monetary expansion in 1971 followed more or less the same pattern as in previous years (Chart 3). The increase in net foreign assets, reflecting the favorable balance of payments, continued to be a major factor influencing the monetary expansion. Credit expansion to the private sector and government enterprises accelerated in 1971, while time and savings deposits continued to increase. Although the monetary expansion was accompanied by a high rate of economic growth, as well as price stability and a further improvement in the balance of payments, the monetary authorities were nevertheless concerned. Consequently, they raised the reserve requirement against both demand and time and savings deposits in July 1971. At the same time, the Central Bank limited the amount of credit extended to the commercial banks. In addition, moral suasion which is an important policy instrument because of the close relation between the Central Bank and leading commercial banks was intensified.

In the meantime, postal savings funds redeposited with the Central Bank had increased considerably on a net basis (after deducting in Central Bank credit to the specialized banks). The authorities expressed the view that this arrangement was useful in the light of the direction of the monetary policy in this period. The staff team suggested that the Central Bank might consider an additional entry in its balance sheet, so as to reflect the net impact of this scheme on the liquidity of the banking sector and thereby provide data for day-to-day operations.

The Chinese representatives said that it was their policy to bring down the level of interest rates generally in the long run, and also to reduce the spread between deposit and lending rates of the banks. The

Central Bank had reduced its lending rates in May 1971, e.g., the rate on advances against secured loans from 10.5 per cent to 10.0 per cent per annum, and commercial bank lending rates were reduced (from 12.6 per cent to 12.0 per cent per annum for secured loans). At the same time, however, the rates for one month and three months time deposits, and passbook savings deposits were raised; the increase in these rates reflected the concern of the authorities that unduly low rates on such deposits might encourage a transfer of savings to the unorganized money market.

The policy of bringing domestic lending rates in line with rates abroad was also directed partly toward stemming the pressure from the inflow of short-term funds in the form of loans to Chinese enterprises from foreign banks and associated companies. For this purpose, the Central Bank of China suspended its approval of such loans in September 1970. Furthermore, the Central Bank made available US$20 million to the International Commercial Bank of China to finance installment payments on import credits of up to five years. In view of the decline in overall capital inflow, the authorities resumed approvals for short-term borrowing from abroad in January 1972. While their reaction to these external developments was understandable, the staff team suggested that the authorities should continue their long-term policy in the general area of interest rate reduction, while taking appropriate measures to avoid undue credit expansion.

The Chinese authorities took certain measures during 1971 to improve the efficiency of the capital market. In July 1971, a free market was established for public bonds; previously they were traded at par over the counter of the Bank of Taiwan. More enterprises are being encouraged to issue stocks publicly or place bonds on the market. The authorities also approved the establishment of eight investment trust companies; five of these were in operation at the end of 1971. Commenting on these developments, the staff representative drew the attention of the authorities to the need to review the policy of granting tax exemptions for interest on public bonds. The Chinese representatives said that the matter was under consideration.

Changing external conditions during the year had some effect on the stock market, as indicated by the sharp fluctuations during the second half of 1971. The authorities took certain measures such as temporary suspension of the collection of security tax to counter these developments during the year. The market appears to be recovering somewhat in recent months.

4. Balance of payments

Due to the remarkable increase in exports, the balance of payments showed a further improvement in 1971. The surplus on current account--including net transfers--was US$171 million, resulting in a record overall surplus of US$218 million in spite of a sharp decline in net capital receipts. It is to be noted that the improvement in the current account took place at a time when there was a deterioration in the capital account (Table 1).

Table

The Chinese representatives estimated export growth in 1972 at 20 per cent. While agreeing that last year's export performance may not be repeated in 1972, the staff team expressed the view that the estimate might be too conservative. They noted that the manufacturing sector had been able to adapt to difficult situations, as indicated by the response of the textile industry toward quota restrictions abroad. Even in the agricultural sector which faced increasing competition, e.g., pineapples from the Philippines, and continued difficulties regarding the export of agricultural products to Japan, producers were shifting to other items such as fish products, vegetables, and flowers.

Regarding the trade pattern, the trade deficit with Japan in 1971 increased by US$154 million to US$500 million, while the surplus with the United States (US$289 million) and other countries increased. With a view to expanding trade and improving the trade pattern, the Chinese authorities are endeavoring to diversify export markets. Vigorous export efforts will be directed to the EEC and other new markets, as well as Japan and the United States. In this connection, the authorities indicated a major policy shift toward expanding trade with as many countries as possible regardless of political relations.

Capital inflow, which had increased in 1969 and 1970, declined considerably in 1971; the private short-term net capital inflow of US$68 million in 1970 was converted into a net outflow of US$48 million in 1971. The Chinese representatives explained that one of the reasons for this change was the Central Bank's decision to discourage short-term borrowing abroad by business enterprises and to reduce trade credit from abroad. In addition, direct investment and other long-term capital receipts declined, particularly from Japan, but investment from Europe increased.

The staff team discussed the considerations which led to the retention of the exchange rate of NT$40 per U.S. dollar. The Chinese representatives explained that the major considerations were the importance of exports, uncertainties regarding the international situation, and the need to maintain China's competitiveness in the U.S. market. A committee has been set up to conduct, inter alia, a further study on exchange rate policy in the light of the changing economic situation.

The authorities took further measures during 1971 to liberalize the trade and payments system. Import controls were liberalized on 1,600 items since the last consultation. About 82 per cent of the commodities are now on the permissible list, and 18 per cent are subject to control. The efforts toward further liberaliztion of imports were interrupted in the latter part of the year because of uncertain economic conditions abroad. The authorities are continuing to facilitate the administration of import controls through the simplification of procedures. Both the automatic approval and the general licensing system introduced in 1970 were expanded in 1971. During the year, the authorities adopted the Brussels Tariff Nomenclature.

The authorities further relaxed controls on service payments. Personal allowances for private travel were doubled from US$300 to US$600 for adults, and from US$150 to US$300 for each accompanying child of under 12 years per trip. The allowance for business travel was raised from US$700 to US$1,000 per month for up to three months. The entire cost of tuition and living expenses of Chinese residents studying abroad will now be approved on the basis of estimates provided by the host institution. Additionally, up to US$2,400 (previously US$1,800), may be remitted each year after the first year. The staff representative emphasized the need to maintain the pace of import and exchange liberalization in the long-run interest of the efficiency of the economy.

In November 1971, the Government revised the Regulations governing the Supply and Trading of Ornamental Gold by altering the definition of fineness from 0.875 to 0.945 per troy ounce, and by designating the Central Trust of China as agent of the producers to sell gold to processors through open tenders. The main objectives are to ensure a stable price of gold on the domestic market, and to eliminate the need for the Central Bank to engage in domestic gold transactions.

III. Staff Appraisal

The economy of the Republic of China in 1971 achieved the highest growth rate in the past six years. This was accompanied by continuous price stability. The balance of payments, which resulted in an overall surplus larger than in the two preceding years, registered for the first time a substantial surplus in the current account. This achievement was due to the continuing rapid expansion of exports which stimulated industrial production as well as investment activity. The recently adopted Long-Range Development Plan stresses the main goals of modernization and stability with emphasis on heavy and petrochemical industries and exports. Economic growth in 1972 is estimated at a lower rate and the prospects for export expansion are less favorable than in 1971. Nevertheless, the authorities view future developments with confidence. Trends in the first quarter of 1972 indicate that the projected growth rate will be reached, if not surpassed, barring unforeseen factors.

The manufacturing industry, largely export-oriented, has shown a high degree of adaptability in adjusting to changes in demand in foreign markets. However, the policy of concentrating on a few specific commodities for export has encountered either resistance from importing countries or strong competition from countries which export similar products. To meet this situation, the efforts made by the textile industry to shift from low quality to higher quality merchandise should not only minimize the restrictive effects but also increase the ability of its products to compete in neighboring countries. Revaluation of the Japanese yen will undoubtedly have adverse effects on those industries which rely heavily on imports of Japanese machinery, equipment and raw materials. To meet this challenge, domestic producers are slowing down purchases of certain products from Japan while developing import substitutes and purchasing imports from other sources.

The Chinese authorities have also been confronted with certain problems associated with the transformation from an agriculture-based to an industry-dominated economy, such as shortages of farm labor, rising production costs, lower farm incomes, etc., and have introduced an agricultural modernization and mechanization program. The various measures being pursued in this area are in the right direction. It is hoped that, with the more active role played by the Government in agricultural development, a healthy and prosperous agricultural sector will be a permanent feature of the national economy.

The budget performance has shown continued improvement in recent years. Since FY 1969, there have been substantial budget surpluses. On the other hand, the rapid economic growth in recent years has led to a situation where the development of infrastructure facilities has lagged far behind the needs of the economy. Since the rather conservative attitude of the authorities is likely to lead to further delays in the development of infrastructure, it appears to be desirable for the Government to re-examine its fiscal policy with a view to increasing expenditures substantially in selected areas. Owing to the rapid growth of the economy and the nature of the tax structure, the average tax burden has declined (from 22 per cent of GNP to 18 per cent) recently, so that there is still considerable scope for increasing taxes in order to meet increased capital expenditures.

In view of the high rate of economic growth and the favorable price developments and balance of payments, monetary expansion in 1971 cannot be considered to be excessive. Meanwhile, the authorities have pursued as a long-run objective the lowering of interest rates to the level prevailing abroad and the development of a more rational interest rate structure at home. This policy is expected to continue. The staff agrees with the authorities that, from the long-run point of view, there is a need for further refinement of monetary policy instruments and techniques of debt management.

The balance of payments performance in 1972 is expected to be less favorable than in 1971. Though there are some uncertainties due to changing external conditions it appears that the basic trend in the balance of payments will continue to be favorable. The staff believes there is still considerable scope for further liberlization of restrictions on trade and payments.

IV. Proposed Decision

The following draft decision is submitted for consideration by the Executive Directors:

1. This decision is taken by the Executive Directors in concluding the 1971 consultation with the Republic of China pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. During 1971 the growth rate continues at a high level and the price increase was moderate. Although the rate of expansion of money supply in 1971 was high mainly because of the accumulation of exchange reserves and the expansion of credit to the private sector and government enterprises, timely measures of credit control by the authorities kept the monetary expansion consistent with price stability. The Fund hopes that the authorities will continue their program of improvement of financial markets.

3. The balance of payments remained strong in 1971 as improvement in the current account offset some deterioration in the capital account. The high growth rate of exports was maintained despite a number of unfavorable developments abroad.

4. Although a number of steps were taken in 1970 and 1971 to liberalize restrictions on trade and current payments, this [illegible] trend was interrupted in the latter part of 1971 as the authorities responded to uncertainties abroad. In view of the strong balance of payments and reserve position, the Fund believes that there is considerable scope for relaxing restrictions on trade and current payments and hopes that the present suspension of the liberalization program will be ended soon.

Fund Relations with China

China is an original member of the Fund and has a quota of SDR 550 million. During the Fifth General Review of Quotas, China indicated that it did not wish to have its quota increased. China completed its payment of the gold portion of its subscription to the Fund on August 14, 1970. An initial par value of NT$40 per U.S. dollar was established on September 4, 1970.

On December 20, 1971, China informed the Fund that the exchange rate of NT$40 per U.S. dollar would remain unchanged. This represented a decrease in the gold value of the New Taiwan dollar of 7.89 per cent. On May 8, 1972, this rate, which corresponds to NT$43.4386 per SDR 1, was agreed with the Fund as the new par value. On the same date, China notified the Fund that it availed itself of wider margins under Executive Board Decision No. 3463-(71/126), adopted December 18, 1971. A gold tranche purchase of SDR 60 million was made on October 20, 1971. Present Fund holdings of New Taiwan dollars amount to 100 per cent of China's quota.

China is a participant in the Special Drawing Account. China notified the Fund that it did not wish special drawing rights to be allocated to it under the decision of the Fund on the allocation of special drawing rights for the first basic period, but has reserved the right to request the Fund to terminate the effect of the notification with respect to the second and third allocations for the first basic period. No further notification in this respect was received by the Fund and no allocation made.

The Fund has provided substantial technical assistance to the Chinese authorities recently in relation to the introduction of a sales tax, the drafting of a general banking law, the preparation of an operation manual for the Central Bank, and the management of public debt. Mr. Quinton from the fiscal panel was assigned for a term of one year, beginning in May 1971, to assist the Chinese Customs in the adoption of the Brussels Tariff Nomenclature. The services of Mr. Quinton have been extended for another term of one year with effect from May 4, 1972.

The last Article XIV Consultation with the Chinese authorities was held in Taipei from March 22 to April 1, 1971 (SM/71/108, 5/5/71; SM/71/115, 5/13/71; and correction 1, 5/25/71). The Executive Board's decision, taken on May 28, 1971 was as follows (EBM/71/47--Decision No. 3340):

1. This decision is taken by the Executive Directors in concluding the 1970 consultation with the Republic of China pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. The very high growth rate continued in 1970 in an environment of relatively stable prices, and the balance of payments improved further. Trends in the early months of this year together with the policies being pursued by the Government suggest that prospects for 1971 are favorable.

