cc: Mr Bruce, Mr Jenkins for info.
BF

Office Memorandum

TO: Mr. Levy

November 13, 1986

FROM: K. Saito

SUBJECT: China--External Trade and Capital Mission

We have read Mr. Pohl's back-to-office report (which Ms. Kelly did not see before it was circulated) and the aide-memoire which the mission left with the Chinese authorities, and found these documents disturbing in a number of respects. In particular, we found the discussion of exchange rate issues surprising given my conversation of September 4, 1986, with Mr. Pohl and Ms. Kelly's subsequent conversation with Mr. Harrold on the terms of reference for the mission.

The first and most important issue concerns the recommendations in the back-to-office report and the role proposed to be given to exchange rate issues in the final report (see also paragraphs 15-16 in particular of the aide-memoire), which are given inordinate attention. Some features of the proposals made by the Bank mission appear to be inconsistent with China's commitments as a member of the Fund and could result in the adoption by China of multiple currency practices in a manner that would be inconsistent with Fund policies under Article VIII.

Second, the statement on paragraph 5, page 2, that "the exchange rate is not yet a very effective tool of balance of payments management" overstates the point. Progress in exchange rate management has been made, and the major task now is to improve the links between international and domestic prices through major price and trade policy reforms. We believe it would be more useful for the Bank report to identify major price distortions that need correcting and the microeconomic reforms needed to make the exchange rate a more effective instrument rather than concentrating, as appears to be the intention, on exchange rate issues as such.

Third, in contrast with the statement in paragraph 7 of the back-to-office report, many officials at policy making level, including those within the People's Bank of China, are most definitely aware of the connection between overly expansionary monetary and credit policies in 1984/85 and the deterioration in the balance of payments.

Fourth, as you know, China, as a member of the Fund, is under a number of obligations to the international community with regard to its conduct of exchange rate policy, and the Fund staff is given the task of working closely with the authorities in this respect. Partly because of this feature, Bank-Fund collaboration on China--and I believe, on other countries--has evolved in such a way that the Fund staff takes the lead in conducting discussions with the authorities on exchange rate matters. The Bank staff's views are, of course, taken into account through close contacts between the two staffs. We would like to propose that this collaboration be continued in the context of the Bank's study on China's external trade and capital. Specifically, we would like to request that the Bank report would not discuss, in detail, proposals for alternative exchange rate mechanisms, nor the Fund's recommendations on the appropriateness of the current exchange regime. We would also like to request that any sections of the report that deal with exchange rate policy will be discussed with us.

cc: Mr. Narvekar
Mr. Brau
Ms. Kelly
Mr. Pohl (IBRD)

Mr. Brau

Office Memorandum

November 12, 1986

MEMORANDUM FOR FILES

Subject: China--Meetings with Mr. Dai

On November 10-11, 1986, Mr. Fetherston and I met Messrs. Dai and Wang Xiaoping several times to follow up Mr. Narvekar's memorandum to Mr. Dai dated November 7, 1986.

Mr. Dai said that, after having carefully read the memorandum, he found most useful the analysis of advantages and disadvantages of the proposed scheme for exchange arrangements of foreign investment enterprises. He thought that the authorities (to whom he has already sent a copy) would also find the memorandum very useful and timely, as they are currently considering the details of the scheme. The authorities would appreciate the conclusion of the memorandum that they should consider the matter very carefully before taking any further action. They would share the staff's concern expressed in the memorandum, including the concern for possible conflicts with China's obligations as a member of the Fund.

Mr. Dai thought that the memorandum conveys the message about China's obligations to the Fund sufficiently and adequately. In this context and with reference to our earlier conversation with Mr. Wang Xiaoping (see below), Mr. Dai assured us that the authorities are fully aware of China's obligations under the Articles of Agreements and the proposed stand-by arrangement. In fact, he asked us directly whether we could doubt China's understanding of its obligations to the Fund after it has been a member for five years and after the authorities have gone through lengthy negotiations on the stand-by. He said that, at any rate, he would talk to (Messrs. Narvekar, Finch, and Brau) clarify that China does understand its obligations.

In the early part of the meetings, we explained to Mr. Wang Xiaoping China's obligations to the Fund by presenting to him a note (in the form of a draft of part of this memorandum) which states:

> "China, as a member of the Fund, is under obligation to consult with the Fund on exchange rate matters. Article 8, Section 5 requires Fund members to furnish information regarding exchange arrangements and restrictions, in particular, information necessary for ascertaining the existence or not of a multiple currency practice. Also, Decision No. 1034-(60/27) of June 1, 1960 requires members to consult with the Fund with respect to the maintenance of such

measures. Furthermore, China has undertaken, in paragraph 19 of the memo on economic policies, which accompanies the request for a stand-by arrangement, that it will not introduce new or modify existing multiple currency practices during the period of the arrangement."

K. Saito

cc: Mr. Narvekar
Mr. Brau
Ms. Kelly
Mr. Quirk

Mr. Braw

Office Memorandum

TO: Mr. Narvekar November 6, 1986

FROM: Margaret R. Kelly MRK

SUBJECT: China: World Bank Mission on the Study of External Trade and Capital

A World Bank mission visited China during October 6-25, 1986 to conduct a study of China's external trade and capital policies. I participated in the second half of this mission (October 12-24, 1986) which held discussions with government agencies and visited a number of enterprises and foreign trade corporations in Shanghai, Fuzhou, Xiamen, Special Economic Zone, and Beijing. A Chinese counterpart team, which included officials from the Ministry of Foreign Exchange Relations and Trade, the Ministry of Finance, the Research Center of the State Council and the State Administration of Exchange Control within the Peoples' Bank of China, also traveled with the mission. The mission intends to discuss an initial draft of its report with the counterpart team in February, before finalizing it for internal review in the World Bank and transmittal to the Government.

In the area of trade policy, the mission focused its attention on import policies; export policies; the effects of trade and other policies on technology transfer; and the scope for increasing the links between foreign and domestic markets and prices. Issues covered under import policies included the role of quantitative restrictions, the scope for replacing quantitative restrictions with tariffs, the level of tariffs and dispersion of "effective" protection. Issues covered under export policies included the role of the system of foreign exchange retention quotas, the requirement for joint-venture enterprises to balance receipts and payments of foreign exchange, and related aspects of exchange rate policy; export subsidies; export financing; access to inputs required for production of exports free of import duties and indirect taxes; the role of export production bases and agricultural trade issues. In the area of external capital the mission examined current policies aimed at encouraging foreign direct investment in terms of their effectiveness in providing access to foreign technology, better management skills, export markets and finance; the role of foreign borrowing vis-a-vis direct investment; and external debt management. The mission also discussed the need to coordinate external policy reforms with reforms in other sectors of the economy (financial reform, enterprise reform, tax reform, and price reform) and to support such reforms with appropriate macroeconomic policies.

The following sections cover exchange rate, external debt, import policy, and pricing policy issues that are of immediate concern to the Fund, given the forthcoming Executive Board discussion on China's request for a first credit tranche stand-by and the 1986 Article IV consultation.

1. Exchange rate policy

Much of the discussion on export policies centered on the system of foreign exchange retention quotas which allow provinces and enterprises to use part of the foreign exchange they earn from exports for imports. There seems to be fairly widespread agreement that this system is inefficient in that it encourages provinces to set up direct exporting capacity, often duplicating capacity in other provinces, without taking into account whether products can be efficiently exported; on the other hand, it provides less incentive for efficient export industries that have little need for imports. At the same time, the foreign exchange retention scheme has, for a variety of reasons, not performed its main goal of achieving balance between the availability of and use of scarce foreign exchange.

In view of these problems, members of the Chinese counterpart team were interested in changing this system although exactly how was not clear. In some discussions they indicated they were considering the possibility of abolishing the foreign exchange retention scheme and substituting it with an exchange rate system that would involve different exchange rates for different transactions and were interested in the Bank's and Fund's views on multiple rate systems. They did not present a clear rationale for a multiple rate system other than to isolate producers from import price increases that would result from an across-the-board devaluation. At other times, the counterpart team suggested the existing exchange retention system might be centralized under the State Planning Commission.

I attempted to steer the Bank mission away from a discussion of exchange rate issues and indeed the mission did not comment specifically on the appropriateness of the current exchange rate (or the Fund's precise recommendations in this area) other than to agree that the rate is overvalued. It was not possible to avoid discussions of future exchange rate mechanisms, however, partly because the Chinese counterpart team insisted on discussing this issue, but also because the Bank mission was keen to enter into discussion on this issue.

Various members of the Bank mission expressed the view that eventually the foreign exchange retention system should be substituted by an exchange rate that clears the market; this would involve a devaluation of the exchange rate. They also mentioned other possibilities--as interim measures--such as trading of foreign exchange earnings between enterprises, the trading of foreign exchange quotas, or the use of export subsidies. They noted, however, that the exchange rate mechanism was an issue that the Chinese authorities should discuss with the Fund. Mr. Pohl's back-to-office report, however, suggests that the Bank intends to deal with exchange rate mechanisms in a detailed fashion. Mr. Saito is sending a memorandum to Mr. Levy requesting that the Bank minimize discussion of exchange rate issues and to clear any discussion of this issue with the Fund.

I explained that the Fund's involvement with multiple exchange rates and exchange rate matters derived from its jurisdiction under Article VIII of the Articles of Agreement and its general role in surveillance of members' exchange rate policies. I stated that in general the Fund was opposed to multiple exchange rate mechanisms because at best they are second-best options, they tend to have high economic costs, to result in a misallocation of resources, and were often difficult to eliminate once established. I added that the Fund had, in very limited circumstances, supported a multiple exchange rate system as an interim measure in the move toward a more realistic exchange rate, when it was clear that such a mechanism would be temporary and when the authorities had a clearly defined plan to unify the exchange rate at an appropriate level in a brief time period. Finally, I indicated that if the Chinese authorities have specific proposals in this area, they should discuss the proposals with the Fund. I restated this point to officials in the Peoples' Bank of China (PBC) in Beijing who are responsible for China's relations with the Fund.

The Chinese counterpart team also devoted a lot of attention to the requirement for joint ventures (enterprises with foreign participation) to balance their receipts and payments in foreign exchange. Many enterprises have not been able to meet this requirement and the problem has been solved by (i) allowing joint ventures to sell their products on the domestic market for foreign exchange, (ii) allowing joint ventures with foreign exchange deficits to buy foreign exchange from joint ventures with surpluses, and by (iii) outright sale of foreign exchange to joint ventures. However, these measures are applied unsystematically and create uncertainty. In an attempt to address these problems more generally, the State Council issued 22 articles on October 22, 1986. Article 14 of these regulations would allow joint ventures to exchange their foreign exchange surpluses and deficits among each other under supervision of the exchange control authorities.

It is possible that regulations necessary to implement Article 14 could result in a multiple currency practice subject to Article VIII. After consultation with headquarters (Messrs. Brau, Saito, and Quirk), I contacted officials within the PBC in Beijing to obtain clarification of this issue. I was told that the regulations necessary to implement Article 14 have not yet been drafted by the State Administration of Exchange Control (SAEC). I impressed on PBC (Mrs. Yang) the urgent need to consult with the Fund on this issue before the Board meeting on China.

2. <u>External debt management</u>

The Bank mission endorsed measures which the Chinese authorities, with assistance from the Fund, have taken to improve and centralize external debt management. At the provincial level, there was evidence that external borrowing had been brought under greater control since the end of 1985. However, governments and financial institutions at the provincial level are pressing the Central Administration to decentralize borrowing (and guaranteeing) authority (currently eight financial institutions have the right to borrow abroad, with SAEC approval, while some fifty financial institutions can in theory guarantee foreign borrowing by enterprises). The Chinese counterpart team agreed that it was necessary to resist these pressures to ensure that total external debt does not become excessive, to improve the structure of debt, and to minimize the overall cost of borrowing. There have been press reports subsequent to the mission that additional financial institutions and enterprises will be given the right to guarantee foreign borrowing. In our discussions with SAEC officials in Beijing on this issue, we were informed that regulations related to guarantees were being revised but no mention was made of extending the right to guarantee to additional institutions.

3. Import Policy

In the area of import policy, the aide-memoire left with the Chinese authorities made some useful general comments on the need to replace quantitative restrictions with tariffs and subsequently to reduce the level and dispersion of effective protection. It is not yet clear whether the Bank report will contain more specific proposals in this area. I indicated to Mr. Pohl during the mission that it would be desirable for the World Bank to include quite specific proposals since the Bank has more expertise in this area than the Fund.