3. During the past year, the accumulation of exchange reserves has been a major factor accounting for monetary expansion. With reserve accumulation being supplemented by demands for development finance, it appears that the monetary authorities face a major challenge in 1971 in keeping credit expansion within the limits consistent with maintenance of price stability. The Fund hopes that the Chinese authorities will keep this situation under continuing review and will take the steps necessary to promote the effective functioning of capital markets and of domestic credit controls.

4. The Fund welcomes the steps that China has taken during the past year to establish a par value, to eliminate the system of registered foreign exchange which involved multiple currency aspects, and to liberalize the restrictions on trade and payments, particularly by expanding the permissible list and by introducing an automatic approval system for imports. The Fund believes that with the present balance of payments and reserves situation there is a good opportunity to make rapid progress in dismantling the remaining restrictions on trade and current payments.

The Managing Director

February 3, 1972

D. S. Savkar and Donald K. Palmer

Republic of China--1971 Article XIV Consultation - Briefing Paper

Attached hereto for approval is the Briefing Paper for the forthcoming mission to China. This has been cleared with the Departments concerned.

Attachment

cc: Mr. Smith

REPUBLIC OF CHINA

1971 Article XIV Consultation - Briefing Paper

Prepared by the Asian Department and the
Exchange and Trade Relations Department

Approved by D. S. Savkar and Donald K. Palmer

February 3, 1972

I. Introduction

The 1971 Article XIV staff consultation discussions with China will be held in Taipei, Taiwan, from March 6 to March 17, 1972. The staff team will consist of Messrs. Koji Suzuki, Alex Ashiabor, Mrs. Hui Chen Wu Yang, and a secretary. Mr. Suzuki will arrive in Taipei on March 5, following his mission to Western Samoa.

II. Fund Relations with China

China is an original member of the Fund and has a quota of SDR 550 million. During the Fifth Quinquennial Review of Quotas, China indicated that it did not wish to have its quota increased. China completed its payment of the gold portion of its subscription to the Fund on August 14, 1970. An initial par value of NT$40 per U.S. dollar was agreed with the Fund on September 4, 1970. In connection with the currency realignmentsthe Government notified the Fund on December 20, 1971 that the existing rate with U.S. dollar is to be maintained. A gold tranche purchase of SDR 60 million was made on October 20, 1971. The 1970 Article XIV consultation discussions with China were held in Taipei from March 22 to April 1, 1971.

China is a participant in the Special Drawing Account. China notified the Fund on December 30, 1969 that it did not wish special drawing rights to be allocated to it under the decision of the Fund on the allocation of special

drawing rights for the first basic period, but reserved the right to request the Fund to terminate the effect of the notification with respect to the second and third allocations for the first basic period. No further notification in this respect was received by the Fund and no allocation made.

The Fund has provided substantial technical assistance to the Chinese authorities in 1969 and 1970 concerning taxation reform and banking legislation. In response to a request from the Minister of Finance, the Fund has recommended Mr. S. G. Quinton, a customs expert, to advise the Chinese authorities from July 1, 1971 for a period of one year on the preparations necessary for adopting the Brussels Tariff Nomenclature.

III. Recent Economic Developments

In 1971, the economy continued to expand at the high rate achieved in the past decade. Preliminary estimates show that GNP at current prices rose by 11.4 per cent. In constant prices the rate of growth in 1971 may be slightly lower than the 10 per cent achieved in the previous year. The average annual rate of growth was about 9 per cent during the period 1953-70 compared with a minimum target of 7 per cent. In January 1972, a ten-year economic development plan (1971-80), which projects an annual increase of real GNP of 8.5 per cent, was adopted. The plan proposes to modernize the economy by accelerating its industrialization and mechanizing agriculture. Emphasis is placed on the development of the chemical and heavy industries. The plan envisages a higher rate of investment than in the past. In view of this and of the changed political climate in particular, the Government now urges the nation to step up domestic saving to provide investment resources rather than to rely heavily on foreign loans and investments.

Money supply increased by 18 per cent in the first eleven months of 1971 compared with less than 10 per cent in the corresponding period of the previous year.

A continued increase in the net foreign assets of the monetary system and in credit to the private sector at an even higher rate than in 1970 were mainly responsible for the higher rate of monetary expansion in the 1971 period.[1/] These expansionary factors were offset to a large extent by a substantial increase in time and savings deposits, equivalent to more than 41 per cent of the outstanding money supply at the beginning of 1971. Net credit to the public sector as a whole showed some increase in the 1971 period in contrast to a decrease in the 1970 period due to a drawing down of government deposits and a larger increase in credit to public enterprises. Despite the rapid expansion in money supply, prices remained relatively stable. Between December 1970 and November 1971 consumer prices rose by 3.2 per cent and wholesale prices by 2.2 per cent.

Budget projections for FY 1972 (ending June 30, 1971) suggested a small surplus. Actual revenues from taxation and monopoly profits increased somewhat more than projected. However, NT$2.8 billion of government bonds were issued during the fiscal year for the redemption of outstanding bonds. Budget projections for the current fiscal year (beginning July 1, 1971) are not yet available. It is only known that the budget is expected to be financed with the same amount of government bond issues as in FY 1971, being the amount needed to meet redemption of public debt falling due.

The overall balance of payments registered substantial surpluses in every year since 1966 except for 1968, with current account deficits generally being more than offset by net capital inflows. In 1970, the overall surplus rose to a record high of US$183 million, about twice the amount of the preceding year. With

1/ The expansionary monetary effects of external transactions of about NT$7 billion during January-November contrast with a decline in total gross gold and foreign exchange reserves (including holdings of both official and commercial banks) equivalent to about NT$2 billion in the same period. The staff does not have any information which would explain the discrepancy.

the increase in exports (about 40 per cent) exceeding the rising imports, there was a trade surplus for the first time since 1954. Direct investment and other private long-term capital inflows decreased somewhat. There was, however, a sharp reversal in the private short-term capital account from a net outflow in 1969 to a net inflow in 1970. The balance of payments for 1971 is not yet available. However, exchange settlement data for the first eleven months of 1971 show that exports were 37 per cent above the corresponding period of 1970 while imports rose by 26 per cent. There was a trade surplus of US$182 million compared with US$13 million for the same period of the preceding year. In line with the pattern of both 1969 and 1970, trade with the United States resulted in a surplus of US$265 million while trade with Japan resulted in a deficit of US$442 million in the eleven-month period. Exports to the United States accounted for 41 per cent of total exports, and imports from the United States were 30 per cent of total imports. Exports to Japan accounted for 12 per cent of total exports, and imports from Japan were 40 per cent of total imports. Trade with Hong Kong resulted in a surplus of US$108 million and with the Federal Republic of Germany US$16 million.

Despite the large surplus resulting from foreign trade, gross official holdings of gold and foreign exchange showed a substantial decrease, from US$624 million at the beginning of 1971 to US$505 million at the end of November 1971. The decline was almost entirely in foreign exchange holdings as the decrease in gold holdings was merely US$2 million. It is not possible to assess this development without a balance of payments estimate for the year.

The exchange and trade control systems were developed during years of balance of payments pressures, and continue to involve extensive controls and restrictions. Beginning mid-1970, the authorities embarked on a major import liberalization program which envisaged gradual shifting of a large number of commodities from the controlled list to the permissible list. An automatic approval system was introduced, and a general licensing system was established for imports by large manufacturers and other direct users. However, following the U.S. measures of August 15, 1971 the authorities suspended further decontrol action.

In spite of the steps taken by the U.S. in August 1971 which had wide ranging currency effects, listed currencies (Australian dollar, deutsche mark, Hong Kong dollar, Malaysian dollar, pound sterling and Swiss franc) continued to be quoted daily, based on their market rates abroad with buying and selling margins of 0.75 per cent. It is understood that the authorities are considering adoption of wider margins under the "Fund's decision on Central Rates and Wider Margins" E.B. Decision No. 3463-(71-126), adopted December 18, 1971.

IV. Issues for Discussion

As the above developments indicate, the economy, in 1971, continued to expand at a high rate without great difficulties. However, considering the effects of the recent realignment of currencies and the potential effects of external political developments, future development of the economy is clouded by uncertainties. The staff will discuss with the authorities the following issues.

There have been five Four-Year Development Plans; 1972 is the last year of the Fifth Four-Year Plan. There has so far been no indication of intentions to introduce a new Four-Year Plan. However, a Ten-Year Plan (1971-80) which appears to be a perspective plan was adopted at the beginning of 1972. The staff team will review the assumptions underlying the projections of the Ten-Year Plan, and explore how it is related to the four-year plans. The staff team will also discuss with the authorities their policies, planning strategies, and future outlook for continued growth, particularly in the light of the potential decline in the inflow of external resources.

Regarding monetary developments, the expansionary forces stemming from the increases in foreign assets (which may not continue) and the recent acceleration of credit could generate some inflationary pressures. The staff team will endeavor to reconcile the increase in the monetary system's foreign assets with the decline in gold and foreign exchange holdings. The staff team will explore with the authorities the scope for pursuing compensatory fiscal, monetary and other policies to cope with disturbances generated by external factors. The staff team will also review the progress made in the improvement of money and capital markets, as well as in the use of instruments of monetary policies and the outlook for adjustments and modifications in the context of the changing internal and external circumstances.

The overall balance of payments generally registered surpluses in the last few years, largely due to the rapid growth in exports and continued inflows of foreign capital. The trade pattern is characterized by surpluses vis-à-vis the United States and chronic and growing deficits vis-à-vis Japan. The recent revaluations, particularly of the yen, will substantially increase the cost of imported materials, spare parts, and equipment which could in turn affect trade balance, production costs and general price level. The staff team will discuss with the authorities the impact of realignment of currencies on domestic prices and the trade balance. Due to the fact that industries and factories in Taiwan are structurally highly geared to the use of Japanese machinery and materials, demand for imports from Japan is relatively inelastic with regard to price changes. On the other hand, exports to Japan are unlikely to benefit much from the yen revaluation as they are restrained more by direct rather than cost restrictions. The staff team will explore with the authorities a possible solution to improve the situation. In regard to long-term strategy, the staff team will discuss with the authorities the feasibility of import diversification and will also assess the authorities' view on the appropriateness of the current exchange rate particularly in the context of the changing circumstances after the currency realignments.

Despite the strengthened trade position (a surplus of $182 million for January-November 1971) the gross official holdings of foreign exchange showed a decrease of $117 million during the same period. Apparently, some outflows of capital might in part account for this development. The staff team will, in this respect, examine the capital account and foreign debt position as well as other foreign transactions. In view of the changing circumstances the staff team will also discuss with the authorities their policies regarding external financing, both short-term and long-term.

During the consultations of previous years, the staff teams urged the authorities to liberalize the import control system. Little progress had been made until 1970; in early 1971 an automatic approval system was introduced for a number of imported goods, a large number of items was shifted from the controlled list to the permissible list, and a general license system was established for imports by endusers. Potential effects of this relaxation will be assessed during this consultation. The staff team will also inquire about the progress made in respect to tariff revisions which were expected to come into effect during the summer of 1971. Due to the political pressures, the resistance to further rationalization of tariffs and liberalization of the present trade system at this particular time is likely to be strong. The staff team will inquire about plans for future modifications of the trade and exchange system and discuss related issues.

At the time of 1969 consultation discussions the staff team expressed concern about official gold transactions that were inconsistent with the Fund's policies on gold and official purchases were made, though for very small amounts, of domestically produced gold at a price in excess of US$35 per ounce. In early 1971, the authorities suspended these arrangements. At the time of the previous consultation discussions new regulations were being prepared whose main objective is to ensure a stable price of gold in the domestic market. The staff team will review with the authorities the proposed arrangements and will also attempt to obtain information on recent developments in the gold market in Taiwan.

MEMORANDUM

January 31, 1972

To: Exchange & Trade Relations
Legal
Treasurer's

File

From: K. Suzuki K.S.

Subject: Republic of China--1971 Article XIV Consultation - Briefing Paper

May we please have your comments by close of business

Wednesday, February 2.

Attachment

CONFIDENTIAL

REPUBLIC OF CHINA

1971 Article XIV Consultation - Briefing Paper

Prepared by the Asian Department and the Exchange and Trade Relations Department

Approved

February 31, 1972

I. Introduction

[illegible]1 Article XIV staff consultation discussions with China will be [illegible] Taipei, Taiwan, from March 6 to March 17, 1972. The staff team will consist of Messrs. Koji Suzuki, Alex Ashiabor, Mrs. Hui Chen Wu Yang, and a secretary. Mr. Suzuki will arrive in Taipei on March 5, following his mission to Western Samoa.

II. Fund Relations with China

China is an original member of the Fund and has a quota of $550 million. During the Fifth Quinquennial Review of Quotas, China indicated that it did not wish to have its quota increased. China completed its payment of the gold portion of its subscription to the Fund on August 14, 1970. An initial par value of NT$40 per U.S. dollar was agreed with the Fund on September 4, 1970. In connection with the currency realignment the Government notified the Fund on December 20, 1971 that the existing rate with U.S. dollar is to be maintained. A gold tranche purchase in the equivalent of $60 million was made on October 20, 1971. The 1970 Article XIV consultation with China was held in Taipei from March 22 to April 1, 1971.

China is a participant in the Special Drawing Account. China notified the Fund on December 30, 1969 that it did not wish special drawing rights to be allocated to it under the decision of the Fund on the allocation of special

drawing rights for the first basic period, but has reserved the right to request the Fund to terminate the effect of the notification with respect to the second and third allocations for the first basic period. No further notification in this respect has been received by the Fund up to the present.