4. Price Reform

Several times during the mission both Bank mission members and members of the Chinese counterpart team indicated that domestic price reform is an essential prerequisite for trade and economic reforms to be successful. This is an area where the World Bank also has more expertise than the Fund. Unfortunately, the Bank does not intend to address this issue in the report on Trade and Capital or in any other report. Energy pricing policy is to be taken up as a separate issue.

cc: Mr. Brau
Mr. Saito

CHINA

1986 Annual Meeting Brief

Head of delegation: Mr. Liu Hongru, Deputy Governor of the People's Bank of China. A meeting with the Managing Director is scheduled for Wednesday, September 24 at 3:15 p.m.

I. Topics for Discussion

Discussion during the meeting with Management is likely to focus on China's request for a first credit tranche stand-by arrangement, in particular on the issue of exchange rate policy. The staff position on this issue and a recommended course of action for the meeting are set forth in the memorandum to Management dated September 22 (copy attached following this page).

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 22, 1986

FROM: P.R. Narvekar and E. Brau

PRN

SUBJECT: China--Staff Position on Stand-By Arrangement

As you know, discussions with the Chinese authorities in connection with their request for a first credit tranche arrangement have been going on since the beginning of this year. Formal discussions were held in June-July, when Article IV consultation discussions were also begun, and more recently during September 10-15. By the time of the former round of discussions, the authorities had already succeeded in substantially cooling the economy, made a sizable exchange rate adjustment, and begun work on setting up a system to control external borrowing. The most recent mission found (as reported by Mr. Saito in his back-to-office report of September 22) that substantial further progress had been made in improving external debt management; that adequate assurances were provided concerning the necessary tightening of financial policies; that balance of payments developments are somewhat more favorable than anticipated a few months ago; but that the authorities, having recently devalued the renminbi, were not willing to commit themselves on a specific time for a further exchange rate adjustment, even though they agreed in principle on the need for such action and, more generally, for exchange rate flexibility.

In sum, the principal shortcoming that keeps the staff from endorsing the present set of policies is the exchange rate. This brings us to the critical juncture at which we must decide whether present policies and the assurances that we have about future policies, considered as a whole, are adequate for a first credit tranche arrangement; or whether further action on the exchange rate should be required as a prior action. On net balance, it is the staff's recommendation for the reasons stated below that you should now give your approval to the requested arrangement, provided that the Chinese authorities give you the assurance that they would take the necessary exchange rate action by the time of the staff visit that we envisage for March/April 1987. (Being a first credit tranche arrangement there would be no formal review but the staff would undertake an informal review and make a report to the Executive Board for its information.)

At the commencement of the negotiations, the staff urged the authorities to devalue the renminbi from their prevailing Y 3.2 per US$1 to at least Y 4 per US$1, saying that the need to promote exports was urgent and that a devaluation of this magnitude was needed to send a strong message to the market that the authorities meant to deal firmly with their payments problem. On July 5, the authorities devalued the renminbi by 13.5 percent to Y 3.7 per US$1. While we believe a further move to Y 4 is necessary, it is also noteworthy that in real effective terms, the renminbi has depreciated by some 40 percent during the past eighteen months and is now some 25 percent more depreciated than the average for the period 1981-early 1984. It would be hard to argue that without a further depreciation of 7-8 percent, economic and financial policies would remain so deficient and the price structure would remain so much more distorted as to warrant our withholding of support to the Chinese effort. This is all the more so in the Chinese situation in which the effectiveness of an exchange rate change is still not as clear as in predominantly market economies.

The argument that support to the Chinese should no longer be withheld is buttressed by broad considerations. It is evident that over the past year and a half, the Chinese authorities have made remarkable progress in coming to grips with their macroeconomic problem. They have demonstrated that they have a clear view of all aspects of the macroeconomic situation--something that we had at one stage doubted; they have succeeded in cooling down the domestic economy; the balance of payments situation has begun to turn around, despite the adverse impact of the oil price decline; and, most important, the authorities have brought external borrowing under better control and have begun to improve the debt profile. This is a sea change from the situation less than a year ago. Present overall policies and policy indications for the near term are such that one can have reasonable assurance that during the next year or so, a payments position viable over the medium term can be attained--the need for commercial borrowing being dispensed with by 1988. At the same time, structural reforms have also continued and are likely to be pushed further in the coming year. In this crucial period, we would consider it essential that the Chinese authorities be able to demonstrate the existence of Fund support. On any broad reckoning, their policies are worthy of our support through a first credit tranche arrangement.

Recommended course of action for the meeting
with Deputy Governor Liu

1. The exchange rate issue

In Deputy Governor Liu's meeting with Management on Wednesday, September 24, the staff can once again make a case for a further exchange rate action to Y 4 per U.S. dollar. You could put your weight behind the staff position but also give a sympathetic hearing to Governor Liu. You could finally tell him that you would be prepared to commend the arrangement for Executive Board action if you are assured that they would take such action before the staff visit envisaged for March/April 1987 and that they would maintain exchange rate flexibility thereafter. If such an assurance is forthcoming, we could issue the staff papers in time for an Executive Board meeting by November 8.

2. Other topics for discussion

You could also emphasize the need for the authorities: (i) to maintain their resolve to tighten financial policies--monetary expansion needs to be slowed from its tempo in the first half of 1986; and (ii) to continue to improve debt management further.

a. Domestic financial restraint

China is currently engaged in the delicate process of attempting adjustment through new indirect instruments while enterprises still face a relatively soft budget constraint. Tight financial policies introduced since 1985--including the recent increase in the lending rates of the PBC--curbed the excessive growth of demand and output, but the subsequent economic slowdown in the early months of 1986 led to a deterioration in financial performance of state enterprises. In the absence of bankruptcy provisions, for which legislation is currently being considered, this deterioration created pressures to expand credit to finance enterprise losses and accumulation of unsalable inventories. The economic slowdown also lowered fiscal revenue and the overall budget position weakened. While expressing some understanding of these difficulties, you may wish to stress the need for the authorities to maintain their resolve to tighten financial policies.

b. External debt management

Commendable progress has been made over the summer in improving statistics for external debt management. It should be stressed that this is just the beginning of an ongoing effort to strengthen debt management; steps for the coming months should include collection of data on short-term trade credit, which appears to account for the major part of the remaining discrepancy between official and creditor estimates of total debt, and establishment of approval procedures for all categories of nonconcessional borrowing.

cc: Mr. Brown

II. Background

1. Political situation

The leadership has demonstrated considerable skill in maintaining the consensus in support of economic reforms and further opening up to the outside world. The grooming of younger, reform-minded officials for future senior positions has continued, but the scenario for the eventual succession to the leadership of Mr. Deng Xiaoping's government is not yet clear.

2. Economic developments

Since mid-1985, the authorities have intensified their efforts to reduce macroeconomic imbalances while continuing to implement economic reforms. The stabilization measures brought the growth of domestic demand and output under control, and the external current account deficit, while still at a high level, has recently shown signs of improvement.

Growth of real GDP slowed to 12 percent in 1985, and is projected by the staff at 6.5 percent for 1986. Industrial output growth declined from 23 percent in the first half of 1985 to about 5 percent in the first half of 1986, but has since recovered to about 7 percent. Agricultural output (including village industry) increased by 14 percent in 1985, although crop yields were adversely affected by a series of natural disasters; preliminary information for 1986 indicates a more encouraging crop picture. Retail price increases, which accelerated to 9 percent in 1985, partly on account of reform-related adjustments in urban food prices, slowed to about 3 percent by mid-1986.

Consumption and investment demand began to moderate in the early part of 1986 as stabilization measures became effective and overall economic activity slowed. Growth of retail sales declined from 28 percent in 1985 to about 12 percent in the first half of 1986; over the same period, growth of investment by state-owned units moderated from 45 percent to 17 percent.

The growth of money and credit has been sharply reduced since the dramatic expansion of 1984. Net domestic assets of the banking system increased by 24 percent in 1985, compared with 45 percent in 1984; over the same period, the growth of total liquidity declined from 41 percent to 18 percent. Credit and monetary conditions eased somewhat during the second quarter of 1986, but the authorities are taking additional measures to contain the growth of net domestic assets to 19 percent and total liquidity to 17 percent during 1986. In August the authorities raised interest rates on credit from the People's Bank of China to the specialized banks. Measures have also been taken to tighten credit to enterprises, espcially for financing of their investment.

The budget deficit was reduced from 1.6 percent of GDP in 1984 to 0.5 percent in 1985, largely reflecting a buoyant revenue performance. In early 1986, revenue growth slowed as economic expansion moderated, while expenditure growth was sustained, particularly at the local government level, by the carryover of revenues from the previous year. The authorities have introduced additional measures to curb expenditures during the remainder of the year.

The external current account moved from surplus in 1984 to a deficit of almost $12 billion in 1985. In the wake of the earlier rapid credit expansion, imports rose by 60 percent; export growth was only 5 percent, as declining competitiveness affected manufactured exports. In the first seven months of 1986, import expansion slowed sharply to about 7 percent (Chart 1), reflecting the earlier adjustment measures and the slowdown in output growth, while growth of export earnings picked up to 15 percent, as improved non-oil exports offset a sharp decline in oil exports. For the year as a whole, the staff projects a deficit of $10 billion (4 percent of GDP).

Financing for the large external deficit has been provided by a combination of reserve drawdown and borrowing, and external debt has risen rapidly. International reserves fell by $4.6 billion during 1985, and by a further $1.2 billion to $12.0 billion (3.7 months of imports) by end-July 1986. External debt is estimated to have increased from $13.1 billion at end-1984 to $20.0 billion at end-1985, and its structure became less favorable; this year the debt structure has improved, with greater recourse to concessional borrowing and a reduction in short-term liabilities. The debt service ratio is projected to rise from 8 percent in 1985 to about 9 percent in 1986.

The exchange rate for the renminbi, which had remained close to Y 3.2 per U.S. dollar since end-October 1985, was devalued to Y 3.7 (13.5 percent) on July 5, 1986 (Chart 2). The real effective exchange rate is estimated to have depreciated by about 40 percent during the last 18 months.

3. Training and technical assistance

Chinese participants have attended nearly all of the English language courses offered by the IMF Institute in recent years. The Bureau of Statistics held seminars on balance of payments methodology in 1983 and on government finance statistics in May 1986.

During the last 12 months, technical assistance has been provided in the fields of balance of payments statistics (STA, November 1985); external debt management (ETR, November 1985 and February 1986; CBD consultant, August 1986); financial programming and monetary policy instruments (CBD, March 1986); and indicators of exchange rate policy (ETR, May 1986).

A colloquium on "Macroeconomic Management, Growth, and the Role of the IMF" is scheduled to be held in Beijing during November 1986.

4. Relations with the Fund

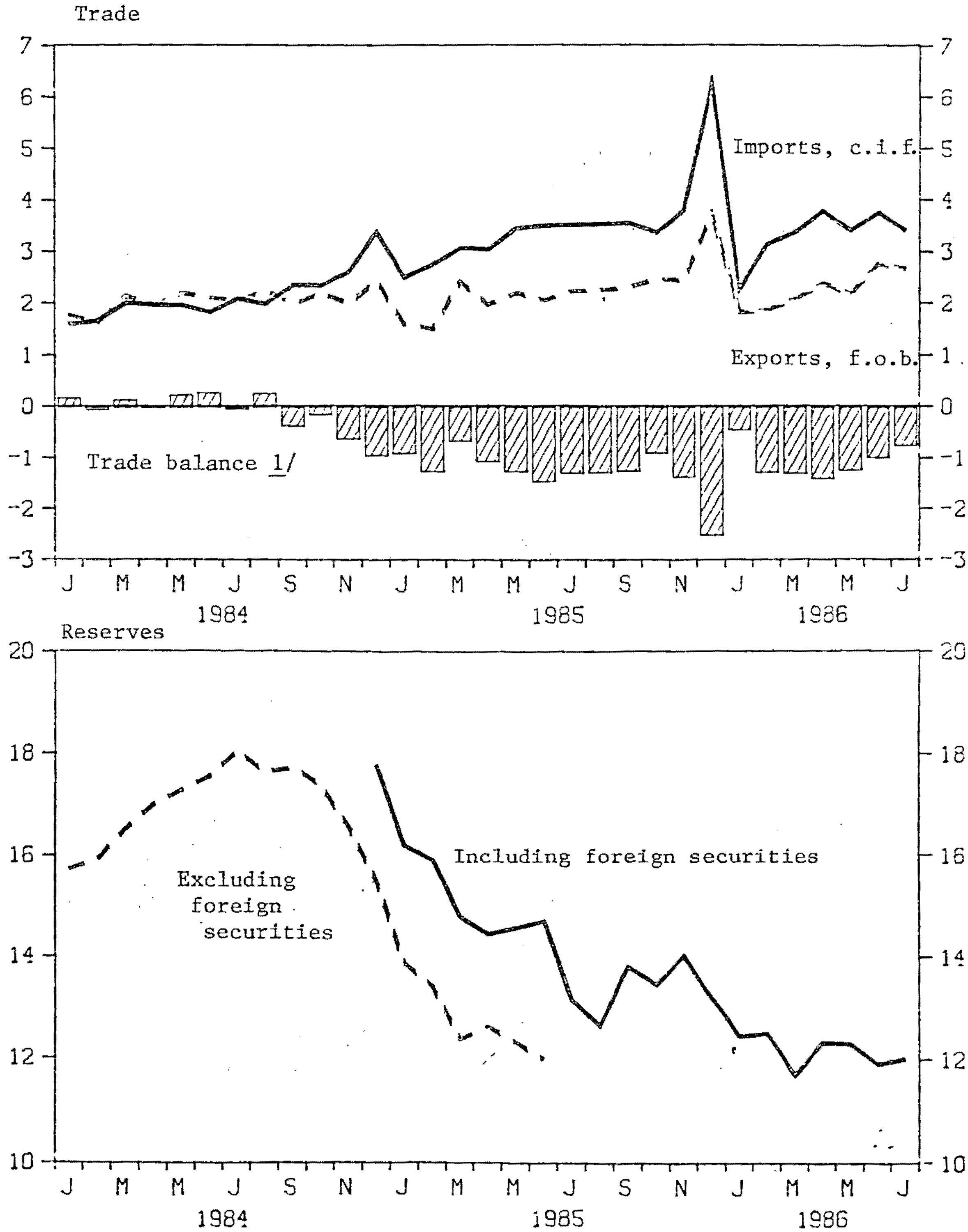
Discussions on the 1986 Article IV consultation and a first credit tranche stand-by arrangement were held in Beijing during June 23-July 9 and September 10-15, 1986. Executive Board consideration is expected in early November. China is on the 12-month consultation cycle.

CHART 1

CHINA

EXTERNAL TRADE AND INTERNATIONAL RESERVES, 1984-86

(BILLIONS OF U.S. DOLLARS)

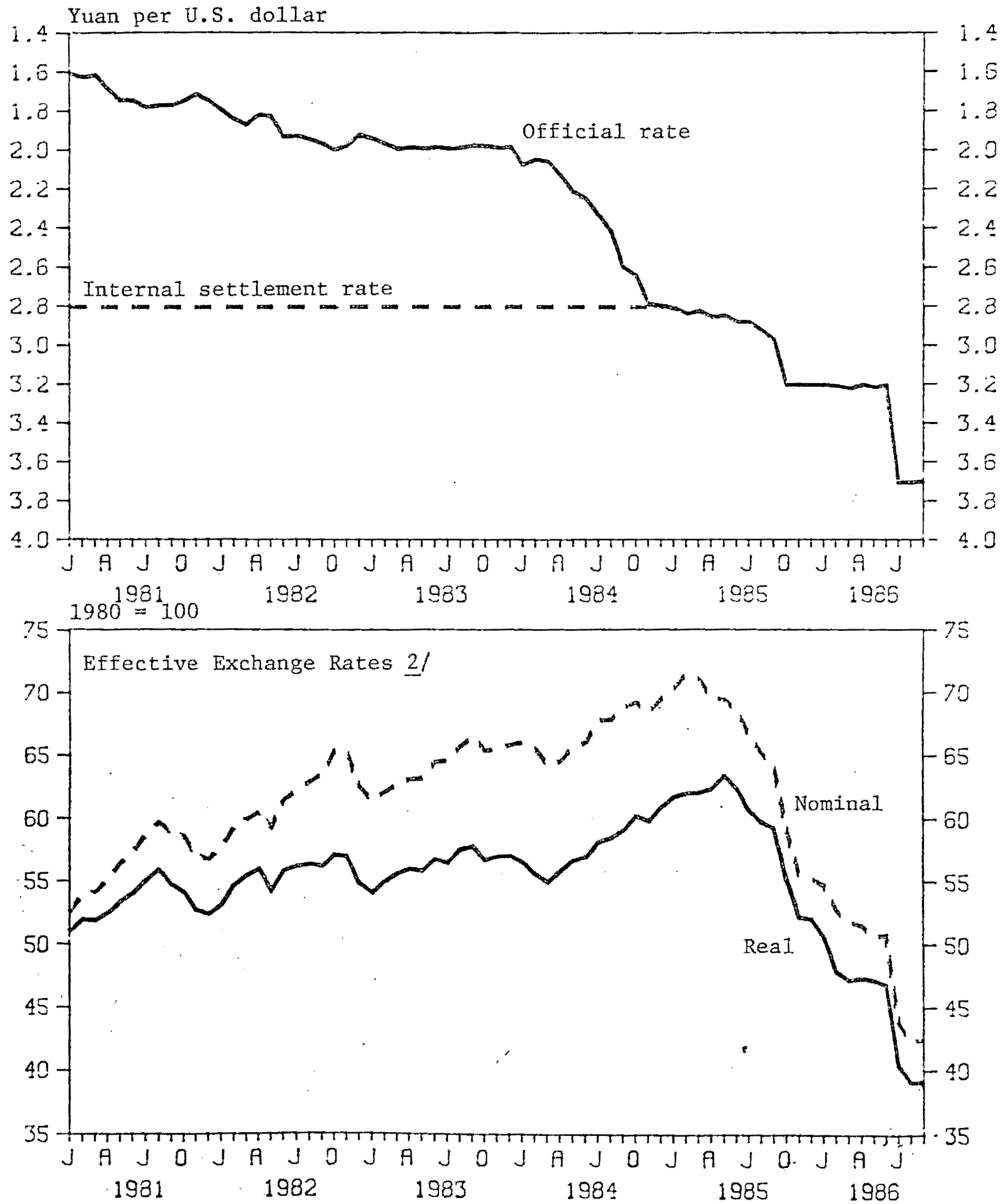


SOURCES: CUSTOMS ADMINISTRATION; AND STATE ADMINISTRATION OF EXCHANGE CONTROL.
1/ ON THE BASIS OF IMPORTS MEASURED C.I.F.

CHART 2

CHINA

EXCHANGE RATES, 1981-86 1/



SOURCES: DATA PROVIDED BY THE CHINESE AUTHORITIES; AND STAFF ESTIMATES.
1/ DOWNWARD MOVEMENT INDICATES DEPRECIATION OF THE YUAN.
2/ DATA FOR 1981 THROUGH 1984 ARE BASED ON THE INTERNAL SETTLEMENT RATE.

CHINA

Basic Data

	1984	1985	1986 Est.	1987 Proj.
	(Year ending December)			
Growth				
Real GDP (change in percent)	13.5	12.3	6.5	6.0
Inflation				
GDP deflator (change in percent)	4.8	7.9	5.0	7.0
CPI (average percent change)	2.8	8.8	5.5	7.0
Terms of trade (percent change)	-0.3	-1.0	-8.1	—
State budget 1/				
Revenue (growth in percent)	15.1	24.4	7.3	9.5
Expenditure (growth in percent)	14.8	19.8	6.9	7.5
Current account (percent of GDP)	7.1	7.7	6.6	7.1
Overall surplus or deficit (percent of GDP)	-1.6	-0.5	-0.4	0.1
Borrowing from the banking system (percent of GDP)	0.7	-0.3	-0.5	-0.8
Foreign borrowing (net) (percent of GDP)	0.3	—	0.3	0.3
Money and credit (end of year, percent change)				
Net domestic assets	44.6	23.6	19.4	13.5
Currency in circulation	49.4	24.7	17.0	15.0
Total liquidity	41.2	18.4	16.7	13.4
Balance of payments				
Exports (bn. $)	23.9	25.1	28.0	31.0
Of which: Oil	(5.5)	(6.7)	(3.3)	(3.9)
Imports (f.o.b., bn. $)	-23.9	-38.2	-38.6	-36.5
Of which: Oil	(-0.1)	(-0.1)	(-0.1)	(-0.1)
Current account (bn. $)	2.5	-11.9	-10.0	-5.6
Current account (percent of GDP)	0.9	-4.5	-4.0	-2.5
Of which: Interest payments	-0.4	-1.0	-1.4	-1.9
Overall balance (bn. $)	1.8	-4.6	-1.9	1.3
(Percent of GDP)	0.6	-1.7	-0.8	0.6
Reserves (end of year)				
Gross official reserves, including gold (bn. $)	17.8	13.2	12.0	13.3
(In months of imports)	8.9	4.1	3.7	4.4
External debt				
Total debt outstanding (bn. $) 2/	13.1	20.0	27.5	33.8
(Percent of GDP)	4.7	7.5	11.0	15.5
Debt service (bn. $)	2.0	2.2	2.7	3.4
(Percent of exports plus service credits)	(6.8)	(8.0)	(8.9)	(9.6)
Use of Fund resources (mn. SDRs)				
EFF	—	—	—	...
SBA	—	—	...	...
CFF	—	—	—	...
RT	—	—	...	...
Repurchases	—	—	—	—
Fund holdings of currency (percent of quota)	89.1	87.3	...	...

Exchange rate
Exchange rate regime: Managed float
Present rate Y 3.7036 = US$1 (September 16, 1986)

Quota: SDR 2,391 million

1/ Fiscal year ending December.
2/ Including short-term debt.

SUR/85/123

CONFIDENTIAL

November 18, 1985

The Chairman's Summing Up at the Conclusion of the 1985 Article IV Consultation with the People's Republic of China
Executive Board Meeting 85/161 - November 8, 1985

All Directors were impressed with the continued rapid growth and change of the Chinese economy and by the authorities' courage and determination to pursue the process of economic reform. Indeed, economic reforms in recent years had brought about substantial gains in living standards as real national income had risen by a spectacular 60 percent since 1980. However, from mid-1984 macroeconomic imbalances had become evident. The growth of money and credit had accelerated, prices had risen rapidly, and by the first half of 1985 the balance of payments had moved into substantial deficit. Directors observed that the authorities had responded to these imbalances with measures to curb domestic demand and to restrain imports. There were signs that output growth was now being reduced toward more sustainable levels. However, the balance of payments had so far been slower to respond. At the same time implementation of wide-ranging economic reforms was continuing.

Directors agreed with the authorities' view that the rate of expansion of demand and output had become excessive in late 1984 and in the first part of 1985. Excess demand pressures had intensified and the faster rate of price increases, while in part attributable to price reform measures, had become a cause for concern. The authorities were, therefore, well advised to introduce corrective measures aimed at reducing demand and output expansion to sustainable rates. In the present circumstances of transition in the mode of economic management, it was understandable that these measures still involved a mix of instruments of different types. Directors noted that one of the most important problems to be solved by the Chinese authorities was the most appropriate combination of the market mechanism and central planning. Directors welcomed the increased use of macroeconomic instruments and stressed the need to develop additional instruments of a macroeconomic nature and to improve the effective application of such instruments.

There was a broad consensus among Directors that in the present phase, particular emphasis should be placed on the use of monetary and pricing policies and that the use of more direct administrative controls should be de-emphasized over time as the reforms toward the strengthening of the price and market mechanisms proceed and as more experience is gained in the use of these macroeconomic instruments.

Directors observed that excess demand pressures had been fueled by rapid expansion of money and credit, particularly in late 1984. The rapid economic growth and significant structural changes taking place made it difficult to judge the appropriate rate of monetary expansion with any great precision, but the rate certainly had been excessive. The rapid expansion had reflected an accommodative attitude toward credit requests and also some technical factors associated with the establishment of the People's Bank as a separate central bank in 1984. In this connection, a number of Directors urged the authorities to strengthen recent efforts to enable the People's Bank to exercise effective monetary control. Directors were pleased to note that increases in interest rates and efforts to tighten the enforcement of credit ceilings had been followed in recent months by some slowing of the rates of money and credit expansion. All Directors believed that cautious monetary policies would continue to be needed, and a number of them advised the prompt implementation of increases in the rate of interest on People's Bank lending to the specialized banks and in redeposit requirements that were currently under consideration. Directors welcomed the decision to incorporate the People's Construction Bank into the credit plan, which should serve to improve the system of monetary control and noted that incorporation of the rural credit cooperatives would also be desirable.