The Fund has provided substantial technical assistance to the Chinese authorities in 1969 and 1970 concerning taxation reform and banking legislation. In response to a request from the Minister of Finance, the Fund has recommended Mr. S. G. Quinton, a customs expert, to advise the Chinese authorities from July 1, 1971 for a period of one year on the preparations necessary for adopting the Brussels Tariff Nomenclature.

III. Recent Economic Developments

In 1971, the economy continued to expand at the high rate achieved in the past decade. Preliminary estimates show that GNP at current prices rose by 11.4 per cent. In constant prices the rate of growth in 1971 may be slightly lower than the 10 per cent achieved in the previous year. The average annual rate of growth was about 9 per cent during the period 1953-70 compared with a minimum target of 7 per cent. In January 1972, a ten-year economic development plan (1971-80), which projects an annual increase of real GNP of 8.5 per cent, was adopted. The plan proposes to modernize the economy by accelerating its industrialization and mechanizing agriculture. Emphasis is placed on the development of the chemical and heavy industries. The plan envisages a higher rate of investment than in the past. In view of this and of the changed political climate in particular, the Government now urges the nation to step up domestic saving to provide investment resources rather than to rely heavily on foreign loans and investments.

Money supply increased by 18 per cent in the first eleven months of 1971 compared with less than 10 per cent in the corresponding period of the previous year. A continued increase in the net foreign assets of the monetary system and in credit to the private sector at an even higher rate than in 1970 were mainly responsible for the higher rate of monetary expansion in the 1971 period.[1/] These expansionary factors were offset to a large extent by a substantial increase in time and savings deposits, equivalent to more than 41 per cent of the outstanding money supply at the beginning of 1971. Net credit to the public sector as a whole showed some increase in the 1971 period in contrast to a decrease in the 1970 period due to a drawing down of government deposits and a larger increase in credit to public enterprises. Despite the rapid expansion in money supply, prices remained relatively stable. Between December 1970 and November 1971 consumer prices rose by 3.2 per cent and wholesale prices by 2.2 per cent.

Budget projections for FY 1971 (ending June 30, 1971) suggested a small surplus. Actual revenues from taxation and monopoly profits increased somewhat more than projected. However, NT$2.8 billion of government bonds were issued during the fiscal year for the redemption of outstanding bonds. Budget projections for the current fiscal year (beginning July 1, 1971) are not yet available. It is only known that the budget is expected to be financed with the same amount of Government bond issues as in FY 1971, being the amount needed to meet redemption of public debt falling due.

The overall balance of payments registered substantial surpluses in every year since 1966 except for 1968, with current account deficitis generally being

1/ The expansionary monetary effects of external transactions of about NT$7 billion during January-November contrast with a decline in official gold and foreign exchange reserves equivalent to about NT$5 billion in the same period. This discrepancy, equivalent to about US$300 million, can at present not be explained.

more than offset by net capital inflows. In 1970, the overall surplus rose to a record high of US$183 million, about twice the amount of the preceding year. With the increase in exports (about 40 per cent) exceeding the rising imports, there was a trade surplus for the first time since 1964. Direct investment and other private long-term capital inflows decreased somewhat. There was, however, a sharp reversal in the private short-term capital account from a net outflow in 1969 to a net inflow in 1970. The balance of payments for 1971 is not yet available. However, exchange settlement data for the first eleven months of 1971 show that exports were 37 per cent above the corresponding period of 1970 while imports rose by 26 per cent. There was a trade surplus of US$182 million compared with US$13 million for the same period of the preceding year. In line with the pattern of both 1969 and 1970, trade with the United States resulted in a surplus of US$265 million while trade with Japan resulted in a deficit of US$442 million in the eleven-month period. Exports to the United States accounted for 41 per cent of total exports, and imports from the United States were 30 per cent of total imports. Exports to Japan accounted for 12 per cent of total exports, and imports from Japan were 40 per cent of total imports. Trade with Hong Kong resulted in a surplus of US$108 million and with the Federal Republic of Germany US$16 million.

Despite the large surplus resulting from foreign trade, gross official holdings of gold and foreign exchange showed a substantial decrease, from US$624 million at the beginning of 1971 to US$505 million at the end of November 1971. The decline was almost entirely in foreign exchange holdings as the decrease in gold holdings was merely US$2 million. It is not possible to assess this development without a balance of payments estimate for the year.

The exchange and trade control systems were developed during years of balance of payments pressures, and continue to involve extensive controls and restrictions. Beginning mid-1970, the authorities embarked on a major import liberalization program which envisaged gradual shifting of a large number of commodities from the controlled list to the permissible list. An automatic approval system was introduced, and a general licensing system was established for imports by large manufacturers and other direct users. However, following the U.S. measures of August 15, 1971 the authorities suspended further decontrol action.

In spite of the steps taken by the U.S. in August 1971 which had wide ranging currency effects, listed currencies (Australian dollar, deutsche mark, Hong Kong dollar, Malaysian dollar, pound sterling and Swiss franc) continued to be quoted daily, based on their market rates abroad with buying and selling margins of 0.75 per cent. It is understood that the authorities are considering adoption of wider margins under the Fund's Decision, December 18, 1971.

IV. Issues for Discussion

As the above developments indicate, the economy, in 1971, continued to expand at a high rate without great difficulties. However, considering the effects of the recent realignment of currencies and the potential effects of external political developments, future development of the economy is clouded by uncertainties. The staff will discuss with the authorities the following issues.

There have been five Four-Year Development Plans; 1972 is the last year of the Fifth Four-Year Plan. There has so far been no indication of intentions to introduce a new Four-Year Plan. However, a Ten-Year Plan (1971-80) which appears to be a perspective plan was adopted at the beginning of 1972.

The staff team will review the assumptions underlying the projections of the Ten-Year Plan, and explore how it is related to the four-year plans. The staff team will also discuss with the authorities their policies, planning strategies, and future outlook for continued growth, particularly in the light of the potential decline in the inflow of external resources.

Regarding monetary developments, the expansionary forces stemming from the increases in foreign assets (which may not continue) and the recent acceleration of credit could generate some inflationary pressures. The staff team will endeavor to reconcile the increase in the monetary system's foreign assets with the decline in gold and foreign exchange holdings. The staff team will explore with the authorities the scope for pursuing compensatory fiscal, monetary and other policies to cope with disturbances generated by external factors. The staff team will also review the progress made in the improvement of money and capital markets, as well as in the use of instruments of monetary policies and the outlook for adjustments and modifications in the context of the changing internal and external circumstances.

The overall balance of payments generally registered surpluses in the last few years, largely due to the rapid growth in exports and continued inflows of foreign capital. The trade pattern is characterized by surpluses vis-à-vis the United States and chronic and growing deficits vis-à-vis Japan. The recent revaluations particularly of the yen, will substantially increase the cost of imported materials, spare parts, and equipment which would in turn affect trade balance, production costs and general price level. The staff team will discuss with the authorities ways and means to reduce the impact of realignment of currencies on domestic prices and the trade balance. Due to the fact that industries and factories in Taiwan are structurally highly geared to the use of

Japanese machinery and materials, demand for imports from Japan is relatively inelastic with regard to price changes. On the other hand, exports to Japan are unlikely to benefit much from the yen revaluation as they are restrained more by direct rather than cost restrictions. The staff team will explore with the authorities a possible solution to improve the situation. In regard to long-term strategy, the staff team will discuss with the authorities the feasibility of import diversification and the appropriateness of the current exchange rate, which at present the staff believes to be not unsatisfactory.

Despite the strengthened trade position (a surplus of $182 million for January-November 1971) the gross official holdings of foreign exchange showed a decrease of $117 million during the same period. Apparently, some outflows of capital might in part account for this development. The staff team will, in this respect, examine the capital account and foreign debt position as well as other foreign transactions. In view of the changing circumstances the staff team will also discuss with the authorities their policies regarding external financing, both short-term and long-term.

During the consultations of previous years, the staff teams urged the authorities to liberalize the import control system. Little progress had been made until 1970; in early 1971 an automatic approval system was introduced for a number of imported goods, a large number of items was shifted from the controlled list to the permissible list, and a general license system was established for imports by endusers. Potential effects of this relaxation will be assessed during this consultation. The staff team will also inquire about the progress made in respect to tariff revisions which were expected to come into effect during the summer of 1971. Due to the political pressures, the resistance to further rationalization of tariffs and liberalization of the present trade system at this particular time is likely to be strong. The staff team will inquire about plans for future modifications of the trade and exchange system and discuss related issues.

At the time of the 1969 consultation discussions the staff team expressed concern about official gold transactions that were inconsistent with the Fund's policies on gold. In early 1971, the authorities suspended the past arrangements providing for official purchases of very small amounts of domestically produced gold at a price in excess of US$35 per ounce. New regulations were being prepared at the time of the previous consultation discussions. The staff team will review with the authorities these new arrangements whose main objective is to ensure a stable price of gold in the domestic market. The staff team will also attempt to obtain information on recent developments in the gold market in Taiwan.

Mr. Starc

Office Memorandum

CONFIDENTIAL

Exchange and Trade Relation Department

RECEIVED APR 5 1971 EXCHANGE & TRADE RELATIONS DEPARTMENT

TO : The Managing Director
The Deputy Managing Director

DATE: April 5, 1971

FROM : W. John R. Woodley

SUBJECT : China--1970 Article XIV Consultation

The mission, which included Messrs. Kari R. Nars, Shi Kwon Yu, Gunter D. Baer, and Mrs. Lucille Said, was in Taipei from mid-March to April 1, 1971, and was treated extremely well by the authorities. The chairman of the meetings was Mr. I. S. Sun, Deputy Governor of the Bank, and we saw the Governor of the Bank and the Minister of Finance both at the beginning and at the end of the discussions.

The general economic situation is good. Total output rose about 10 per cent in real terms in 1970, the price level rose by less than 4 per cent as measured by the national income deflator, and there was a large accumulation of foreign exchange reserves as exports rose sharply. In these circumstances, discussion focused mainly on prospective uncertainties.

The main policy issue concerning the authorities is the increase in foreign exchange reserves. Because of this, there has been progress on the restrictive system including general licensing of materials and open general licenses in the past nine months, and considerably more is planned for the coming year. A new tariff based more closely on a value-added principle to encourage greater domestic content is expected to be introduced in the middle of this year, and it should help further to accelerate the liberalization program. So far, the liberalization has occurred in the "easy" categories with little apparent effect on domestic production but, if the present plans are implemented, more substantial effects should become evident next year. Undoubtedly business opposition will rise as more imports are affected so it remains to be seen if progress will continue.

The high rate of increase of reserves is making evident the weakness in the Central Bank monetary control machinery. The mission did monetary projections showing the amount of credit compatible with price stability at various growth rates, and then indicated appropriate levels of net domestic assets for the Central Bank if reserves rise at amounts between $100 million and $180 million. Even with a 15 per cent growth rate in GNP at current prices, the Central Bank will have to reduce net domestic assets if exchange reserves rise by more than $100 million per year.

While the government officials seemed fully aware of the potential problem, they are not well prepared to take the necessary action. The budget cash surplus which has been offsetting some of the credit expansion to the private sector appears likely to decline by a moderate amount in FY 1972, and the Central Bank is under considerable pressure to finance various development projects. Despite this, the Central Bank (but not the Ministry of Finance) showed reluctance about our suggestions to increase bond sales to the public and to devise new forms of savings instruments. There is no market in Treasury bills or other securities that could be used for open market operations. Increases in bank reserve requirements of the large amount needed are not regarded as practical since commercial bank earnings are a sensitive issue and the Central Bank wants to reduce gradually the high interest rate structure. Some consideration is being given to permitting the commercial banks to hold larger foreign exchange balances to avoid the monetary impact of sales to the Central Bank. This proposal is regarded as "radical," however, since it involves a reversal of the psychological attitudes based on a long period of exchange shortages and some freedom in exchange transactions, while the commercial banks prefer Taiwan dollar to foreign exchange assets because of the sharply higher rate of return (15 to 18 per cent) on the former. Despite the apparent rejection of the various means that could be used to offset the monetary effects of the increase in exchange reserves, our judgment is that the authorities are aware of the problem, that they are determined to prevent an excessive increase in credit, and that methods will be found to keep the situation under reasonable control.

The balance of payments has been very strong in 1970 and so far in 1971 with an increase of close to 40 per cent in exports and about 20 to 25 per cent in imports. Capital inflows in the form of direct investment and short-term trade financing have also been large, and U.S. banks are actively pushing acceptance of additional credits. Steps have been taken to prevent foreign borrowing for local currency financing, and import credits and suppliers' credits are being closely scrutinized. The only problems in evidence are the following. First, about 40 per cent of exports, and the fastest growing segment, is textiles. Second, exports involve substantial import processing, and in some cases the value added seems very small. Government revenues from the export-processing trade zones apparently have been so low as to raise doubts about expansion of them. Third, questions have arisen regarding the tax concessions given to new investors in export industries, mostly because of the effects on tax revenues. Fourth, declining interest rates abroad have reduced the Central Bank's earnings with some effect on their attitude toward concessional rates on domestic transactions.

A few other topics are worth mentioning. The Minister of Finance, who was working with an IFC mission on the functioning of capital markets, requested the Fund to provide an expert on developing sales of various forms of government and other types of savings instruments. I questioned if such help was necessary quoting a report by Rouse, who was sent last year, on the high level of expertise in Taiwan, but the Minister replied that outside technical help was essential, particularly on the operations of markets, to overcome domestic economic conservatism. Since the Central Bank showed little enthusiasm for this idea, I think we should proceed with caution. I will consult with Mr. Mladek and the IFC mission before making firm recommendations. Second, the Government has suspended an arrangement under which it purchased locally produced gold at $44 per ounce. We discussed possible forms of new arrangements not inconsistent with Fund policies, and the Chinese authorities agreed to consult with us before introducing new regulations. Third, the VAT project prepared with the help of Fund technical assistance is apparently in a state of suspense chiefly because of fears created by European experience regarding its possible impact on domestic prices. The Minister of Finance is, however, apparently still convinced of its merits particularly with regard to exports and will attempt to get acceptance of it at an opportune time.

No other major tax changes are planned for FY 1972 apart from the tariff reform mentioned above. Fourth, the growing disparity between incomes in agriculture and industry is causing concern. So far, price support operations have been avoided, but this will remain a sensitive political issue so long as the Japanese market for farm products is so restricted.

cc: Messrs. Gold
Goode
Habermeier
Keesing
Mladek
Polak
Savkar
Sturc
Staff team
Mrs. Yang
Far Eastern Div.

CONFIDENTIAL

REPUBLIC OF CHINA

1971 Article XIV Consultation - Briefing Paper

Prepared by the Asian Department and the
Exchange and Trade Relations Department

Approved by D.S. Sarkar and Donald K. Palmer

February 3, 1972

I. Introduction

The 1971 Article XIV staff consultation discussions with China will be held in Taipei, Taiwan, from March 6 to March 17, 1972. The staff team will consist of Messrs. Koji Suzuki, Alex Ashiabor, Mrs. Hui Chen Wu Yang, and a secretary. Mr. Suzuki will arrive in Taipei on March 5, following his mission to Western Samoa.

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China is an original member of the Fund and has a quota of SDR 550 million. During the Fifth Quinquennial Review of Quotas, China indicated that it did not wish to have its quota increased. China completed its payment of the gold portion of its subscription to the Fund on August 14, 1970. An initial par value of NT$40 per U.S. dollar was agreed with the Fund on September 4, 1970. In connection with the currency realignment the Government notified the Fund on December 20, 1971 that the existing rate with U.S. dollar is to be maintained. A gold tranche purchase of SDR 60 million was made on October 20, 1971. The 1970 Article XIV consultation discussions with China were held in Taipei from March 22 to April 1, 1971.

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drawing rights for the first basic period, but reserved the right to request the Fund to terminate the effect of the notification with respect to the second and third allocations for the first basic period. No further notification in this respect was received by the Fund and no allocation had been made.

The Fund has provided substantial technical assistance to the Chinese authorities in 1969 and 1970 concerning taxation reform and banking legislation. In response to a request from the Minister of Finance, the Fund has recommended Mr. S. G. Quinton, a customs expert, to advise the Chinese authorities from July 1, 1971 for a period of one year on the preparations necessary for adopting the Brussels Tariff Nomenclature.

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In 1971, the economy continued to expand at the high rate achieved in the past decade. Preliminary estimates show that GNP at current prices rose by 11.4 per cent. In constant prices the rate of growth in 1971 may be slightly lower than the 10 per cent achieved in the previous year. The average annual rate of growth was about 9 per cent during the period 1953-70 compared with a minimum target of 7 per cent. In January 1972, a ten-year economic development plan (1971-80), which projects an annual increase of real GNP of 8.5 per cent, was adopted. The plan proposes to modernize the economy by accelerating its industrialization and mechanizing agriculture. Emphasis is placed on the development of the chemical and heavy industries. The plan envisages a higher rate of investment than in the past. In view of this and of the changed political climate in particular, the Government now urges the nation to step up domestic saving to provide investment resources rather than to rely heavily on foreign savings (loans and investments.)

Money supply increased by 18 per cent in the first eleven months of 1971 compared with less than 10 per cent in the corresponding period of the previous year.

A continued increase in the net foreign assets of the monetary system and in credit to the private sector at an even higher rate than in 1970 were mainly responsible for the higher rate of monetary expansion in the 1971 period.[1/] These expansionary factors were offset to a large extent by a substantial increase in time and savings deposits, equivalent to more than 41 per cent of the outstanding money supply at the beginning of 1971. Net credit to the public sector as a whole showed some increase in the 1971 period in contrast to a decrease in the 1970 period due to a drawing down of government deposits and a larger increase in credit to public enterprises. Despite the rapid expansion in money supply, prices remained relatively stable. Between December 1970 and November 1971 consumer prices rose by 3.2 per cent and wholesale prices by 2.2 per cent.

Budget projections for FY 1971 (ending June 30, 1971) suggested a small surplus. Actual revenues from taxation and monopoly profits increased somewhat more than projected. However, NT$2.8 billion of government bonds were issued during the fiscal year for the redemption of outstanding bonds. Budget projections for the current fiscal year (beginning July 1, 1971) are not yet available. It is only known that the budget is expected to be financed with the same amount of government bond issues as in FY 1971, being the amount needed to meet redemption of public debt falling due.

The overall balance of payments registered substantial surpluses in every year since 1966 except for 1968, with current account deficits generally being more than offset by net capital inflows. In 1970, the overall surplus rose to a record high of US$183 million, about twice the amount of the preceding year. With

1/ The expansionary monetary effects of external transactions of about NT$7 billion during January-November contrast with a decline in total gross gold and foreign exchange reserves (including holdings of both official and commercial banks) equivalent to about NT$2 billion in the same period. The staff does not have any information which would explain the discrepancy.

the increase in exports (about 40 per cent) exceeding the rising imports, there was a trade surplus for the first time since 1954. Direct investment and other private long-term capital inflows decreased somewhat. There was, however, a sharp reversal in the private short-term capital account from a net outflow in 1969 to a net inflow in 1970. The balance of payments for 1971 is not yet available. However, exchange settlement data for the first eleven months of 1971 show that exports were 37 per cent above the corresponding period of 1970 while imports rose by 26 per cent. There was a trade surplus of US$182 million compared with US$13 million for the same period of the preceding year. In line with the pattern of both 1969 and 1970, trade with the United States resulted in a surplus of US$265 million while trade with Japan resulted in a deficit of US$442 million in the eleven-month period. Exports to the United States accounted for 41 per cent of total exports, and imports from the United States were 30 per cent of total imports. Exports to Japan accounted for 12 per cent of total exports, and imports from Japan were 40 per cent of total imports. Trade with Hong Kong resulted in a surplus of US$108 million and with the Federal Republic of Germany US$16 million.

Despite the large surplus resulting from foreign trade, gross official holdings of gold and foreign exchange showed a substantial decrease, from US$624 million at the beginning of 1971 to US$505 million at the end of November 1971. The decline was almost entirely in foreign exchange holdings as the decrease in gold holdings was merely US$2 million. It is not possible to assess this development without a balance of payments estimate for the year.

The exchange and trade control systems were developed during years of balance of payments pressures, and continue to involve extensive controls and restrictions. Beginning mid-1970, the authorities embarked on a major import liberalization program which envisaged gradual shifting of a large number of commodities from the controlled list to the permissible list. An automatic approval system was introduced, and a general licensing system was established for imports by large manufacturers and other direct users. However, following the U.S. measures of August 15, 1971 the authorities suspended further decontrol action.

In spite of the steps taken by the U.S. in August 1971 which had wide ranging currency effects, listed currencies (Australian dollar, deutsche mark, Hong Kong dollar, Malaysian dollar, pound sterling and Swiss franc) continued to be quoted daily, based on their market rates abroad with buying and selling margins of 0.75 per cent. It is understood that the authorities are considering adoption of wider margins under the "Fund's decision on Central Rates and Wider Margins" E.B. Decision No. 3463-(71-126), adopted December 18, 1971.

IV. Issues for Discussion

As the above developments indicate, the economy, in 1971, continued to expand at a high rate without great difficulties. However, considering the effects of the recent realignment of currencies and the potential effects of external political developments, future development of the economy is clouded by uncertainties. The staff will discuss with the authorities the following issues.

There have been five Four-Year Development Plans; 1972 is the last year of the Fifth Four-Year Plan. There has so far been no indication of intentions to introduce a new Four-Year Plan. However, a Ten-Year Plan (1971-80) which appears to be a perspective plan was adopted at the beginning of 1972. The staff team will review the assumptions underlying the projections of the Ten-Year Plan, and explore how it is related to the four-year plans. The staff team will also discuss with the authorities their policies, planning strategies, and future outlook for continued growth, particularly in the light of the potential decline in the inflow of external resources.

Regarding monetary developments, the expansionary forces stemming from the increases in foreign assets (which may not continue) and the recent acceleration of credit could generate some inflationary pressures. The staff team will endeavor to reconcile the increase in the monetary system's foreign assets with the decline in gold and foreign exchange holdings. The staff team will explore with the authorities the scope for pursuing compensatory fiscal, monetary and other policies to cope with disturbances generated by external factors. The staff team will also review the progress made in the improvement of money and capital markets, as well as in the use of instruments of monetary policies and the outlook for adjustments and modifications in the context of the changing internal and external circumstances.

The overall balance of payments generally registered surpluses in the last few years, largely due to the rapid growth in exports and continued inflows of foreign capital. The trade pattern is characterized by surpluses vis-à-vis the United States and chronic and growing deficits vis-à-vis Japan. The recent revaluations, particularly of the yen, will substantially increase the cost of imported materials, spare parts, and equipment which could in turn affect trade balance, production costs and general price level. The staff team will discuss with the authorities the impact of realignment of currencies on domestic prices and the trade balance. Due to the fact that industries and factories in Taiwan are structurally highly geared to the use of Japanese machinery and materials, demand for imports from Japan is relatively inelastic with regard to price changes. On the other hand, exports to Japan are unlikely to benefit much from the yen revaluation as they are restrained more by direct rather than cost restrictions. The staff team will explore with the authorities a possible solution to improve the situation. In regard to long-term strategy, the staff team will discuss with the authorities the feasibility of import diversification and will also assess the authorities' view on the appropriateness of the current exchange rate particularly in the context of the changing circumstances after the currency realignments.

Despite the strengthened trade position (a surplus of $182 million for January-November 1971) the gross official holdings of foreign exchange showed a decrease of $117 million during the same period. Apparently, some outflows of capital might in part account for this development. The staff team will, in this respect, examine the capital account and foreign debt position as well as other foreign transactions. In view of the changing circumstances the staff team will also discuss with the authorities their policies regarding external financing, both short-term and long-term.

During the consultations of previous years, the staff teams urged the authorities to liberalize the import control system. Little progress had been made until 1970; in early 1971 an automatic approval system was introduced for a number of imported goods, a large number of items was shifted from the controlled list to the permissible list, and a general license system was established for imports by endusers. Potential effects of this relaxation will be assessed during this consultation. The staff team will also inquire about the progress made in respect to tariff revisions which were expected to come into effect during the summer of 1971. Due to the political pressures, the resistance to further rationalization of tariffs and liberalization of the present trade system at this particular time is likely to be strong. The staff team will inquire about plans for future modifications of the trade and exchange system and discuss related issues.

At the time of 1969 consultation discussions the staff team expressed concern about official gold transactions that were inconsistent with the Fund's policies on gold and official purchases were made, though for very small amounts, of domestically produced gold at a price in excess of US$35 per ounce. In early 1971, the authorities suspended these arrangements. At the time of the previous consultation discussions new regulations were being prepared whose main objective is to ensure a stable price of gold in the domestic market. The staff team will review with the authorities the proposed arrangements and will also attempt to obtain information on recent developments in the gold market in Taiwan.

The Managing Director
The Deputy Managing Director

Mr. R. Tenconi

Mission to China

June 8, 1970

NB

In response to a request from the Chinese authorities a mission comprising Messrs. R. Tenconi and D. Khatkhate of the Central Banking Service and Mr. Effros of the Legal Department visited Taipei from April 19 to May 9 to assist the authorities in drafting a new general banking legislation, revising the negotiable instruments law, and reviewing the operations of the Central Bank. Mr. Robert Rouse, former Senior Vice President of the Federal Reserve Bank of New York, who also served as Manager of the Open Market Account, accompained the mission as a consultant. While Mr. Rouse's primary responsibility was to advise the Chinese authorities on problems associated with public debt management, he worked in very close cooperation with the mission in other fields and his contribution to the mission's work was very valuable.

The mission met several times with the ad hoc committees which had been set up to study the problems included in the mission's terms of reference and to make appropriate recommendations to the authorities. In addition, the members of the mission held informal discussions with various officials, University professors and representatives of the financial community who had been associated with the work of the committees. Finally, we had the opportunity before our departure to discuss our preliminary observations with the Minister of Finance and the Governor of the Central Bank. At the request of the various officials involved, we agreed after our return to headquarters, to send written comments and suggestions on the various problems discussed during our visit.