Many Directors also stressed the role of fiscal policies in limiting excess demand pressures. They welcomed the authorities' intention to keep the fiscal deficit in 1985 at a modest level, and they also urged the authorities that the growth of public expenditure be kept under control. Several Directors believed that under the present circumstances a fiscal surplus might be appropriate. Furthermore, fiscal reform would become more important as the role of market mechanisms gained momentum in the economy.

Directors considered that the authorities had been justified in acting to halt the sharp decline in international reserves. They noted that for this purpose the authorities had relied principally on tightening import restrictions and foreign exchange controls. Although import growth had so far remained at a high level, reflecting a backlog of earlier orders, a slowdown could be expected in due course. Export performance had remained sluggish, however, and the outlook for the balance of payments was uncertain. Most Directors stressed the need for active use of demand management and exchange rate and pricing policies in place of direct controls to prevent the recurrence of a large balance of payments deficit. They observed that a strengthening of the balance of payments would depend, in particular, on efforts to promote exports, and in this connection, they noted the recent loss of export market shares. They, therefore, welcomed the announcement of the adoption of a system of managed floating of the exchange rate as of January 1986, and they noted that a significant effective devaluation of the renminbi had already taken place in recent months. The authorities were commended for the abolition of the internal settlement rate at the end of 1984. Several Directors stressed the importance of research in foreign markets, quality of production, follow-up services, and other measures to promote and strengthen Chinese export performance. In a similar vein, several Directors expressed the view that the projected increase in exports under the seventh Five-Year Plan, roughly in line with the growth of GDP, appeared somewhat modest.

Directors endorsed the authorities' cautious attitude toward external borrowing, noting that external debt and debt service had remained relatively low. They observed that it was important that the proceeds of foreign borrowing be used productively and in this context, appropriate demand management and pricing policies should contribute to that objective.

Directors expressed appreciation of the progress made in implementing economic reforms. Following earlier extensive reforms of the rural economy, urban reforms had begun in earnest in 1984. Already there had been significant changes in the system of agricultural procurement and reductions in the scope of mandatory planning, while the first steps had been taken in the more complex process of reforming the price and wage systems. Much, of course, remained to be done, and Directors welcomed the evident commitment of the authorities to the reform process. Their determination to continue policies of opening up the economy to the rest of the world through strengthened trade, investment, and technology links was particularly encouraging. In this context, Directors took note of the seventh Five-Year Plan, the priorities of which were to continue broad economic reforms, maintain macroeconomic balance, and improve product quality. Directors also endorsed the authorities' view of the key role of price reforms. For example, a number of Directors suggested priority should be given to reform of key industrial sectors--including energy and transportation where present and prospective supply bottlenecks were most pervasive--and to reducing subsidies and strengthening links between domestic and international prices. These measures would need to be complemented by efforts to increase the role of market mechanisms, strengthen financial discipline for state enterprises, and liberalize the foreign trade and exchange control systems. At the same time the development of wages should be more closely linked to trends in output and productivity. The pragmatism and flexibility with which the Chinese authorities had already acted gave confidence that these tasks could be successfully achieved.

Directors welcomed the improvements in statistics supplied for Fund publications and for the consultation reports. They supported the ongoing efforts of the authorities and of the staff to improve statistics further and to broaden the coverage of Chinese data in Fund publications.

It is expected that the next Article IV consultation with China will be held on the standard 12-month cycle.

Office Memorandum

cc: Mr. Brown
Ms Kelly
Mr. Brachet
Ms. Dillon

TO: The Managing Director
The Deputy Managing Director

September 22, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--Back-to-Office Report

Attached is Mr. Saito's report on the recent mission, which reached understanding on most elements of a proposed first credit tranche program, except for exchange rate policy. The staff position on the proposed program will be submitted to you shortly as background for your meeting with Deputy Governor Liu scheduled for Wednesday, September 24 at 3:15 p.m.

Attachment

cc: CBD
ETR
EXR
FAD
LEG
RES
SEC
TRE
Mr. Brown

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 22, 1986

FROM: K. Saito

SUBJECT: China--Back-to-Office Report

A mission 1/ visited Beijing during September 10-15 to conclude Article IV consultation discussions and negotiate a first credit tranche stand-by arrangement. Understandings were reached on most aspects of the program; the main outstanding issue concerns exchange rate policy, which the authorities plan to raise during their meeting with Management scheduled for September 24. The letter of intent is meanwhile being circulated to interested departments.

The economic situation has improved in recent months. Retail price increases declined from an annual rate of over 8 percent at the beginning of the year to about 3 percent by July, while industrial output growth recovered from 4 percent to about 7 percent. Export growth has also picked up despite the weakness in oil prices, and imports are now running below last year's levels. The current account deficit in the first half of 1986 ($4 1/2 billion) was considerably smaller than earlier envisaged, and for the year as a whole is now projected at $10 billion, compared with almost $12 billion recorded last year. Furthermore, the earlier trend of deterioration in the debt structure has been reversed, as longer-term borrowing from bilateral and multilateral sources and the bond market rose sharply and short-term liabilities declined.

Following over a year of strict restraint, financial conditions eased somewhat in the second quarter. The budgetary deficit widened slightly, mainly because of the effects on revenue of slower output expansion and the associated deterioration in enterprise financial performance. Money and credit expansion accelerated, since in the absence of bankruptcy banks were obliged to finance losses of many weak enterprises, as well as accumulation of unsalable inventories.

While acknowledging the unique features of China's situation at the present early stage of enterprise and economic management reforms, the mission expressed concern over these developments and pressed for tighter financial policies in the remainder of 1986 and 1987 to support continued external adjustment. In response, the authorities agreed to strengthen efforts to ensure achievement of their original objectives for 1986 of containing the overall budgetary deficit to 0.8 percent of GDP on GFS definitions (balance on national definitions),

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1/ Messrs. Saito and Fetherston (ASD), Ms. Kelly (ETR), and Mrs. Duffield-Sorkowitz (secretary, ETR).

and limiting monetary expansion to 17 percent. These efforts focus on expenditure restraint at central and local government level, including a freeze on any local spending from revenues in excess of the original budget, and tighter control of bank credit to enterprises, especially for financing of their investment. For 1987, understandings were reached on objectives of further strengthening the budgetary position to achieve a surplus on national definitions and reducing monetary expansion to 13 percent. The authorities stated that details of financial policies for 1987 were being worked out in conjunction with major reforms to be implemented early next year. These reforms would focus on adjustments of industrial prices (especially for energy and raw materials) and on steps to strengthen linkages between domestic and international prices.

In addition to appropriate domestic financial restraint, the staff has been stressing restraint on external financing and toward that end, improvements in external debt management were made a prior condition for a possible Fund arrangement. The mission found that the program of action on debt management was being implemented as earlier agreed, and had already yielded an improved official estimate of total debt outstanding at end-1985 ($15.8 billion) and a better understanding of the difference between this estimate and that of about $20 billion based on creditor sources; this difference appears mainly to reflect the omission from official data of some trade credits and also some borrowing from foreign banks by Chinese enterprises. The authorities agreed to focus their data collection efforts in this area during the coming months, and to establish approval and control procedures concerning all types of external borrowing.

For the stand-by program, the staff had also sought prior actions in two other areas--(i) interest rates charged by the People's Bank (PBC) on its lending to specialized banks, and (ii) exchange rate adjustment. On interest rates, PBC lending rates were adjusted in August by amounts up to almost 6 percentage points in the case of temporary loans for over three months. These adjustments, together with stricter policies on rollovers, have effectively removed the incentive for specialized banks to utilize PBC credit rather than deposits, and have already encouraged repayments of some outstanding PBC loans. On exchange rate policy, the authorities devalued the renminbi from Y 3.2 to Y 3.7 per U.S. dollar on July 5. PBC Deputy Governor Liu Hongru agreed with the logic of the mission's suggestions for further adjustment to Y 4 per dollar. However, he stressed that such further adjustment needed to be carefully coordinated with next year's major reform package, and that two major exchange rate adjustments within a short period could have serious adverse effects. Consequently, while agreeing in principle with the need for further adjustment, he could not give a commitment for action at a specific time in the near future. While reiterating the case for an early devaluation to at least Y 4 per U.S. dollar, we undertook to inform you of the authorities' position in preparation for your meeting with Deputy Governor Liu on September 24.

The authorities agreed to remain on the 12-month consultation cycle, and to receive a staff visit early next year to review the 1987 budget and price reforms.

cc: CBD
ETR
EXR
FAD
LEG
RES
SEC
TRE
Mr. Brown

bcc: Mr. Brachet
Ms. Dillon
Ms. Kelly

Office Memorandum

TO: Mr. Saito

FROM: Eduard Brau

August 28, 1986

SUBJECT: China - Briefing Paper

My comments will be provisional, pending the expected receipt of information through Mr. Huang concerning progress in setting up an external debt management system. Were that message to be broadly satisfactory, we should still flag to management in the cover note that the staff will be debriefed next week by the CBD debt expert and that any important information will, of course, be forwarded.

The main thrust of my comment, however, does not concern whether adequate progress is being made by the Chinese in working toward a functioning debt management system, as this is almost impossible to judge from afar. The key point, of course, is that during the prospective period of use of Fund resources the authorities must be able to adhere to limitations established on the uptake of medium- and long-term commercial debt, the net foreign liabilities of financial institutions, and the growth in short-term external indebtedness of nonfinancial institutions. When short-term indebtedness constitutes approximately one half of quickly rising total external debt, it is not satisfactory to be unable to monitor and control all indebtedness, as this would encourage any pressure to leak out in a most undesirable way, namely, unplanned further increases in short-term debt. Therefore, the authorities will have to convince the mission, in the first instance, that their progress is such as to enable them to reasonably satisfactorily monitor and control the increase in total external indebtedness, as well as shape its composition. I want to note in this context that the briefing paper and letter of intent should also make explicit reference to policy on gross external reserves during the program period.

On the present schedule, details concerning important policies for 1987 will not be available when the report is discussed in the Board, especially for the budget and price reform. I suggest that the brief should mention, for discussion with the authorities, that the staff would intend to describe in a supplement to the initial staff paper on the authorities' program, the details of the 1987 budget and price reform once they become available.

Office Memorandum

TO: The Acting Managing Director   August 29, 1986

FROM: P.R. Narvekar PRN and E. Brau EB

SUBJECT: China--Briefing Paper for the Forthcoming Mission

Attached for your approval is the brief for the forthcoming China mission to follow up discussions on the 1986 Article IV consultation and on a possible first credit tranche program. The brief has benefited from comments by Messrs. Kreis (FAD), Balino (CBD), Gupta (TRE), Francotte (LEG), and Larsen (RES).

We believe that progress in policy formulation and implementation in key areas, especially external debt management, is now sufficiently advanced to warrant a mission. The authorities informed us yesterday, through Mr. Huang's office, that the program of action on debt management is being implemented on schedule, and that comprehensive external debt data have been collected and are being processed for the mission's review. We will be debriefed by a CBD expert on this matter upon his return from China next week and any important information will, of course, be forwarded to you.

One difficulty we have faced in designing the proposed program concerns arrangements for monitoring policy progress. While most key policy measures are set to be in place prior to Board discussion (currently envisaged for mid-November), details of the 1987 budget and forthcoming price reforms may not then be available. Moreover, being limited to the first credit tranche, the program would not include a clause providing for a formal review of these and other aspects of policy implementation. To overcome this difficulty, we plan to suggest to the authorities, with your approval, that a small staff team visit Beijing in early 1987 to review progress in key policy areas and prepare a report for the information of the Executive Board. Further review of performance under the program would then be conducted at the time of the annual consultation discussions later in 1987.

Mr. Saito's last day in the office will be Friday, September 5.