(1) General Banking Legislation

The Chinese banking system is controlled to a large extent by the national and local governments which directly or indirectly own most of the banking institutions. A number of these institutions operate either under special charters or in accordance with administrative orders and guidelines published at the time they were established. Their legal status is still debated in government and financial circles and there are considerable doubts and discussions as to whether the provisions of the present banking law are applicable to them and, if so, to what extent. One of the purposes of the preliminary draft prepared by the Committee on Revision of Banking Legislation under the chairmanship of Vice-Minister of Finance Ma was to clear up these uncertainties and to introduce greater unity in official supervision of the banking system. To this effect the draft provides that all banks would be subject to the new legislation in areas not regulated by special charters, and empowers the supervisory authorities to apply the provisions of the new law to non-banking financial institutions by means of administrative orders.

The special relationship between the Government and the banking system has made moral suasion an effective monetary policy instrument in some instances, but it has also limited the freedom of action of the bank boards, adversely affected competition among banks, and in some instances has led to conflicts between the Ministry and the Central Bank. In particular, the authorities are concerned with the overcautious attitude of the banking system with regard to medium-term lending. One of the main objectives of the draft legislation is to promote and encourage the channeling of savings funds into development use. To achieve this objective, the Committee has under consideration various devices such as the division of banks into several categories according to their lending activities and the use of lending ratios to compel the banks to channel some of their funds into medium- and long-term credits. Discussions on these points revealed a considerable divergence of opinion among the members of the Committee, especially with regard to the division of banks into commercial banks, savings banks, industrial banks, short-term agricultural banks, and long-term agricultural banks. Review of the experience of foreign countries in similar situations and a study of possible alternative solutions helped the Committee in clarifying the arguments on the contemplated classification; however, no final decision had been reached on the subject before the mission's departure.

There were also discussions on the draft provisions relating to capital requirements, reserve requirements and other monetary and credit control instruments, and on methods to achieve better cooperation between the Ministry of Finance and the Central Bank in the field of bank supervision. The mission reviewed in detail the preliminary draft prepared by the Committee and offered suggestions on a number of minor points to complete and improve some of the sections of the draft and to remove a number of ambiguities.

(2) Negotiable Instruments Law

The authorities of the Republic of China have been concerned for some time with the widespread use of postdated checks as credit instruments. It seems that the preference for postdated checks over promissory notes primarily stems from the possibility for the payee or the holder to cash the check before the date stated on it as he may deem fit and from the criminal penalties to which the drawer is subject in the event of dishonored check. That promissory notes are presently ineligible for rediscount at the Central Bank and are subject to a higher stamp duty than checks has also discouraged the substitution of notes for checks. The Committee on Revision of the Negotiable Instruments Law, presided over by Vice-Minister Wang, has not yet decided on how they should deal with the problem of postdated checks, and more especially whether the postdated checks should be given some sort of legal recognition or, on the contrary, whether the law should be amended to make the use of postdated checks more difficult, to remove some of the advantages now associated with it, and to encourage the use of promissory notes.

neither are cheques subject to rediscount & C.B. limitations.

The problem of post dated cheques.

In connection with the contemplated revision of the law on negotiable instruments, the Committee also requested the advice of the mission on a number of problems of a legal or practical nature including penalties for dishonored checks, stop payment orders, return of cancelled checks to the drawer, and payment of foreign negotiable instruments.

The mission, and in particular Mr. Effros, focused essentially on the problem of postdated checks and offered various suggestions to deal with it. Because of the short time available it was agreed that suggestions on the other points raised by the Committee would be sent from Washington.

(3) Central Bank operations

For some time the Central Bank of China has been under criticism from officials of the Ministry of Finance for its monetary and credit policy management. Some of the shortcomings stem from the inadequacy of the legislation, which does not provide the Bank with all the powers generally granted to central banks; there also seems to be some reluctance on its part to make full use of its existing powers. Other difficulties may be related to the special and somewhat anomalous status of the Bank of Taiwan which acted as bank of issue until the reactivation of the Central Bank of China in 1962 and which still retains some of the privileges of a central bank. Finally, the fact that the Government, and more especially the Ministry of Finance, through its holdings of bank shares influences directly the daily decisions of the banking system has undoubtedly limited the autonomy of the Central Bank in implementing a national monetary policy.

In response to criticism raised against it and to problems it has encountered in various fields, the Central Bank is in the process of reappraising its procedures and its techniques of monetary and credit controls. In particular, Deputy Governor Lee and the Committee on Central Bank operations requested the advice of the mission on the various methods to encourage the extension of medium-term credit by banks and to provide rediscounting facilities for some of these credits as the need may arise, without generating undue inflationary pressure on the economy. Various suggestions to deal with these problems were discussed including the establishment of a special rediscount fund out of the Central Bank's profits or budgetary allocations and the use of the savings collected by the Post Office Savings Bank to provide the banking system with medium-term refinancing facilities.

The mission reviewed the present techniques of monetary control used by the Central Bank. Since open market operations on a significant scale are not likely for some time to come, there is little doubt that the Central Bank will have to make its credit policies effective primarily through reserve requirements and rediscount policy. On the latter point, the Central Bank has relied almost exclusively until now on its discount rate policy, despite the general limitations of such measures in most developing countries and the much higher interest rates prevailing on the nonbank credit market in Taiwan. In this context the techniques of discretionary control over the amount of credit made available to the banking system as a whole or to individual banks by the Central Bank were discussed in detail. Discussions on reserve requirements focused primarily on the composition and use of reserves, methods of computation, marginal reserve requirement, and penalties for reserve deficiencies.

A number of other problems relating to monetary policy were also examined including the general requirements for the development of open market operations, ceilings on the outstanding volume of credit extended by banking institutions in the case of severe inflationary pressure, and the use of transfers of government funds to and from the banking system as a substitute for, or complement to, open market operations.

cc. Asian Dept.
Legal Dept.

Mr. Palmer

Rie

The Acting Managing Director | March 5, 1971

D. S. Savkar and Donald K. Palmer

China - 1970 Article XIV Consultation

Attached is the Briefing Paper for the forthcoming mission to China.

Attachment

CONFIDENTIAL

REPUBLIC OF CHINA

1970 Article XIV Consultation - Briefing Paper

Prepared by the Asian Department and the
Exchange and Trade Relations Department

(In consultation with Legal and Treasurer's Departments)

Approved by D. S. Savkar and Donald K. Palmer

March 5, 1971

I. Introduction

The 1970 Article XIV staff consultation discussions with China will be held in Taipei, Taiwan, from March 22 to April 1, 1971. The staff team will consist of Messrs. W. John R. Woodley, Karl R. Mars, Shi Kwon Yu, Gunter D. Baer, and a secretary.

II. Fund Relations with China

China is an original member of the Fund and has a quota of $550 million. During the Fifth Quinquennial Review of Quotas, China indicated that it did not wish to have its quota increased. China completed its payment of the gold portion of its subscription to the Fund on August 14, 1970. An initial par value of NT$40 per U.S. dollar was established on September 4, 1970. China has not made use of the Fund's resources. The last Article XIV consultation with the Chinese authorities was held in Taipei from March 16-26, 1970.

China is a participant in the Special Drawing Account. China notified the Fund that it did not wish special drawing rights to be allocated to it for the first basic period, but has reserved the right to request the Fund to terminate the effect of the notification with respect to the third allocation for the first basic period.

The Fund has provided substantial technical assistance to the Chinese authorities in connection with the introduction of a sales tax. Mr. Duignan spent five months in Taipei for this purpose in 1969 and 1970, and Mr. Egan spent three months in late 1970 to advise on implementation of the tax. Draft provisions of sales tax legislation were subsequently transmitted to the Minister. Following an approach by the Minister of Finance at the Annual Meeting, the Fund has recently offered the services of Mr. Quinton from the fiscal panel, for one year, to advise on the introduction of the Brussels Tariff Nomenclature.

III. Recent Economic Developments

In 1970, the economy continued to prosper with a growth rate estimated at about 10 per cent. The marked rise in exports and the substantial increase in investment, particularly in power facilities, were the main stimulating factors. Industrial production showed a growth rate of 17 per cent, and agricultural output rose by about 4 per cent. With the population increasing at a slower rate in recent years partly as a result of a successful family planning program, real per capita income gained by more than 7 per cent in 1970. The rate of unemployment has dropped to negligible proportions.

Budget projections for FY 1970 (June-July) suggested a deficit of NT$2.8 billion for the central government and local authorities combined, with this being financed by an equal sale of bonds mainly to the public. Total government expenditures, which in FY 1970 were equivalent to about 19 per cent of GNP, are projected, according to press reports, to rise by 27 per cent in FY 1971, a considerably faster rate of increase than estimated in nominal GNP. The main reasons for the increase in public expenditure are the expansion of economic development outlays and increases in educational and scientific spending. Public expenditures may continue to grow more rapidly than GNP in the near future because of the stress on infrastructure development, expansion of educational programs, and increased pay to government employees. There is not sufficient data available at this stage to assess the size of the likely over-all budget deficit for FY 1971. On the basis of the monetary accounts up to the end of 1970, credit to the Government and public enterprises increased slightly more than government deposits, but the Government, apart from public enterprises, was in substantial surplus vis-à-vis the banking system.

Total money supply increased by 19 per cent in 1970 compared with 16 per cent in 1969. Among the expansionary factors, the largest were the increase in bank credit to the private sector and the build-up in net foreign assets. The former expansion amounted to more than 38 per cent of money supply at the beginning of the year, and the latter to more than 25 per cent. There was a pronounced increase in time and savings deposits, which amounted to more than 42 per cent of money supply at the beginning of the year.

Monetary expansion was well under control in the first eleven months when the total increase was less than 10 per cent. During this period a number of small steps reducing rediscount facilities, eliminating some types of short-term capital inflows, and liberalizing foreign payments produced some restraint on monetary expansion. About half of the total expansion for the year as a whole took place in December when credit to the private sector rose by NT$3 billion or 6 per cent of money supply at the beginning of the year. There was also a moderate increase in net foreign assets and a decrease in government deposits in this month. The Central Bank reduced its rediscount rate on December 22, apparently indicating that the authorities were not concerned about the rapid rise in credit in December.

The consumer price index increased by less than 4 per cent during 1970 compared with an increase of almost 6 per cent during 1969. Wage increases apparently were not large, but rising prices of personal services continued to be a major element in the higher cost of living.

Foreign trade has shown a remarkable increase in 1970 with exports rising by 41 per cent and imports by 29 per cent. There was a trade surplus of US$60 million compared with a deficit of US$49 million in 1969. Together with inflows of foreign loans and investments, as well as growing income from tourism, foreign exchange reserves increased by US$183 million to a total of US$621 million at the end of 1970, representing about five months' imports based on preliminary trade data for 1970. Reserves in 1969 rose by US$89 million.

There have been no major changes in the exchange and trade controls since the last consultation, and the restrictions remain relatively severe. Around the middle of 1970, the authorities began examining the trade and exchange restrictive system in detail. It may take some time to complete the review because of the large number of controlled items and some prohibited ones on the trade schedule. According to press reports, a procedural simplification of foreign exchange and trade regulations was completed recently. In July 1970, transfer of registered foreign exchange was suspended to eliminate the multiple rate aspect of the exchange rate structure.

IV. Issues for Discussion

As the above summary of recent developments indicates, the Chinese economy appears to be free of major financial problems. Growth prospects are excellent, price behavior has been good, and the balance of payments has been strong. Because of this, the staff team will concentrate on specific aspects of policy which may merit critical review by the authorities.

With regard to economic growth, one of the principal problems of the last five years has been that the development of infrastructure has lagged behind because its expansion was planned on the basis of unduly cautious estimates of the growth rate. This difficulty has been recognized and overcome to some extent, but further discussion is necessary, particularly in view of the changing standards emerging for environmental protection and urban planning. The other possible issue is the incentives and treatment provided for foreign investors. As the labor situation is now tightening considerably in Taiwan and export marketing of some of the output of foreign enterprises, e.g., electronic components, is encountering difficulties, it may be time to review the situation. Generally Taiwan has been able to achieve reasonable diversification in its foreign investment, but as substantial capital inflows are planned for the rest of the decade it is important that policy is capable of dealing with the changing situation in domestic and external markets.

The domestic financial environment has been satisfactory for a number of years. Budget expenditures, despite the military burden, have not been rising at an excessive rate, and major steps have already been taken to increase the productivity and responsiveness of the tax system. A number of the proposals made by the Tax Commission, including the value added tax, are currently under consideration, and the staff team will discuss the progress that has been made and is in prospect. Much of the public sector borrowing from the banking system has been offset by increased government deposits with the banking system. This situation will be reviewed again to see if it contains potentially disruptive elements and if a more rational financial scheme could be worked out.

Over-all credit expansion during the past year has been approximately in line with previous trends. Given the substantial accumulation of savings deposits, the increase in money supply does not seem to be excessive. The

Government has improved the rate of return on time deposits by exempting them from income tax. The staff team will probe if the potential expansion of liquidity resulting from the high amount of savings deposits poses a threat to continued monetary stability, and if rates of return on various savings instruments, including government bonds, are appropriately aligned.

While monetary controls have operated effectively in the past, the staff team will pay particular attention to the developments in the second half of 1970. During this period, the reserve position of the commercial banks improved markedly, and in December the expansion in credit to the private sector was very large indeed. It may well be that the accumulation of exchange reserves is creating problems for domestic credit control. In both 1969 and 1970, net domestic assets of the Central Bank were reduced to offset the expansion in net foreign assets. This was achieved in 1969 mainly by reducing credit to commercial banks and by a budget surplus, and in 1970 mainly by a budget surplus. With the improvement in commercial bank reserve positions and only limited flexibility in the budget, avoidance of excessive credit expansion in 1971 may require changes in the controls applied to commercial banks. Since the majority of banks are government-controlled, Central Bank direction has been effective in the past.

The balance of payments has continued to be strong in 1970, and the high growth rate of exports seems to be based on firm foundations. The main policy question concerns the import control mechanism. Import licensing extends over a substantial part of total imports and undoubtedly provides a large degree of protection in a less than systematic fashion. In addition, there are minimum domestic content requirements for some important manufacturing products. The Chinese authorities have been studying the possibility of substituting tariff for quantitative restrictions.

Extensive calculations have been made of the effective protection resulting from the existing tariff, and concern has arisen regarding the effects on cost structures of the present system of trade controls, especially since the economy is so heavily export-oriented. Because of the substantial effects that can be anticipated from rationalization and liberalization of the present system, the political pressures to maintain the present system are undoubtedly strong. Nevertheless, the staff team will make every effort to further the reform project, emphasizing that any balance of payments justification for restrictions has disappeared. In particular, there would appear to be no good reason for delaying liberalization of categories such as raw materials and capital goods where there is no domestic production, and the 25 per cent advance deposit requirement on imports should be removed.

China continues to restrict current invisibles and to maintain a full set of restrictions on capital. The rationale of the control on invisibles will be discussed; the controls mainly seem to reflect payments difficulties of earlier days. The capital controls reflect the basic political situation of China, and there is probably little expectation that they will be relaxed. As far as is known, the high interest rates are not in themselves attracting foreign funds primarily because of limits on return flows of capital, but there has been a sharp increase in import financing in recent years. The interdependence between domestic and external interest rates will be discussed.

The increase in exchange reserves in 1970 has been very large; exchange reserves now amount to about five months' imports. Because of the political situation, the Chinese authorities want a high reserve level. Nevertheless, continuation of the present trends would raise questions about the level of foreign borrowing involved in the five-year plan. Debt service requirements, which will be investigated by the staff team, appear to be low but, even so, the foreign exchange needs of some of the state enterprises could perhaps be better financed from current earnings than from further borrowing. There is also a set of related problems arising from the decline during the past three years by $130 million in the net foreign exchange position of commercial banks. This may only reflect increased import financing, but a discussion of the causes of the change and the policies affecting them appears worthwhile.

China has been encountering some marketing difficulties abroad which will be discussed along with commodity problems. In agriculture, policies have been adapted to limit rice acreage in response to external developments, particularly the large rice surplus in Japan. Sugar production is rising despite the obstacles to enlarging the U.S. quota or selling more under the international sugar arrangements. Exports of textiles to the United States are subject to voluntary ceilings, and there are also constraints on sales of a few other foodstuffs. The staff team will review the policy measures taken to control output and sales in these areas, the Chinese attitude toward restrictionist import policies in its chief markets, and discuss the extent to which plans are being made for shifting productive factors from the exports affected.

For a number of years, the Chinese authorities maintained an exchange retention system which, because of the transferability of import entitlements, gave rise to a multiple currency practice. The Government eliminated this transferability on July 1 of last year, thus removing the multiple currency aspect. The elimination will be confirmed by the present staff team, and the question raised if liberalization could not be carried far enough to make any retention scheme unnecessary.

The staff team will discuss any changes since the last consultation in the gold market, including exports and imports, if any, domestic non-monetary uses, and the regulations governing private ownerships. China maintains a government subsidy of a uniform amount per ounce of gold production in the form of a payment of $9.00 per ounce for any gold production not sold to the public at $44 per ounce. Such a subsidy is not consistent with Article IV, Section 2, and the Statement of Policy Concerning Subsidies for Gold Production (EBD No. 233-2 of December 11, 1947). In the past the Chinese authorities have resisted the idea that the subsidy could be linked to some type of private market operation on the grounds that a stable price for gold was necessary to maintain confidence in the local currency. This and other possibilities of avoiding government purchases at prices beyond $35 per ounce or payment of a uniform production subsidy will be discussed with the authorities.

Arrangements have been made to overlap with the end of the IBRD economic mission and certain common statistical tables have been worked out. The IFC group discussing the functions and operations of financial markets and institutions, including a Fund staff member, will also be completing its work about the time of arrival of our mission.

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MAR 31 1970
EXCHANGE & TRADE RELATIONS DEPARTMENT

The Managing Director
The Deputy Managing Director

March 30, 1970

Anand G. Chandavarkar

Preliminary Report - 1969 Article XIV Consultation - China

A staff team consisting of Messrs. A. G. Chandavarkar, S. Kanesa-Thasan, J. W. Rose, and Mrs. Wu Yang visited Taipei from March 16-26, 1970, for the 1969 Article XIV consultation with China. Mr. Rose arrived on March 3 for preliminary talks concerning the review of the restrictive system. On completion of the mission, all members returned to Washington except for Mr. Kanesa-Thasan who proceeded to Manila for negotiations with the Philippine authorities under the current stand-by arrangement. Mr. Beue Tann, Executive Director for China, Korea and Viet-Nam, attended the meetings as an observer.

Besides the regular consultation meetings, which were throughout chaired by Dr. I. S. Sun, Deputy Governor of the Central Bank of China, we had discussions with Mr. K. T. Li, Minister of Finance; Mr. K. H. Yu, Governor, Central Bank of China; Dr. Kan Lee, Deputy Governor; Mr. Wong, Vice Minister, Economic Affairs; and Professor T. C. Liu, Chairman of the Commission on Taxation Reform. We also met with the IBRD mission to China (which includes Mr. Cnossen of the Fund's Fiscal Affairs Department) headed by Mr. S. C. Yang.

On the whole, in 1969 as in the past several years China has had no serious macro-economic problems, which testifies alike to the prudent policies of the authorities and the resourcefulness of the people in responding to the incentives created by the Government. It is noteworthy that GNP advanced by 9.5 per cent in 1969 despite the fall in agricultural production due to the two disastrous typhoons last fall. The balance of payments showed a substantial improvement with an increase of US$95 million in foreign exchange reserves to US$395 million. The expansionary effects of the increase in foreign assets and bank credit to the private sector were largely offset by the growth of quasi-money and the large cash surplus in the government budget in FY 1969 (NT$2.4 billion). Exports increased by 32 per cent in 1969, despite a fall in earnings from sugar, rice and cement, and passed the US$1 billion mark for the first time; nearly two thirds of the increase in exports came from textiles and electronics and another one fifth from plywood, fishery products and refined oil. There is, however, no feeling of complacency and the authorities are acutely conscious of the need to maintain competitiveness of existing exports and to develop new lines. A Chinese team is at present in Japan to study techniques of export promotion.

Although there are no major areas of concern, the staff team pointed to the latent inflationary risks arising from the highly liquid character of quasi-money due to easy withdrawal facilities and of government bonds which the Central Bank buys back from the holders at par, and stressed the need for a judicious curtailment of their liquidity consistent with the high rates of interest paid on them. The staff team also suggested: "depegging" of government bond prices and a review of their tax exemption; issue of Treasury bills geared to the ways and means position and the need to create a money market asset; the scope for specialized financial institutions for housing to reduce the pressure of long-term finance on commercial banks.

China terminated its last remaining bilateral payments agreement (with Spain) in December 1969. The authorities have also initiated a phased termination of the system of registered foreign exchange which gives rise to a multiple currency practice and assured us of their intention to eliminate it in due course. The staff team also ascertained the nature of the subsidy to the private gold mines in China. The staff will be considering what action is appropriate and necessary on these jurisdictional matters.

In reviewing the restrictive system we suggested; a restructuring of the tariff as a basis for the elimination of quantitative import restrictions, pending which it would be appropriate to suspend further movement of items to the controlled list; revocation of import margin requirements; speedy elimination of the registered foreign exchange scheme; and examination of tax concessions for exports and "cooperative" financial arrangements between exporters, which have the effect of subsidizing export sales from profits derived from the domestic market.

The Chinese authorities have in fact given thought to restructuring of the tariff. The switchover to the Brussels nomenclature has been almost completed. The Commission on Taxation Reform has undertaken some study of the "effective" rates of protection. Minister Li may request the Fund for technical assistance in reclassifying and restructuring the tariff as well as for "in-service" training for customs appraisers. Professor Liu also strongly endorsed the need for technical assistance from the Fund in this sphere.

The Commission on Taxation Reform is expected to submit its report in June 1970. Referring appreciatively to Mr. Duignan's report on sales tax, which is now being translated into Chinese for presentation to the Legislative Yuan, Professor Liu also mentioned the need for further supporting studies and for an intensive educational and publicity campaign before a radical measure like a tax on value added could be implemented effectively.

As regards the terms of reference of the Central Banking Service's technical assistance mission, scheduled to visit Taipei from April 8-May 1, 1970, Governor Yu said that he expected them to review the commercial banking legislation and the laws relating to negotiable instruments, etc. and to revamp the departmental manuals of the Central Bank to improve operational efficiency. He stressed that there was no intention to review the Central Bank's statute. The use of post-dated checks, although not too widespread, also appears to be a matter of some concern.

The request for technical assistance (through the CBS) on government debt management (for which the Fund has selected Mr. Rouse of the Federal Reserve Bank of New York) seems to have emanated from the Ministry of Finance and apparently the Central Bank was not even consulted on this matter. This, among others, suggests a certain lack of rapport between the Ministry and the Bank.

✓ ETRD
Fiscal Affairs
IMF Institute
Legal
Research
Treasurer's
Central Banking

Mr. Woodley
Mr. Kanesa-Thasan
Mr. J. Rose
Mrs. Wu Yang

Managing Director
Deputy Managing Director
W. John R. Woodley

March 3, 1970

China - Briefing Paper, 1969 Art. XIV Consultation

Attached hereto for approval is the Briefing Paper for the forthcoming mission to China. This has been cleared with the concerned Departments.

Attachment

cc: ETRD

WJRW:thm

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INTERNATIONAL MONETARY FUND

REPUBLIC OF CHINA

1969 Article XIV Consultation - Briefing Paper

Prepared by the Asian Department and the
Exchange and Trade Relations Department

Approved by W. John R. Woodley and Donald K. Palmer

March 3, 1970

I. Introduction

The 1969 Article XIV consultation discussions with China will be held in Taipei, Taiwan from March 16-25, 1970. The staff team will consist of Messrs. A.G. Chandavarkar, S. Kanesa-Thasan, John W. Rose, Mrs. Hui-Chen Wu Yang, and a secretary.

In response to the request from the Chinese Government to the Fund for technical assistance in reviewing the trade and restrictive system Mr. John W. Rose will arrive in Taipei ahead of the mission, on March 3, 1970 for preparatory work.

II. Fund Relations with China

China is an original member of the Fund and has a quota of $550 million. It has not paid its subscription with the exception of the payment in U.S. dollars for administrative expenses, amounting to one one-hundredth of one per cent of the quota, pursuant to Article XX, Section 2(d) of the Fund Agreement. China indicated during the Fifth Quinquennial Review of Quotas that it did not wish to have its quota increased. No par value has been agreed with the Fund. China has not made use of the Fund's resources.

China is a participant in the Special Drawing Account. China has, however, notified the Fund that it did not wish special drawing rights to be allocated to it for the first basic period but has reserved the right to request the Fund to terminate the effect of the notification with respect to the second and third allocations for the first basic period.

The Fund had assigned a fiscal expert, Mr. J.C. Duignan (Ireland), from its panel as Advisor to the Commission on Taxation Reform during July-October 1969. Mr. Duignan visited Taipei again in January 1970 and has subsequently submitted his report to the Tax Commission.

III. Recent Economic Developments

In 1969, gross national product at constant prices is estimated to have increased by 9.5 per cent compared with 10.1 per cent in 1967 and 10.5 per cent in 1968. The rapid growth in industrial production and the continued increase in exports mitigated the damage to agricultural output by typhoons and floods in September and early October. Per capita income in 1969 is estimated to have reached the equivalent of US$258, an increase of 8 per cent over 1968, which, however, falls short of the target of $270.

The budgets for both FY 1967 and FY 1968 were balanced with the assistance of bond issues and U.S. counterpart fund transfers. Budget estimates for the current fiscal year 1970 and budget results for the previous fiscal year (ending June 30, 1969) are not yet available. Judging from the partial information available the budgetary position in FY 1969 and FY 1970 appears to have improved. Bank loans to Government and the Central Bank's holdings of public bonds have been declining while government deposits have continued to increase. In FY 1969, the issues of public bonds totaled NT$2,100 million compared with NT$3,455 million in FY 1968. No public bonds were offered in the first four months (July-October) of FY 1970. Tax revenues in FY 1969 rose by 32 per cent, and despite the typhoon damages, which may involve a lower growth rate, are expected to increase by about 17.5 per cent in FY 1970. Following the recommendations made by the Commission on Taxation Reform, revisions have been made in the income tax law and in the regulations governing tax rebates.