Attachment

cc: The Managing Director (on return)
Mr. Brown

INTERNATIONAL MONETARY FUND

CHINA

Briefing Paper--1986 Article IV Consultation
and Possible Use of Fund Resources

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Research, Central Banking, Legal,
and Treasurer's Departments)

PRN
Approved by P.R. Narvekar and Eduard Brau BJ

August 29, 1986

I. Introduction

A mission consisting of Messrs. Saito and Fetherston (both ASD), Ms. Kelly (ETR), and Mrs. Duffield-Sorkowitz (secretary, ETR) will visit Beijing from September 10-15, 1986. The staff team will conclude the 1986 Article IV consultation discussions and seek to finalize negotiations on a first credit tranche stand-by program (SDR 597.7 million), both of which were initiated by an earlier mission in July. Although preliminary staff calculations indicate the likelihood of an oil-based export shortfall, the authorities gave the July mission no concrete indication of a possible CF request, and no discussions on this matter are presently envisaged.

The July mission found that (i) the domestic economic situation was being brought under control, but the balance of payments position continued to be difficult; (ii) financial policies remained quite tight, but renewed efforts would be needed to reduce the external deficit and lay a sound basis for reforms and sustainable growth. The mission therefore suggested additional credit and fiscal restraint, further steps in economic reform and, as prior actions for the first credit tranche program: (i) an exchange rate adjustment from Y 3.2 to at least Y 4 per U.S. dollar, with appropriate subsequent flexibility; (ii) an increase of at least 3 percentage points in the cost of PBC credit to the specialized banks; and (iii) improvements in external debt management to provide a basis for controlling external borrowing. The authorities broadly agreed on the need for these actions and during the mission's stay devalued the renminbi to Y 3.7 per U.S. dollar. They also indicated that they: (i) were considering a further exchange rate action; (ii) would adjust the PBC lending rates; and (iii) would implement a program of action to improve external debt management, as agreed with the mission. Subsequently, the PBC lending rates were raised by a range of 1.4 to 5.8 percentage points, effective August 1. The authorities have also confirmed through Mr. Huang's office that the program of action on external debt management is being implemented on schedule.

The September mission will evaluate progress in key policy areas and seek to reach understanding on policies to be incorporated in the letter of intent. In particular, the mission will (i) review the impact of the recent exchange rate and interest rate changes, and discuss the authorities' timetable for further actions; (ii) review progress in implementing the program of action on external debt management; and (iii) seek to resolve outstanding issues relating to the stance of credit and budgetary policies.

China purchased SDR 450 million under a first credit tranche stand-by arrangement in March 1981, and effected full repurchase by August 1983. Trust Fund obligations amount to SDR 309.5 million, on which repayments amounting to SDR 61.9 million fall due during September 1986-June 1987. The authorities have announced their intention not to avail themselves of the structural adjustment facility.

II. Economic Background

China began to experience macroeconomic difficulties in late 1984. Urban economic reforms were introduced and planning controls reduced in scope at a time when a new system of indirect economic management was not yet developed. Money and credit expanded rapidly, output and demand growth became excessive, and a large external deficit emerged, prompting a series of corrective measures during 1985 (Table 1).

The corrective measures--tighter fiscal and monetary policies, interest rate, exchange rate and other price adjustments, together with some tightening of administrative controls on domestic demand and imports--brought the economy under better control. Industrial output growth decelerated sharply from over 20 percent in mid-1985 to about 5 percent currently, and investment and consumption demand became less buoyant. Inflationary pressures abated, with retail price increases slowing from 9 percent in 1985 to 5.5 percent (annual basis) by the first half of 1986. Slower growth of domestic demand contributed to a sharp reduction in import growth, from 60 percent in 1985 to 9 percent in the first half of 1986.

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Table 1. China: Selected Economic and Financial Indicators, 1982-87

	1982	1983	1984	1985	1986 1st half	1986 Est.	1987 Proj.
				(Changes, in percent)			
Real GDP	8.3	9.8	13.5	12.3	...	6.5	5-7.5
Agriculture 1/	(11.1)	(9.6)	(17.1)	(14.2)	(...)	(6.0)	(...)
Industry 1/	(7.7)	(10.5)	(14.0)	(18.0)	(4.9)	(7.1)	(...)
Retail prices	1.9	1.5	2.8	8.8	5.5	5.5	7.0
Budgetary revenue	1.9	12.9	15.1	24.4	...	7.3	9.5
Budgetary expenditures	2.7	14.0	14.8	19.8	...	6.9	7.5
Net domestic assets	...	17.0	44.6	23.6	18.6 2/	17.0	12.5
(Loans)	(...)	(14.0)	(35.3)	(21.8)	(18.3) 2/	(14.9)	(11.9)
Total liquidity	...	19.2	41.2	18.4	15.3 2/	14.5	12.4
(Currency)	(10.8)	(20.7)	(49.4)	(24.7)	(14.1) 2/	(18.0)	(15.5)
Exports	2.0	-2.0	15.4	5.0	14.4 3/	9.5	11.0
Imports	-18.7	10.9	27.6	60.0	8.6 3/	1.0	-6.7
Terms of trade	10.1	8.1	-0.3	-1.0	...	-8.1	--
				(In percent of GDP)			
Investment	30.3	30.9	33.4	38.5	...	38.2	36.6
Savings	32.3	32.4	34.1	33.9	...	33.8	34.0
External current balance	2.2	1.6	0.9	-4.5	-2.5	-4.3	-2.5
Overall budgetary balance	-1.3	-1.6	-1.6	-0.5	...	-0.4	0.1
Domestic bank financing	0.6	0.8	0.7	-0.3	...	-0.5	-0.8
				(In billions of U.S. dollars)			
Current account balance	5.7	4.5	2.5	-11.9	-6.4	-11.0	-5.6
Exports	21.1	20.7	23.9	25.1	13.5	27.5	30.5
Imports	-16.9	-18.7	-23.9	-38.2	-19.9	-38.6	-36.0
Services and transfers (net)	1.4	2.5	2.5	-1.2	--	--	-0.1
Capital account balance	0.6	0.3	-0.7	7.3	...	9.1	6.9
Net external borrowing	...	...	...	6.8	...	8.3	6.0
Of which: Borrowing from commercial banks	(...)	(...)	(...)	(5.6)	(...)	(6.0)	(4.0)
Other	...	...	...	0.5	...	0.8	0.9
Overall balance of payments	6.3	4.8	1.8	-4.6	...	-1.9	1.3
Gross reserves	11.2	16.0	17.8	13.2	12.3 4/	11.3	12.6
(In months of imports)	(8.0)	(10.3)	(8.9)	(4.1)	(3.8)	(3.5)	(4.2)
State foreign exchange	7.0	8.9	8.2	2.6	2.3 4/	...	...
External debt	8.8	10.8	13.1	20.0	...	28.3	34.3
Debt service ratio (as percent of exports of goods and services)	11.3	6.2	6.8	8.0	...	8.9	9.6
Exchange rate at end period (yuan per U.S. dollar)	1.9	2.0	2.8	3.2	3.2	3.7 5/	...

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Gross value of output at constant prices.
2/ End-March 1986 compared to end-March 1985.
3/ Compared to first half of 1985.
4/ End of May.
5/ As of August 29.

These favorable developments notwithstanding, the external position remains weak. The current account deficit, which reached almost $12 billion (4.5 percent of GDP) in 1985, was running at about the same annual rate in the first half of this year, as the effects of slower import growth and a pickup in non-oil exports were offset by declining oil prices and rising net interest payments resulting from the earlier current account deterioration. International reserves, which declined by $4.6 billion in 1985, fell in the first five months of this year by a further $0.9 billion to $12.3 billion (3.8 months of imports); the entire decline since end-1984 was reflected in state foreign exchange (from $8.2 billion to $2.3 billion) while Bank of China reserves, which are largely financed by borrowing, rose slightly. As the level of reserves provides limited scope for additional current account financing, external debt, which rose rapidly to $20 billion by end-1985, is likely to show a further large increase (about $8 billion) in 1986. While a high proportion of borrowing in 1985 was from banks, suppliers, and other sources of short-term credit (which accounted for nearly half of the outstanding stock of debt by end-year), borrowing this year appears to have been more diversified, including increased bond issues and long-term financing from export credit agencies.

III. Policy Issues

During the July discussions, the authorities expressed their serious concern at the continuing balance of payments difficulties. They agreed with the assessment of the staff team that policy adjustments will have to be continued to restore the sound financial environment which would provide the essential basis for additional reforms and future economic growth.

For the medium term, the authorities agreed that policies should be framed to ensure external viability along the lines of a scenario prepared by the staff. On the basis of policy adjustments in the key areas discussed below, this scenario, as modified to take account of revised WEO projections, envisages (i) a reduction in the current account deficit to about 1 percent of GDP by 1990; (ii) net commercial bank borrowing virtually eliminated by 1988; (iii) total external debt held to less than 16 percent of GDP through 1990; and (iv) the debt service ratio contained below 14 percent during the period (Table 2). An alternative scenario without policy adjustments to correct the external imbalances shows the current account deficit rising by 1990 to over 8 percent of GDP, external debt exceeding 35 percent of GDP, and a debt service ratio approaching 40 percent.

For the immediate future, the authorities agreed that the adjustment objectives should be to reduce the current account deficit to \$11 billion (4.3 percent of GDP) in 1986 and \$5.6 billion (2.5 percent of GDP) in 1987. Inflation would be limited to 5.5 percent in 1986 and, taking account of exchange rate effects and forthcoming price reforms, is tentatively projected at 7 percent in 1987. However, views differed somewhat on the output growth target consistent with external adjustment --an especially difficult issue, as economic reforms have substantially increased uncertainty about the relationships between major macro-economic variables such as output, investment, and imports. The authorities, while appreciating the need for caution, expect that

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Table 2. China: Medium-Term Balance of Payments Scenario, 1985-90

(In billions of U.S. dollars)

	1985	1986 Est.	1987	1988	1989	1990
Current account	-11.9	-11.0	-5.6	-4.4	-2.8	-3.0
Exports, f.o.b.	25.1	27.5	30.5	33.9	37.6	41.7
Imports, f.o.b.	-38.2	-38.6	-36.0	-38.0	-40.1	-44.2
Net services and transfers	1.2	--	-0.1	-0.3	-0.3	-0.5
Capital account (net)	7.3	9.1	6.9	5.1	3.5	4.0
Net external borrowing	6.8	8.3	6.0	3.9	2.3	2.5
Of which: borrowing from commercial banks	(5.6)	(6.0)	(4.0)	(0.5)	(--)	(--)
Other 1/	0.5 2/	0.8	0.9	1.2	1.2	1.5
Overall balance	-4.6	-1.9	1.3	0.7	0.7	1.0
Reserve changes (- = increase)	4.6	1.9	-1.3	-0.7	-0.7	-1.0
IMF drawings	--	---	--	--	--	--
Memorandum items:						
Current balance (percent of GDP)	-4.5	-4.3	-2.5	-1.8	-1.0	-1.0
Gross reserves	13.2	11.3	12.6	13.3	14.0	15.0
(in months of imports)	(4.1)	(3.5)	(4.2)	(4.2)	(4.2)	(4.2)
External debt	20.0	28.3	34.3	38.2	40.5	43.0
(in percent of GDP)	(7.5)	(11.3)	(15.7)	(15.5)	(14.6)	(13.8)
Debt service ratio	8.0	8.9	9.6	13.1	13.6	13.7

Sources: Data provided by the Chinese authorities; and staff estimates.
1/ Direct investment and nonmonetary asset transactions.
2/ Including errors and omissions.

adjustment objectives can be attained with growth maintained at the 7.5 percent rate recently announced in the Seventh Five-Year Plan (1986-90). However, the July staff mission projected GDP growth at 6.5 percent this year and felt that a rate of only about 5 percent in 1987 would be compatible with the program's external objectives. The September mission will further review appropriate growth targets with the authorities, stressing that a prudent approach is warranted.

There was broad agreement between the authorities and the July mission that the above objectives should be pursued primarily through (i) restraints on financing from both domestic and external sources; and (ii) adjustments of prices, including most importantly, the exchange rate and key interest rates. Traditional direct controls on investment, consumption, and imports should be avoided to the extent possible and, in any case, have become less effective with the progress in economic reforms. The authorities accordingly agreed to take a number of actions over the summer (see Section I above) and to formulate additional measures for implementation later in 1986 and in 1987. The mission will discuss progress in policy formulation and implementation in key areas.