Money supply rose by 17.0 per cent in 1969 compared with 10.7 per cent in 1968. The major expansionary factor in 1969 was the large increase in private credit. The other contributory factor was the increase by NT$3.8 billion (US$95 million) in foreign assets in contrast with a decrease of NT$1.9 billion in 1968. In the first eleven months, the rate of credit expansion slackened as a result of a drastic fall in central bank claims on the Bank of Taiwan and a decline in central bank holdings of public bonds, and the money supply increased by only about 5 per cent. However, in December, money supply went up by 12 per cent mainly due to a sharp increase of 5.5 per cent in credit to the private sector.

In 1969, fluctuations in prices were moderate except for a sharp rise of 4.8 per cent in wholesale prices and 9.2 per cent in consumers' prices in October caused by shortages in some food items following the typhoons. They declined in the last two months of the year, and by the end of 1969 the index of wholesale prices was at the same level as at the end of 1968 and that of consumers' prices was 2.5 per cent higher.

There was a deficit of $43 million in the over-all balance of payments in 1968, in contrast to the surplus of $59 million in 1967, due primarily to a larger merchandise deficit arising from the increase of $206 million

(26 per cent) in imports to $980 million (c.i.f.) as against an increase of $172 million (27 per cent) in exports, together with a much smaller surplus in the service account as compared with 1967. According to foreign exchange settlements data for 1969, exports, at US$1,111 million, showed an increase of 32 per cent over that of 1968; and imports, at $1,205 million, rose by 17 per cent. The trade deficit, at $94 million, was just about half of that of previous year. Gross official gold and foreign exchange holdings, amounted to $477 million at the end of 1969, representing a gain of $95 million over the year.

IV. Major Topics for Discussion

Development planning and policies: Despite sustained economic growth for nearly two decades, the economy is still faced with the problem of accelerated price increases from time to time and a slowing down in the rate of growth of private savings. In the context of reviewing the implementation of the Fifth Four-Year Plan (1969-72) the staff team will discuss with the authorities, in particular, measures to promote domestic savings. Following previous discussions with Fund and Bank missions, the authorities have formulated an annual over-all resources budget within the framework of the Plan. The staff team will examine this budget and assess its bearing on short- and medium-term policies and the distribution of resources.

Financial policies: The staff team will discuss and evaluate the new policy measures in the government budgets for FY 1970 and FY 1971, taking into account the newly revised income tax law and the regulations governing tax rebates and other reforms undertaken by the Commission on Taxation Reform. The staff team will also examine the effects of the changes already made by the authorities concerning the relationship of the Central Bank with the Bank of Taiwan. The authorities have decided to undertake a comprehensive review of the commercial banking system and legislation so that it may better meet the needs of a rapidly growing and changing economy. The staff team will discuss with the authorities their intention regarding the nature and scope of the reform. In this connection they have requested technical assistance from the Fund and a staff team from the Central Banking Service is expected to visit Taipei toward the end of March 1970.

External economic policy: Although China's balance of payments position remains strong, its outlook is clouded by various problems. While exports have so far moved satisfactorily, future prospects may be affected by restrictions in foreign markets, the increase in domestic wages due to labor shortage, and developments in Viet-Nam, etc. The staff team will discuss with the authorities the competitiveness of exports and the prospects of improving the trade balance.

During the last consultation, the staff team urged the Chinese authorities to take advantage of the favorable level of international reserves to move toward greater liberalization of trade and payments. Following discussions during the Annual Meeting, the Chinese authorities requested the Fund's technical assistance in reviewing the present trade and restrictive system. According to the memorandum of February 6, 1970, by Mr. Beue Tann, Executive Director, the Chinese authorities are particularly interested in the following areas: (1) The structure of the present trade restrictive measures and their effect on economic development; (2) identification of areas where and how the present restrictive measures could be gradually liberalized in the best interests of the economy without losing sight, however, of the fact that a large import surplus is likely to remain in the future; and (3) making a review of the present management of foreign exchange and recommending ways and means for its improvement. In the light of the preparatory work done by Mr. Rose, the staff team will discuss and suggest possible changes toward liberalization and simplification of the trade and exchange system. China's last bilateral payment agreement (with Spain) has been terminated.

The discussions on the restrictive system will also cover the "registered foreign exchange" scheme, which is intended to serve as an export incentive. The scheme allows export manufacturers to register part of their export earnings for import of raw materials, and to transfer any excess amount to other parties at margins sometimes more than 1 per cent above the official exchange rate. The scheme, therefore, may involve a multiple rate practice. The staff team will examine this system as part of the review of the restrictive system and, if it seems desirable, recommend its replacement by some other form of export incentive. The staff team will also discuss China's views as regards regional cooperation schemes.

In the Board discussion on the 1967 Article XIV Consultation with China certain directors had asked whether China could not "adopt a more regular relationship in the Fund." In view of this and the generally favorable developments in China's economy and China's participation in the Special Drawing Account, the staff team will take the opportunity to seek very informally the authorities' views on matters relating to China's position in the Fund, in particular the questions of the quota and subscription, the par value, and the duration of Article XIV status.

The staff team will discuss the gold trade generally, the control of imports and exports of gold, its use in industry including jewelry and the

~~Here~~ As to the question of quota & subscription, I strongly advise not the future; and (3) making a review of the present management of foreign exchange and recommending ways and means for its improvement. In the light of the preparatory work done by Mr. Rose, the staff team will discuss and suggest possible changes toward liberalization and simplification of the trade and exchange system. China's last bilateral payment agreement (with Spain) has been terminated.

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The staff team will discuss the gold trade generally, the control of imports and exports of gold, its use in industry including jewelry and the arts, and regulations governing private ownership. A government agency, the Central China Trust, which acts as a broker on commission basis, buys domestically produced gold at the equivalent of $35 per ounce, sells it for ornamental use at prices roughly equivalent to $44 an ounce, and distributes the profits from the sale to domestic gold producers. In the light of the Statement of Policy concerning subsidies for gold production (Executive Board Decision No. 233-2, adopted December 11, 1947) the staff team will seek details of this government agency's role and functions in this arrangement.

The staff team will also obtain details of the domestic arrangements, if any, for holding special drawing rights and the related accounting procedures.

An IBRD mission headed by Mr. S.C. Yang, which also includes Mr. Cnossen of the Fund's Fiscal Affairs Department, will be in Taipei from March 11 to April 4. The staff team had some informal discussions with the IBRD team.

Exchange and Trade Relations Department

No. 763 Date: 9/19/67

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TB

The Managing Director

J. Ahrensdorf

September 11, 1967

China - 1967 Article XIV Consultation

The discussions were held in Taipei, Taiwan, from August 23 to September 2, 1967. The mission included Mrs. H.C. Wu Yang and Mr. H.C. Kim.

Economic developments and outlook

Gross national product at constant prices increased by 8.1 per cent in 1966 following increases of 12.4 per cent and 13.5 per cent in the two preceding years. In the first half of 1967 industrial production rose by 19 per cent and agricultural production by nearly 5 per cent over the corresponding period of 1966. These rates of increase were higher than in the previous year and also than originally projected for the current year as a whole. Accordingly, the Chinese authorities estimate that GNP at constant prices may grow at about 9 per cent in 1967. Preliminary thinking on the Fifth Four-Year Development Plan beginning in 1969 suggests that an average growth rate of about 8 per cent may be feasible. The new Plan is expected to be centered on exports. The monetary and fiscal situation was broadly under control in 1966 and prices remained generally stable. In the first half of 1967, prices were, however, by 4 per cent higher than in the corresponding period of 1966. The Government is reviewing these price developments and is considering remedial measures. Exports increased in 1966 by 20 per cent to about US$540 million and further by 17 per cent in the first half of 1967 over the corresponding period of the previous year. The increase in exports occurred entirely in manufactures, which to a large extent went to Viet-Nam. As regards the outlook for exports, the Chinese authorities were considerably concerned about the recent discontinuation of U.S. offshore procurement of iron and steel products. Relatively small trade deficits in 1966 and the first half of 1967 were more than offset by increased net receipts from invisibles and capital inflow. In the 18 months ended June 1967, gold and foreign exchange reserves increased by about US$100 million to nearly US$400 million, equivalent to about 7 months' imports. During the same period China acquired an unusually large amount of gold of US$ 26 million, representing an increase in gold holdings of about 50 per cent. The capital inflow from Hong Kong and Macao amounted in the first 8 months of 1967 to nearly US$11 million compared to about US$3 million in the corresponding period of 1966. The Chinese authorities generally welcome an inflow of overseas Chinese capital but do not actively encourage it in order to avoid embarrassing the British authorities.

Policy discussions

The discussions focused on problems that may arise in the future with respect to sustained and high economic growth. The staff team stressed that investment in infrastructure has generally lagged, which is bound to become increasingly a bottleneck for further economic growth. It is the Government's intention to base further growth increasingly on the establishment of more sophisticated and even heavy industries while using, whenever a choice is available, relatively more labor-intensive rather than more capital-intensive techniques. The Government has come to an agreement with the Government of Korea as regards some division of labor in the establishment of petro-chemical industries. In view of generally rising capital requirements the staff team stressed the importance of raising the average savings rate further from its present level of nearly 16 per cent of GNP. With regard to the increasing investment requirements for infrastructure, it stressed the need to increase public investment and saving and welcomed that budgetary policy is to be coordinated with development policies. The staff team emphasized the need to review fiscal policy which has been characterized by liberal granting of tax exemptions and rebates resulting in increasing revenue losses and a general decline in the tax burden while being accompanied by increasing recourse to borrowing by bond issues. At the same time, however, government deposit balances with the Central Bank increased much more than the net proceeds from bond issues. The Chinese authorities generally agreed that there was considerable scope for improving the fiscal, and in particular, the tax structure and expressed the intention to review the whole range of tax exemptions before 1970, when the present Statute for Encouragement of Investment expires. They expressed awareness of the potential dangers of a rapidly rising and highly liquid public debt, with de facto pegged bond prices, for an efficient and flexible implementation of monetary policy. Considering the need for mobilizing increasing resources, the staff team suggested that caution in further reductions in the general level of interest rates may be appropriate. In the light of the narrow domestic market it was emphasized that economic growth continued to depend to a large extent on exports and the attraction of foreign capital and know-how. In part, export growth would depend on diversification of foreign markets as recently Chinese exports, particularly of processed agricultural products, had met with increasing resistance, for instance in the United States and Germany. As the export effort is to be concentrated on manufactures the staff team noted that such exports were bound to encounter increased competition from other countries, both developed and developing, and marketing may involve increasingly the need to extend credits to foreign importers. As regards further progress in trade liberalization and rationalization of tariff and commodity tax structures, the Chinese authorities appeared to be somewhat more hesitent than during previous consultation discussions. The staff team stressed the importance of progress in this area for over-all efficiency of the economy and particularly for the export performance, and emphasized that in an environment of increasing foreign exchange reserves, beyond a level considered already comfortable some time ago, elimination of quantitative restrictions on imports and current transfers was bound to encounter less resistance and be less difficult than in an environment of balance of payments pressures. A published observation of a senior official on the likelihood of China assuming the obligations of Article VIII was generally considered as premature.

cc: ETRD ✓
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Fiscal Affairs
IMF Institute
Central Banking
Editor

JA/cu/9/11/67

Exchange and Trade Relations
Department
No. 736 Date: 7/24/67

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EXCHANGE & TRADE RELATIONS
DEPARTMENT

Mr. Sturc

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The Acting Managing Director

July 12, 1967

W. John R. Woodley

Conference on Economic Development of Taiwan

On my way to the Viet-Nam discussions I stopped in Taipei from June 19-22 for the conference on economic development organized by the Social Science Research Council. The conference which was chaired by Simon Kuznets was attended by about 15 prominent U.S. professors, many academic economists from Taiwan universities, and Chinese Government officials particularly from the Ministry of Economic Affairs and the Central Bank.

The conference was organized on the basis of descriptive papers prepared by resident economists and discussion by the visiting U.S. professors. Further exchange of views was very much limited by the time available, but usually included responses by government officials to criticisms of, or questions about, government policies.

The most interesting aspect of the conference for me was the light it shed on the direction of current academic work. Almost all the papers consisted of attempts to fit available data into rather simple models (e.g., the demand for money is a function of GNP, interest rates and the rate of price level change), and a good deal of the discussion dealt with how to make the models more realistic. While this frequently gave an air of considerable lack of reality, it did suggest the need for more emphasis in our work on testing the existence of relationships between economic variables for individual countries.

From the point of view of the Fund, the most helpful comments were made by John Gurley of Stamford on the advantages of monetary stability and realistic interest rates in promoting savings, and by Alfred Kahn of Cornell on the rationale of various types of government intervention in the economy. Kahn was particularly helpful on the benefits of removing restrictions on trade and payments and on the need to calculate the costs of import restrictions.

My intervention in the discussion was limited to questioning some of the assumptions made by the discussants. I pointed out that Dorfman in arguing the case for government intervention because of external economics simply overlooked the pervasive nature of existing government controls in Taiwan. I also questioned whether Gregory Chow of IBM was right in saying that monetary analysis was not meaningful because it was based on ex post accounting identities, and the correctness of Tsiang's statement that use of monetary accounts involved the acceptance of the quantity theory of money. I also suggested that two guiding rules for Chinese policy implicit in the discussions--that the budget should be balanced every year without fail, and that exchange reserves should increase--required justification in terms of fiscal policy and development considerations.

A major concern of the conference was the drain of economists from Taiwan and the plans for establishing graduate work in economics at the National

University during the next academic year. T.C. Liu is working hard to arrange for two or three visiting professors from the United States to supplement the local faculty. I suggested to him that when the school was underway Fund personnel travelling in the area could perhaps be persuaded to give an occasional seminar. In response to a proposal made in the course of the discussions, Walter Galenson of Cornell reported to the conference that a special advisory committee to President Johnson had recommended that the U.S. not put special restrictions on foreign professional personnel that wanted to stay in the United States after completing graduate studies.

cc: Mr. Savkar
Mr. Sturc
Mr. Keesing
Mr. Polak

Exchange and [illegible] Department
No. 497 Date: 9/14/66

The Managing Director
The Deputy Managing Director

J. Ahrensdorf

September 13, 1966

Republic of China--1966 Article XIV Consultation

The consultations were held in Taipei from August 29 to September 8, 1966. The mission included Mr. Tsusaka and Mrs. Yang. No major questions regarding relations with the Fund arose.

Economic Situation:

China's economy grew in 1965 at a rate of 10 per cent, which was somewhat lower than the rate achieved in 1964 but was above the rate of 7 per cent projected in the Fourth Four-Year Economic Development Plan. For 1966, a growth rate of about 7 per cent is anticipated. Price stability has been maintained and the expansion of liquidity has been moderate. The budget estimates for the fiscal year beginning July 1966 are generally conservative. The over-all external payments position in 1965 and the first half of 1966 has been generally satisfactory with a small decline in the external reserves during 1965, following a rapid accumulation in 1963 and 1964, and a partly seasonal rise in the first half of 1966.

Topics of Discussion:

Considering the generally favorable economic developments, the discussions focused on areas which, in the mission's view, merit close attention if a high and stable growth rate under conditions of internal price stability and a sound balance of payments position is to be maintained.

Exports: The high growth rate achieved by the Chinese economy in the 1950's was largely related to activities oriented toward the domestic market, with considerable support by U.S. aid. In the early 1960's, the continued high growth rate was, to a considerable extent, sustained by the upsurge of sugar prices in the world market which generated an expansion of incomes, saving and investment, and provided the foreign exchange to finance induced increases in imports. This development was supported by a very marked increase in exports of processed agricultural products and manufactures. In 1965 and the first half of 1966, the expansion of exports slowed down to about 4 per cent compared with increases of about 30-50 per cent in the previous two years, despite a rather sharp increase in exports to South Viet-Nam. About one fourth of the increase in exports in 1965 was accounted for by the increase in exports to Viet-Nam, and about one third of the increase in the first half of 1966. There also was a rather marked change in the pattern of exports. The decline in earnings from exports of sugar in 1965 was nearly completely offset by exports of primary agricultural products, while the rise in exports of manufactures and processed agricultural products, such as canned pineapples, mushrooms and asparagus, was much smaller than in previous years. With regard to the latter products, in which China accounts for a large share in world trade, important importing countries have established restrictions against such imports. The mission emphasized that these developments warrant considerable concern, not only from the balance of payments viewpoint but also in respect of the objective of maintaining a high and stable growth rate. The mission expressed the view, and the Chinese authorities generally agreed, that in the future the external position, and particularly the export performance, will represent a still more important limitation to the maintenance of a high growth rate than in the past, considering the narrowness of the domestic market. Consequently, a major policy objective will be promotion of exports, not only by using various export promotion devices but also by orienting the development policies toward improving the efficiency and international competitiveness of the economy, for instance, by avoiding excessive protectionism. In this context the Government has to make difficult decisions as to the relative emphasis to be placed on heavy industries and light industries, respectively, considering availabilities and costs of factors of production relative to established industries in potentially competing countries.

Development Policy and Fiscal Policy: The Chinese authorities indicated that they viewed the Fourth Four-Year Plan as a frame of reference for decision-making in both the public and private sectors rather than a program to be implemented in a rigid fashion. There were discussions on the scope for further coordination between development planning and policy on the one hand, and financial, and, in particular, fiscal planning and policy on the other hand. The mission noted that the Government has in recent years depended relatively less on taxes as a source of revenue and has relied increasingly on bond issues. The ratio of such issues (gross) to total government expenditure had increased from 4.5 per cent in FY 1964 to over 12 per cent in FY 1967. The mission questioned the feasibility and wisdom of continuing this tendency, considering that an increased proportion of new bond issues has been absorbed by banks and as a result the private sector had less access to bank credit than it would have had otherwise. Furthermore, it pointed out that the increased reliance on bond issues may prolong any tendency to postpone any improvement in the tax system which for a good many years has not undergone any significant change and which might well be strengthened.

Monetary Policy: The mission discussed the implications of the growing amount of outstanding government bonds for monetary policy. It emphasized that such a growing amount of bonds outstanding, coupled with a de facto support policy may in certain situations impinge on the flexibility of monetary policy. This de facto support policy is being implemented by the Central Bank providing quasi-automatic discount facilities against collateral of bonds, which so far have been utilized to a very limited extent, and by having the Bank of Taiwan purchase and sell bonds from and to the nonbank public at par.

Restrictive System: The Chinese authorities indicated that they are considering a reduction in the excess of domestic ex-factory prices over the c.i.f. price of comparable imported goods from 15 to 10 per cent as a criterion for protection through import restrictions. The mission welcomed the intention of the Government to eventually abolish direct restrictions on imports and to rely on cost restrictions through tariffs, stressing that rapid progress in this direction is bound to be beneficial for China's economy by improving its efficiency and competitiveness and by strengthening the fiscal position.

cc: Savkar
Gold
Sturc
Polak
Keesing
Goode
Horsefield
Mr. Jones

Mr Sture

Exchange Restrictions

Department
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CONFIDENTIAL

The Managing Director
The Deputy Managing Director

September 15, 1965

J. Ahrensdorf

Republic of China--1965 Article XIV
Consultations, Aug.30 to Sept. 8, 1965

The mission included Mr. Itchon and Mrs. Yang. No major questions regarding relations with the Fund arose.

The economic situation and trends in mid-1965 contrast rather markedly with those observed during the consultations about a year ago. Since July 1964 the very rapid accretion of external reserves has given way to a leveling off as exports grew much more slowly while imports expanded rapidly. In part as a result, the large expansion in domestic liquidity through mid-1964 progressively abated in the following twelve months even though domestic credit tended to rise on balance at an increasing rate.

The reduced rate of expansion in exports since mid-1964 was related to the marked decline in earnings from sugar which in general, however, was slightly more than offset by increased earnings from other exports, notably rice and bananas. The large rise in imports in the last twelve months, which was facilitated by some further relaxation of import restrictions, appears to reflect a lagged response to the exceptional increase in domestic liquidity. This development as well as the large increase in output and in the public's willingness to increase its holdings of liquid assets must have been the major reasons for the remarkable degree of price stability since 1963.

Production in 1964 showed record increases in comparison with recent years, in part however due to fortuitous circumstances such as exceptionally favorable weather. GNP in real terms rose by over 10 per cent, industrial production by some 25 per cent and agricultural production by some 10 per cent. For 1965 much smaller gains are anticipated. Real GNP is expected to rise by some 4-5 per cent, industrial production by some 18 per cent and agricultural production by some 4 per cent. The Five-Year Development Plan for the period beginning 1965 envisages an average rate of growth of some 7 per cent which is more or less in line with the historical record over the last decade. No details of the plan are available so far.

Against this background the discussions focused on the scope for strengthening financial policies to smoothen and to facilitate adjustments in external payments while at the same time meeting the financial requirements of domestic investment.

With respect to fiscal operations the Chinese authorities expressed the view that it continues to be their policy to adjust public expenditures to the availability of resources of non-inflationary origin and that, in general, policy has not been directed toward raising the ratio of tax revenue to national income. In particular, they emphasized that they endeavored to minimize the inflationary impact of the budget but did not yet feel prepared to adapting fiscal operations in a compensatory manner to offset expansionary forces originating in other sectors. The markedly reduced scale of the budget for fiscal year 1965/66 was explained in terms of adjustments made necessary by the anticipation of reduced revenues from profits of public enterprises, in particular from the Taiwan Sugar Corporation.

As regards monetary developments it was confirmed that the recent rise in the rate of credit expansion and projected further increases in the remainder of the year were motivated by the desire to slow down the accretion of external reserves and to accommodate domestic investment requirements. Generally, the authorities appeared to be open minded with respect to the staff team's reservations regarding the assumption of a further rising rate of increase in the public's willingness to add to its holdings of liquid assets, which was implied in the estimates of monetary developments for the whole year of 1965, and the associated potential hazards of an expansionary credit policy for continued maintenance of internal financial stability. In discussions of monetary policies it transpired that the Central Bank does have at its disposal instruments other than only moral suasion which could be employed at any time within the existing institutional framework. Furthermore, they were studying the scope for engaging in open market operations in view of the progress made in recent years in placing government securities in roughly equal proportions with the banks and the nonbank public. There were discussions of the possibility of adapting such open market operations to the pattern employed by the Bank of Japan in its securities operations.

A number of steps toward further liberalization of the restrictive system have been taken since the last consultations. Noteworthy are the reduction of the cost margin over domestic products governing the placement of comparable imported goods on the controlled list from 25 per cent above the c.i.f. import price to 15 per cent. Also, for the first time there was the introduction of a minimum general allowance for all tourists of US$300.00. With respect to the general rationale of the restrictive system as between balance of payments considerations, protection of domestic industry, and provision of incentives and disincentives to influence the directional pattern of economic activities it was indicated that it was the Government's policy to rely in the future to a still lesser extent on direct restrictions on current payments and to a larger extent on indirect means, i.e. flexible and timely domestic financial policies and appropriate tariff and tax policies.

cc: Messrs. Gold
Sturc
Kessing
Polak
Goode
Murphy
Tun Thin
Liang
Mattera
Itchon
Mrs. Yang

E. R. D.

The Managing Director — August 12, 1964

W. John R. Woodley JW

Mission to the Republic of China

The mission which included Mr. Raman and Mrs. Yang had friendly discussions with the Chinese authorities. No major questions regarding relations with the Fund arose, and the mission concentrated its attention on the problem of the domestic impact of the export boom. The following summary of our conversation is a supplement to my letter to Mr. Southard of July 31, 1964.

The Republic of China is one of the outstanding cases of a rapid rate of economic growth and successful diversification of the economy. Substantial progress is being made in agriculture and industrial production is rising quite rapidly. Prices and wages rose only moderately in 1963, and prices have remained virtually stable so far in 1964.

The balance of payments has improved very sharply since mid-1963. This has been due to the higher prices for export products, particularly sugar, to the continued growth in the volume of traditional exports, and to the emergence of new industrial products. Exports remain heavily dependent upon the Japanese market, and liberalization of restrictions there has been of considerable help. Imports have not risen sharply. The larger exports and an increased inflow of private capital have more than compensated for the decline in U.S. aid and exchange reserves have risen sharply. By the end of 1964 it is expected that international reserves will be equal to about 12 months imports.

The exchange rate has been stable for some time and there are no signs that it is not at an appropriate level. Restrictions on trade and payments continue to be important, partly because of excessive concern about the longer range balance of payments prospects and partly because of a desire to protect domestic industry.

The chief problem we discussed with the Chinese authorities was the effect of the export boom. The rise in sugar prices has produced $50 million a year in export income and the domestic counterpart of this, about NT$2 billion in 1963 and about the same amount in 1964 is very large relative to the money supply which amounted to about NT$10 billion at the beginning of 1963. This has been super-imposed on a favorable balance of payments and expansion of bank credit to the private sector. The increase in money supply and in time and savings deposits from the beginning of 1963 to the end of 1964 is estimated at about 75 per cent.

The Government has taken virtually no steps to offset this strong expansion. The tax burden has actually been reduced. Some monetary measures have been taken, e.g., central bank rediscounts have fallen, some funds have been transferred from the state banks to the Central Bank, and there has been a slowing down in the rate of credit expansion to the private sector. Import restrictions have been liberalized but only by a minor amount since imports are expected to rise by 10 per cent in 1964 not much more than the growth in GNP.

In view of this situation the mission suggested that the Government should put major emphasis on fiscal policy in an attempt to dampen the effects of the export boom. In particular, it was suggested that the Taiwan Sugar Corporation which has a monopoly of sugar exports should be used in a contracyclical way and that the sharp increase in the liquidity of this institution should be sterilized. The possibility of increase in utility rates, the revenues of government monopolies, and of imposing taxes on agricultural land were also discussed.

The interest rate structure in Taiwan is very high and is centered upon the rate of 9 per cent paid for saving deposits. The Chinese authorities envisage reducing these rates as a longer run goal, but the mission urged caution until such time as the fiscal policy is tightened up.

The mission put its main emphasis on the possibility of liberalizing import restrictions in order to reduce the rate of reserve accumulation. It was suggested that an automatic licensing system be introduced for raw materials, spare parts, essential consumer goods, and raw materials for export processing industries. It also suggested that investment projects could be approved quite liberally and that less restraint should be imposed for balance of payments reasons.

My impression was that the Chinese authorities had been discussing the various policy issues involved for quite sometime and that the Government was not likely to take any vigorous action.

cc: Asian
✓ ERD
Fiscal Affairs
Legal
Research