1. Domestic financial policies

a. Money and credit

The July mission suggested that the growth of broad money be targeted at about 15 percent in 1986 and 12 percent in 1987, implying limits on credit expansion (net domestic assets of the banking system) of about 17 percent and 13 percent, respectively. These money and credit limits were based on the above macroeconomic objectives, including the lower output growth envisaged by the staff. The authorities, while firmly stating their commitment to continued restraint, felt that money and credit limits about 3-4 percentage points higher would be appropriate; in part, this position reflected their view that a higher rate of GDP growth would be compatible with external adjustment objectives. The mission, while acknowledging the uncertainty over appropriate output targets, will maintain that given the present delicate external position, policy making should err on the side of caution.

The People's Bank (PBC) has been improving its monetary policy instruments, and is now exercising reasonably firm control of its own credit to specialized banks, which is the key element in the current system of monetary management. At the same time, the PBC is prepared to take additional measures to control money and credit expansion, including if necessary the reintroduction (as in 1985) of ceilings on the credit extended by individual specialized banks. The mission will support this position, stressing the need for close monitoring of the credit operations of the banks and their positions with the PBC.

b. Budget

The state (i.e., centrally-controlled) budget has undergone two major changes in recent years. First, the budget's dominant role in resource allocation has been significantly reduced--expenditure declined from almost 40 percent of GDP in the late 1970s to below 30 percent in 1985--and the basis of revenue has switched from profit remittances to taxation, both as part of reforms which provided greater financial autonomy to enterprises. Second, while implementing these reforms, the authorities reduced the overall fiscal deficit substantially from over

5 percent of GDP in 1979 to 0.5 percent by 1985. During the July mission, the authorities indicated their intention to continue implementing budgetary reforms (especially in the area of enterprise taxation and investment responsibilities) while pursuing overall fiscal balance; they also pointed to the difficulty of this task, as the reforms give rise to uncertainties in revenue and expenditure prospects.

While basically supporting the authorities' position, the July mission took the view that, although the budget had been reduced in relative size and increased fiscal deficits were not a factor in the emergence of external imbalances, an appropriate contribution by the budget was needed to help bring about the rise in net domestic saving required for external adjustment. The September mission will broadly maintain this position and stress that efforts are needed to reduce the deficit for 1986 to 0.4 percent of GDP (below the budgeted 0.8 percent) and to achieve a fiscal surplus in 1987. The mission will discuss measures required to attain these objectives, including firm control of expenditures and further improvements in the tax system. As preparations for the 1987 budget will begin only around the time of the mission's visit, the authorities may not be ready to discuss specific measures in detail; the mission will seek to reach understandings on the broad fiscal strategy for 1987 to be incorporated in the program.

2. External financing and reserve policies

The large external current deficits of the last two years have been accompanied by a rapid buildup in external debt, which was in part attributable to weaknesses in debt management, notably the absence of coordinated monitoring and approval procedures that would cover all types of debt. In April 1986 the authorities, recognizing the need for urgent improvements, designated the State Administration of Exchange Control (SAEC) within the PBC as the agency with sole responsibility for coordinating the monitoring of external debt. The July mission discussed with the authorities a program of action for the new debt unit of the SAEC to develop a comprehensive debt management system. Steps to be taken over the summer included establishment of reporting channels for all borrowing units, training of officials, and compilation of more comprehensive data on debt outstanding and scheduled debt service payments. A CBD panel expert is currently in Beijing on a two-week assignment advising the authorities on these and other aspects of debt management and, as noted earlier, the authorities have indicated that the work is progressing as scheduled. Comprehensive data relating to debt outstanding at end-1985 have been collected, and are currently being processed. The mission will review progress in improving debt management, and discuss mechanisms to control the amount and structure of borrowing and new approval procedures.

Against the background of the new procedures for debt management, the mission will discuss borrowing policies for 1986 and 1987. The staff's preliminary projections envisage net external capital inflows of about $9 billion in 1986 and $7 billion in 1987, of which commercial banks would provide $6 billion and $4 billion, respectively. The mission will review external financing prospects consistent with the program's adjustment objectives, and ensure that monitoring procedures are adequate to control the amount and structure of all external borrowing by establishing appropriate benchmarks. As a minimum, these benchmarks would cover all nonconcessional medium and long-term borrowing by nonfinancial institutions, as well as borrowing of all maturities by financial institutions. The remaining element of nonconcessional borrowing comprises short-term credit to nonfinancial institutions, which is mostly trade-related and after rising rapidly in 1985 appears to be increasing more slowly this year in line with import developments. The mission will review the nature of short-term borrowing by nonfinancial institutions, assess recent trends and prospects and should such borrowing be likely to pose difficulties for the control of total debt, will set an additional benchmark to cover all outstanding short-term debt.

The mission will discuss policies on gross international reserves, which in light of the liabilities of the Bank of China appear to be close to the minimum level that would provide a margin of comfort. The program will accordingly target some recovery in total gross reserves to at least 4 months of imports by end-1987. The mission will also discuss the authorities' intentions regarding the possible encashment of their reserve tranche and SDR positions.

3. Exchange rate, interest rate and price policies

The authorities recognize the central importance of providing proper price signals for both short-term adjustment and the longer-run reform process. They have implemented exchange rate and interest rate adjustments, and are preparing a major package of price reforms for implementation in early 1987.

a. Exchange rate

On July 5 the authorities depreciated the exchange rate from Y 3.2 to Y 3.7 per U.S. dollar, citing the need to promote exports and strengthen the external position. The staff had suggested, and continues to maintain, that a depreciation to at least Y 4 per U.S. dollar is appropriate in light of the magnitude of the required external adjustment. Officials of the People's Bank indicated to the mission in July that a possible further adjustment was already being considered. The September mission will discuss the authorities' plans for further action, reiterating the position that an adjustment to at least Y 4 per U.S. dollar should be in place prior to Board consideration of China's stand-by request. The mission will also review progress in establishing a mechanism to ensure appropriate future exchange rate flexibility, based on close monitoring of the overall balance of payments and of external trade, exchange rate and price developments in major competitor countries.

b. Interest rates

The last mission suggested an increase of 3 percentage points in the cost of PBC credit to the specialized banks. The authorities agreed that an increase was warranted, and a set of adjustments were implemented on August 1. The adjustments generally range between 1.4 and 1.8 percentage points, but for overdue loans may reach as much as 5.8 percentage points, including penalties. The mission will review these adjustments, assessing the extent to which they eliminate the incentive for specialized banks to rely on PBC credit rather than deposit mobilization, and if necessary, suggest a further increase. The mission will also discuss progress in the ongoing review of the structure and levels of specialized bank interest rates.

c. Price reforms

During the July mission, the authorities were not able to provide details of the price reforms to be implemented in early 1987, but indicated the main aspects of the present structure which have given them concern; these are the low prices of energy and raw materials relative to manufactured products, the large price subsidies on basic consumer goods, and the lack of adequate differentials for quality. The September mission will discuss required adjustments in these and other areas and stress the importance of prices for the program of adjustment and growth. In particular, it will emphasize that to enhance the effectiveness of exchange rate policy, priority should be given to steps to strengthen links between domestic and international prices by permitting greater flexibility in price determination by enterprises engaged in foreign trade.

4. Program benchmarks

Being limited to the first credit tranche, the proposed arrangement would not include phasing or performance criteria but would incorporate indicative benchmarks for the purpose of monitoring policy implementation. These would include: (a) quarterly limits for net domestic assets of the banking system; (b) quarterly limits for net domestic assets of the People's Bank; (c) limits on contracting of nonconcessional external borrowing of from one to fifteen years' maturity, with sub-limits on borrowing of from one to five years' maturity; (d) limits for the net foreign liabilities of the financial institutions (i.e., the banking system and international trust and investment corporations); and, if appropriate, (e) limits on outstanding debt of less than one year's maturity. These indicative benchmarks will be established through December 1987.

CHC tfr6ch (8/29/86)

China--Fund Relations
(As of July 31, 1986)

I. Membership status

a. Date of membership: Original member (the People's Republic of China assumed representation on April 17, 1980)
b. Status: Article XIV

A. Financial Relations

II. General Department

a. Quota: SDR 2,390.90 million
b. Total Fund holdings of currency: SDR 2,088.3 million or 87.34 percent of quota
c. Reserve tranche: SDR 302.6 million
d. Current operational budget (June-August 1986): not included
e. Lending to the Fund: None

III. Stand-By or Extended Arrangements and Special Facilities

a. Current stand-by: None
b. Stand-by and extended arrangements in last ten years: Stand-by (first tranche), March 1981; SDR 450 million (25 percent of quota); China repurchased the full amount by end-August 1983
c. Special facilities in last two years: None

IV. SDR Department

a. Net cumulative allocation: SDR 236.8 million
b. Holdings: SDR 452.4 million (191 percent of cumulative allocation)
c. Current designation plan (June-August 1986): not included

V. Administered Accounts

a. Trust Fund
(i) Disbursed: SDR 309.5 million
(ii) Outstanding: SDR 309.5 million
b. SFF Subsidy Account: None

VI. Overdue obligations to the Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

The exchange arrangement for China's currency, the renminbi, is a managed float. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi vis-a-vis the U.S. dollar. As of July 31, 1986, the representative rate for the renminbi was Y 3.7036 per U.S. dollar.

VIII. Last Article IV Consultation

The Executive Directors reviewed SM/85/226 on November 8, 1985 and adopted the following decision (excluding the first paragraph):

"China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The Fund welcomes the termination of the bilateral payments arrangement with a Fund member, and notes with satisfaction the intention of the authorities to eliminate the remaining bilateral payments arrangements with Fund members. The Fund also welcomes the elimination of the internal settlement rate for trade transactions. The maintenance by China of an exchange tax on remitted profits of joint ventures, excluding most ventures in designated areas, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The exchange restrictions, multiple currency practice and bilateral payments arrangements that relate to this decision are described in SM/85/266 (9/27/85) and in SM/85/272 (10/24/85)."

IX. Technical Assistance

Since 1980, the IMF Institute has received more than 30 Chinese officials in its courses and seminars. In late 1983, the Institute organized a three-week course in Xian on "Banking and Monetary Policy." The Bureau of Statistics has sent four missions to discuss data presented in IFS, including a mission on balance of payments statistics in November 1985, and has presented seminars in China on balance of payments methodology in 1983 and on government finance statistics (May 1986).

Two staff members of the Central Banking Department visited Beijing and Shanghai in May 1985 for discussions and lectures on central banking matters with officials and staff of the People's Bank. A CBD mission visited China in March 1986 for advisory work relating to financial programming methods and monetary policy instruments.

The External Relations Department held a colloquium in China in November 1982. The proceedings of the colloquium were published in 1983 under the title "The Fund and China in the International Monetary System." A second colloquium is scheduled for November 1986 on "Macroeconomic Management, Growth, and the Role of the IMF."

X. Resident Representative/Advisor: None

(CHC) trwbg6ch (8/22/86)

China--Relations with the World Bank Group

Representation: The People's Republic of China assumed China's representation in the World Bank Group on May 15, 1980.

Capital subscription: China holds 25,142 shares or 3.1966 percent of the total authorized capital of the Bank. China voted in favor of the Special Capital Increase under which it would be eligible to subscribe to 1,660 additional shares. No formal action has yet been taken to subscribe for these shares, but the Government is planning to complete subscription before the 1986 Annual Meetings.

Lending activities:

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
	(In millions of U.S. dollars)			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.1	--
1983	150.4	463.1	32.6	0.6
1984	423.5	616.0	100.9	19.6
1985	442.3	661.2	146.2	235.7
1986	450.0	687.0	251.9	352.2
Total	1,626.2	2,527.3	531.7	608.1

Approved projects: FY 1981, University Development; FY 1982, North China Plain Agriculture; FY 1983, Three Ports, Agricultural Education and Research, China Investment Bank I, Petroleum I and II, and State Farms I; FY 1984, Polytechnic/TV University, Technical Cooperation, Rubber Development, Lubuge Hydroelectric, Railway I, Rural Credit I, Rural Health/Medical Education, Petroleum III, China Investment Bank II, and Agricultural Education II; FY 1985, Agricultural Research II, Power II, University Development II, Changcun (Luan) Coal Mining, Seeds, Rural Water Supply, Highway I, Railway II, Fertilizer Rehabilitation and Energy Saving, Forestry Development, PiShi Hang-Chaohu Area Development, and Weiyuan Gas Field Technical

Assistance; FY 1986, Rural Credit II, China Investment Bank III, Technical Cooperation II, Provincial University, Railway III, Tianjin Port, and Freshwater Fisheries, Beilungang Thermal Power, Yantan Hydroelectric, Liaodong Bay Petroleum Appraisal, and Rural Health and Preventive Medicine.

Economic Development Institute: Since May 1981, the Economic Development Institute has held several courses a year for China, making it EDI's largest country program. Nine courses were given by EDI in FY 1984, ten in FY 1985, and 13 are planned for FY 1986, using UNDP funds. Chinese participants have also been attending EDI regional courses and programs in Washington. In June 1985 a three-week seminar on development policy and management was held in Washington and New York for senior Chinese officials.

Economic missions: The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, China: Recent Economic Trends and Policy Developments (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984 an economic mission visited China to focus on long-term economic issues and options. A Fund staff member participated in this mission. A report by this mission (No. 5206-CHA) entitled China: Long-Term Issues and Options was discussed with the Chinese authorities in March 1985 and approved by the Bank's Executive Directors in June 1985. In October the report was published in book form by the Johns Hopkins University Press. A Chinese translation was published concurrently in China. In February/March 1986 a mission which included a Fund staff member examined finance and investment issues. The report is expected to be discussed with the authorities in October/November 1986. A mission is planned for October 1986 to examine China's foreign trade regime and use of external capital.

Resident mission: A resident IBRD office in Beijing was formally opened in October 1985.

Office Memorandum

cc: Mr. Brau
Mr. Bracket
Ms. Dillon

CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

July 16, 1986

FROM: P.R. Narvekar PRN

SUBJECT: China--Back-to-Office Report

Attached is Mr. Saito's back-to-office report on the recent mission to China, in which I also participated for the last few days.

I was impressed by the following: (i) to a much greater extent than I had thought before the mission, the authorities appeared well aware of the difficult balance of payments situation they face and prepared to take corrective action; (ii) the authorities appear sufficiently confident as to actively contemplate major further steps in the reform process--a significant price reform and possibly also a tax reform are understood to be on the anvil; (iii) the authorities have requested a substantial increase in the World Bank's lending activity, including policy-based lending, which will be followed up in the coming months.

All the same, the progress of policy formulation and implementation is not yet sufficient for us to move in with financial support. There does appear to be a reasonably good chance, however, that progress in the next few months will be adequate for us to contemplate a staff visit in mid-September, issuance of a Board paper by about October 10, and Board action a month later, subject of course, to your approval at the important stages.

Attachment

cc: CBD
ETR ✓
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Mr. Brown

Office Memorandum

CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

July 16, 1986

FROM: K. Saito

SUBJECT: China--Back-to-Office Report

A mission 1/ visited Beijing during June 23-July 9 for Article IV discussions and to consider a program that could be supported by a first credit tranche stand-by arrangement. Mr. Narvekar was present for the last few days of discussions. The mission met People's Bank Governor Chen Muhua, Deputy Governor Liu Hongru, People's Bank Council Member Shang Ming, Vice Minister of Finance Li Peng, Vice Minister of Planning Gan Ziyu, and other senior officials.

The major policy elements of a possible stand-by program were extensively discussed, and, at the request of the authorities, a very preliminary draft letter of intent was prepared. However, it was not possible to conclude the negotiations, because additional time was required to formulate and implement some important policies to be included in the program, including budgetary strategy for 1987 and improvements in external debt management. To evaluate progress in these areas and finalize the program, it was agreed that a small staff team should visit Beijing in September. The consultation discussions would also be completed at that time and, if negotiations could be concluded, Executive Board consideration of the stand-by request and the consultation could be held in early November.

The domestic economic and financial situation is being brought under control, but the external position remains difficult. Fiscal and monetary policies have been quite tight over the last 12 months. In response, industrial output growth has declined from over 20 percent to about 5 percent, and inflation has moderated from 9 percent to about 4 percent. Growth of investment demand and imports responded less quickly, and began to slow only in the early months of this year. Coincidentally, however, export prospects were dimmed by the sharp decline in the price of oil (which accounted in 1985 for about one fourth of total exports). As a result, even with strong policy adjustments, the external current account deficit in 1986 may remain at about the same level ($12 billion) as in 1985. International reserves provide little cushion (a large part being matched by the Bank of China's short-term liabilities) this year, and external debt is likely to rise substantially from the $20 billion estimated for end-1985.

1/ Other members were Ms. Kelly (ETR), Mr. Fetherston, and Ms. Tseng (both ASD), Mr. Williamson (RES), and Miss Yeong (secretary, ADM), Ms. Wallich (IBRD) was attached to the mission.

(continued)

Senior officials in the key economic policy agencies are keenly aware of the serious balance of payments situation and are prepared to implement the major policy actions that are needed. Indeed, Governor Chen chose the occasion of our meeting with her, immediately upon Mr. Narvekar's arrival, to make the formal announcement of the depreciation of the renminbi from Y 3.2 to Y 3.7 per U.S. dollar (13.5 percent). While welcoming this action, we made it plain that we considered its magnitude inadequate. In response, Deputy Governor Liu told us that the timing and magnitude of further exchange rate action is already being considered. We urged that the action be taken well before Executive Board consideration of the stand-by request and also stressed the importance of maintaining flexible policies subsequently. The Deputy Governor also indicated that the interest rate on People's Bank lending to the specialized banks will be raised soon, and that a general review of the structure of interest rates is being undertaken--actions which we had said were urgently necessary. Also, he expressed firm commitment to achieving major improvements in debt management and discussed with us the specific measures to be undertaken over the summer; indeed, we were impressed with the earnestness and sense of urgency with which the authorities are going about this important task.

Two aspects of the present economic situation appear of particular concern to the authorities. One is the likelihood that, at least for the next year or two, external considerations will not permit output growth of 7.5 percent targeted in the recently announced Seventh Five-Year Plan (1986-90). Our estimates suggest that output expansion may be as low as about 6 percent this year and 5 percent in 1987 (compared with double-digit rates in 1984-85). On this point, however, we were assured by Vice Minster Gan of the State Planning Commission that the authorities are fully cognizant of the weak external situation and the associated need for caution, and that lower growth may be needed for the time being so as to lay a firm foundation for growth in the latter part of the Plan period. These thoughts were echoed by Finance Ministry and central bank officials, who indicated that the authorities are determined to maintain cautious fiscal and monetary policies, although they also noted that the scope for further tightening is limited, especially on the budget side.

The possible implications of adjustment measures for economic reforms, to which the authorities remain firmly committed, are the other main concern of the authorities. They are currently preparing a package involving price adjustments for energy and raw materials and steps to liberalize consumer prices--which, together with a possible tax reform, is planned to be implemented early next year. The authorities fear that price reforms may be hampered by adjustment measures, in particular by the effects of currency depreciation on prices. We pointed out that the use of macroeconomic instruments for adjustment purposes is both necessary for the eventual success of the reforms and an integral element of the reform process itself.

The authorities gave no concrete indication of a possible request for a compensatory financing purchase, and did not provide the data required for shortfall calculations.

The first part of our stay coincided with the visit of a World Bank team to discuss the future lending program for China. The Bank's activity in China is set to increase further: the lending program which was discussed envisaged about $10 billion in new commitments over the next five years. For the year ahead, some $1.8 billion in project commitments are expected ($0.6-0.7 billion in disbursements); in addition, the authorities have expressed an interest in policy-based lending, and this will be discussed in the coming months. We are collaborating closely with our Bank counterparts in a number of areas.

cc: CBD
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Mr. Brown

Office Memorandum

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TO: The Managing Director | June 18, 1986

FROM: P.R. Narvekar and Eduard H. Brau
PRN EB

SUBJECT: China--Your Comments on the Briefing Paper

In your comments on the China brief, you have remarked that the authorities must not be under the illusion that a first credit tranche program implies "soft" conditionality. We think we can fairly say that any such illusion has been dispelled since your April meeting with Deputy Governor Liu Hongru and an earlier staff visit. In other formal and informal contacts, as well, we have underscored the importance of a strong program and of prior actions. The forthcoming mission will again emphasize that substantive policy actions are needed to address China's present difficulties and to generate Board support.

You have also indicated that you would have thought that a somewhat larger stand-by arrangement amount (but with phasing) would have been more appropriate. We too have seen the attractions of this option and tried it out on Chinese officials. They have so far been firmly opposed to it. At the same time, we have been concerned whether China is ready, at this stage in its economic reform process, to provide us with adequate assurance of being able to implement policies to satisfy a range of quarterly performance criteria. As you know, the authorities are still in the process of devising fully workable macroeconomic policy instruments and will require, together with the staff, more experience in estimating the effectiveness of these instruments in terms of attaining policy targets. On net balance, therefore, we consider that a strong first credit tranche arrangement might be more appropriate at this stage and provide a necessary learning experience both for the authorities and the staff.

More specifically on policies, you have raised questions in three areas--price reform, credit policy, and external borrowing. As regards price reform, the authorities' announcements that the next steps would not be taken until 1987 were motivated by the need to quell popular discontent which emerged last year after large reform-related increases in urban food prices. However, the authorities do remain committed to price reforms as a crucial element of China's economic management and the overall process of reform. The mission will endorse this emphasis, discuss with the authorities their specific intentions for the next package of price reforms, and urge that the key elements of this package be put in place as soon as possible. We do not believe, however, that it would be appropriate to go as far as making this a prior action.

Tight control of money and credit is, of course, the most crucial element of China's adjustment effort. The projections in the brief assume an unchanged velocity of broad money, although the general trend in velocity has been one of substantial decline, reflecting the rapid monetization of the economy. Inflation is targeted to decline from 9 percent in 1985 to 7 percent in 1986 and to the range of 5 to 7 percent in 1987 (taking into account the impact of price reforms); GDP growth, which exceeded 12 percent in 1985, is targeted at 7.5 percent in 1986 and 4 to 7 percent in 1987. The authorities are likely to react to these projections by arguing that credit policy has already been substantially tightened, and that further declines in velocity are likely. Nevertheless, the mission will press for a 1987 credit program at the lower end of the range of 12-15 percent specified in the brief, down from 21 percent in 1985 and the 17 percent projected for 1986.

In the area of external borrowing, you have asked whether the level of bank borrowing in the balance of payments projections for 1986 and 1987 is indeed consistent with a cautious approach. The debt situation is a problem, and the mission will stress the need for early action. However, 1986 is nearly half over, and appropriate measures, even if implemented immediately, will necessarily take some time to show effects on the balance of payments and the level of borrowing. Despite a reduction in imports, the recent weakening in oil exports is expected to result in a large current account deficit in 1986, financed through continued heavy bank borrowing (part of which will already have occurred); the current account deficit and bank borrowing are expected to decline in 1987. The scenario presented in Table 3 of the brief would eliminate the need for net bank borrowing by 1988, and would maintain a manageable debt service burden over the medium term on the basis of the staff's present tentative estimates of the level and structure of debt.

cc: The Deputy Managing Director (on return)
Mr. Brown

cc: Mr. Finch
Ms. Kelly

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

June 13, 1986

FROM: P.R. Narvekar PRN and Eduard H. Brau

SUBJECT: China--Article IV Consultation and Use of Fund Resources

1. Attached for your approval is a briefing paper for the forthcoming mission to China. The paper has been reviewed by Messrs. Hood (RES) and Tait (FAD), Ms. Koenig (CBD), and Messrs. Francotte (LEG), Chandavarkar (TRE), Gill (STA) and Levy (IBRD). Mr. Saito, who will lead the mission, will be in the office through June 19.

2. As we have reported to you for the past many months, the Chinese economic situation has been rather worrisome. The very process of economic reform and errors of policy have led to an overheating of the economy and a difficult external payments situation. The corrective measures taken have noticeably cooled the domestic economy but the payments situation remains difficult and debt management has emerged as an important issue.

3. The authorities are requesting use of Fund resources in the first credit tranche. The attached paper sets out the economic policy and management changes that are necessary to warrant such Fund support and, under the circumstances, is heavy on prior actions. Besides seeing action on exchange rate and interest rate policies, we will need to satisfy ourselves that some element of the governmental machinery does oversee and monitor the overall macro and external payments situation and also that a firm grip has been obtained on external borrowing. We do believe our cautious approach is justified.

4. The quantitative relationships in the Chinese economy (i) between output growth, investment and import demand, and (ii) between output growth and external supply are unclear and this makes medium-term projections difficult. It does nevertheless appear clearly that restoration of a viable payments position will require a further slowing of economic growth to a rate substantially below the 7.5 percent rate visualized in the Seventh Five-Year Plan that has just been adopted, unless a sharp improvement occurs in investment efficiency. The authorities may find this implication of a Fund stabilization program hard to accept.

5. The authorities have expressed to you on more than one occasion their desire to conclude negotiations for the stand-by arrangement as early as possible. The mission will, of course, push its work with deliberate speed--and make it clear to the authorities that it is doing so--but we fear that it will soon emerge and also become apparent to the authorities that the task cannot be completed in one

mission. Consensus needs to be established among the authorities on various aspects of policy and a good deal of work needs to be done, by the authorities and by us, in the crucial area of debt management. It is likely that another mission will be required later in the year to evaluate progress and finalize the program.

6. The authorities have informally expressed interest in a CFF drawing. A substantial oil based shortfall--which is likely to exceed 50 percent of quota (SDR 1.2 billion)--is emerging in respect of 1986. If the authorities pursue this matter, the mission will not itself encourage such a drawing, and, in any event, not a drawing based on partly estimated data. A better view can be taken after the payments prospects and policies have been assessed.

Attachment

cc: Mr. Brown

CHC cbp6ch (6/12/86) CONFIDENTIAL

INTERNATIONAL MONETARY FUND

CHINA

Briefing Paper - 1986 Article IV Consultation and Use of Fund Resources

Prepared by the Asian Department

(In consultation with Exchange and Trade Relations, Fiscal Affairs, Research, Central Banking, Legal, and Treasurer's Departments and the Bureau of Statistics)

PRN

Approved by P.R. Narvekar and Eduard H. Brau EB

June 13, 1986

I. Introduction

A mission consisting of Messrs. Saito, Fetherston, Ms. Tseng (all ASD), Ms. Kelly (ETR), Mr. Williamson (RES), and Ms. Yeong (secretary, ADM) will visit Beijing from June 23 to July 9, 1986. Ms. Wallich (IBRD) will be attached to the mission. Mr. Narvekar will join the mission for the last three days of discussions. The mission's objectives are: (1) to conduct the 1986 Article IV consultation discussions; (2) to discuss, ad referendum, economic and financial policies that would warrant support with Fund resources; and (3) to collect data relevant for consideration of a possible request for a purchase under the compensatory financing facility.

The authorities have expressed interest in a first credit tranche stand-by arrangement (SDR 597.7 million) and in a CF drawing. Preliminary staff calculations indicate the likelihood of an export shortfall, largely on account of the sharp decline in oil prices. China purchased SDR 450 million under a first credit tranche stand-by arrangement in March 1981; the full amount was repurchased by August 1983. China has outstanding Trust Fund obligations of SDR 309.5 million, on which the first repayment falls due in September 1986. The authorities have indicated their intention not to avail themselves of the structural adjustment facility.

The authorities have stressed that they wish to reach an understanding on a Fund-supported program during the forthcoming mission, as the early implementation of such a program is considered crucial for the success of China's current economic adjustments and the continuation of economic reforms. However, the complex and dynamic nature of China's economy, the relatively novel nature of some key policy instruments, and the time that may be needed for the authorities to establish internal consensus on major policy actions is likely to make it difficult for the mission to reach detailed understandings on all aspects of the program and be assured that adequate monitoring mechanisms are in place. In particular, the authorities may need some time to establish consensus on exchange rate and interest rate policy actions and to implement improvements in the monitoring of external debt. It is, therefore, likely that another mission will be required later in the year to evaluate progress in these areas and to finalize the program.

II. Economic Background

The Chinese economy has undergone dramatic change in recent years. Since 1979, a series of wide-ranging economic reforms has decentralized decision-making powers to individuals and enterprises.

The reforms contributed to a remarkable output performance, with growth of GDP averaging 9 percent per annum during 1979-85. At the same time, the reforms complicated the task of economic management. Direct planning controls were reduced in scope, and indirect methods of macroeconomic management were still relatively unfamiliar and untried.

The challenge of combining reforms with economic and financial stability was first faced at the beginning of the 1980s. Soon after the initiation of highly successful agricultural reforms, an ambitious investment program led to the emergence of substantial fiscal and balance of payments deficits in 1979 and 1980. With the support of a first credit tranche stand-by arrangement with the Fund, the authorities launched a stabilization program in 1981 which, while maintaining a rapid growth of output, contributed to large balance of payments surpluses in 1982 and 1983 (Table 1).

In 1984 a new round of reforms began with the granting of increased autonomy to state enterprises, the relaxation of exchange and trade restrictions, and the transformation of the People's Bank of China (PBC) into a separate central bank with responsibility for macroeconomic management. The reforms contributed to buoyant economic activity and increasingly strong demand pressures. With the PBC still developing its techniques of monetary control, the growth of money and credit accelerated sharply, especially during the fourth quarter. At the same time, price increases accelerated and an external deficit emerged.

In 1985, the authorities responded to the deteriorating price and balance of payments situation with a series of corrective measures.

(CHC) tse6ch (6/11/86) MF

Table 1. China: Selected Economic and Financial Indicators, 1982-87

	1982	1983	1984	1985 Prel.	1986 Qtr.I	1986 Proj.	1987 Target
	(Annual percentage changes, unless otherwise specified)						
Output and prices							
Real GDP	8.3	9.8	13.9	12.3	...	7.5	4-7
Real gross industrial production	7.8	11.2	15.9	21.4	4.4	8.0	4-7
Real gross agricultural production	11.3	7.7	9.9	3.0	...	3.0	3-4
Retail prices	1.9	1.5	2.8	8.8	7.5	7.0	5-7
External sector							
Exports, f.o.b.	2.0	-2.0	15.4	4.7	4.3	2.4	11.2
Imports, f.o.b.	-18.7	10.9	27.6	58.2	3.6	-4.1	0.4
Terms of trade	10.1	8.1	-0.3	-1.0	...	-8.1	—
Nominal effective exchange rate 1/	65.2	70.9	77.4	63.4	60.1	...	...
Real effective exchange rate 1/	55.6	57.5	61.2	52.8	50.2	...	...
State budget							
Revenue	1.2	8.3	17.2	26.3	...	2.4 2/	...
Expenditure	2.0	9.6	16.7	21.2	...	4.6 2/	...
Money and credit							
Net domestic assets	...	17.3	43.6	21.2	...	16.9	12-15
Of which: Claims on nongovernment	(...)	(14.0)	(35.3)	(21.3)	(...)	(14.7)	(11-14)
Money and quasi-money	...	19.2	41.2	18.4	...	15.6	11-14
	(In percent of GDP)						
State budget							
Revenue	28.4	27.8	27.3	28.2	...	25.6	...
Expenditure	29.7	29.4	28.9	28.7	...	26.5	...
Surplus/deficit	-1.3	-1.6	-1.6	-0.4	...	-0.9	...
Domestic bank financing	0.5	0.7	0.7	-0.3	...	—	...
Other domestic financing	0.9	0.8	0.6	0.8	...	0.6	...
Foreign financing	—	0.2	0.3	—	...	0.3	...
External current account	2.2	1.6	0.9	-4.4	...	-4.0	-3.2
External debt	...	...	4.3	7.4	...	10.6	13.4
Debt service ratio 3/	11.3	6.2	4.0	8.3	...	11.0	10.7
	(In billions of U.S. dollars)						
External current account	5.8	4.5	2.5	-11.8	...	-10.6	-8.0
Overall balance of payments	6.3	4.8	1.8	-4.6	...	-0.5	—
Gross international reserves 4/	11.8	16.0	17.8	13.2	12.5 5/	12.7	12.7
(In months of imports) 6/	(7.6)	(8.0)	(5.7)	(4.4)	(4.2) 7/	(4.2)	(4.2)

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ End of period; 1980 official rate = 100. Based on internal settlement rate during 1982-84.
2/ Budget estimates.
3/ In percent of exports of goods and services.
4/ End of period.
5/ End-February.
6/ In months of imports of the following year.
7/ In months of projected 1986 imports.

Fiscal and monetary policies were tightened; the state budget deficit was narrowed from 1.6 percent of GDP in 1984 to 0.4 percent in 1985 (well below the budgeted 1.2 percent), and the rate of expansion of money and credit was reduced by more than half to about 20 percent. Interest rates were raised on two occasions and duty rates increased on selected imports, while selected food prices were allowed to rise as part of price reforms; the yuan was depreciated considerably both vis-a-vis the U.S. dollar and in effective terms. Also, the authorities strengthened administrative controls over wages and investment and selectively tightened import restrictions and foreign exchange allocations.

These policy measures did not immediately stabilize aggregate demand, prices, and the balance of payments. This was partly on account of time lags, but also because of the absence of measures to restrict external borrowing. Both investment and household consumption remained buoyant, although the rate of expansion of industrial output was halved from over 20 percent in the first half of 1985 to about 10 percent by end-year. The strong demand pressures, combined with the reform-related price adjustments, raised the inflation rate to 9 percent in 1985 from less than 3 percent in 1984. The external position remained weak during the year and the current account shifted to an estimated $12 billion deficit in 1985 from a $2.5 billion surplus in the previous year. This turnaround occurred largely on account of imports, which rose by over 50 percent. The credit expansion of late 1984 and the simultaneous liberalization of trade and exchange controls contributed to the increase in imports, while more recent measures to curb imports had little impact during 1985. Exports rose by only about 5 percent, the increase being entirely on account of a sharp increase in the volume of oil exports (about one fourth of the total); manufacturing exports declined as China lost market shares.

The current account deficit in 1985 was financed by a combination of drawing down reserves and increased borrowing. Gross international reserves--not all of which may be readily usable--declined by $4.6 billion to $13.2 billion (about 4.5 months of imports) at end-year. Net external borrowing is estimated to have been close to $8 billion. Consequently, China's external debt is estimated by the staff to have risen from about $11-12 billion at end-1984 (about half of which was short term) to about $20 billion (7.5 percent of GDP) by end-1985. The debt service ratio rose from 4 percent in 1984 to an estimated 8 percent in 1985.

Available data for 1986 show signs of economic slowdown, as the earlier stabilization measures were maintained and began to take effect. The growth of real industrial output declined further to 4 percent (on a year-on-year basis) during the first four months. Inflation moderated to 7.5 percent in the first quarter. In the first four months exports increased by 9 percent, despite the sharp decline in oil prices, and the growth of imports decelerated sharply to about 10 percent; these data suggest that the current account deficit was running at about the same annual rate as in 1985. Gross international reserves declined further by $1.6 billion during the first quarter.

III. Issues for Discussion

The policy discussions will take into account the comments made by Executive Directors during the last consultation with China and will focus on stabilization policies and economic reforms that would be crucial to a Fund-supported program. Although the reforms have successfully invigorated domestic economic activity in recent years, their continuation may be threatened unless the inflation and balance of payments problems are promptly brought under control. Moreover, the short-term export outlook has deteriorated as a result of the recent weakness in the price of oil.

1. Policy priorities and objectives

The authorities remain firmly committed to reforms, but for the immediate future they place policy priority on economic stabilization. While supporting this position, the mission will stress that the momentum of reforms should not be lost. In particular, stabilization should be effected as far as possible through the application of indirect policy instruments--which form an integral part of the reforms--rather than the reintroduction of direct planning controls.

The authorities have recently set out their medium-term policy strategy in the Seventh Five-Year Plan (1986-90). Further reforms introduced during the Plan period are to focus on invigorating state enterprises, developing market mechanisms, and improving macroeconomic management through indirect policy instruments. In the immediate future, policies would aim at reducing the current account deficit to a level that will prevent the emergence of debt servicing problems, maintaining an adequate level of international reserves, and reducing domestic inflationary pressures, while maintaining reasonable growth.

For the Seventh Five-Year Plan period, the authorities plan real GDP growth of 7.5 percent per annum, well below the unsustainably high rates of 1984-85 (averaging 13 percent per annum). They have indicated that a more stable macroeconomic background is a prerequisite for the resumption of price reforms. Without further policy adjustments, however, it may be difficult to achieve these goals while maintaining a viable external position over the medium term.

Medium-term balance of payments projections are extremely tenuous in the case of China because the relationships between output growth, investment, and import demand and between output and export supply are even more difficult to estimate than for most other countries. The alternative scenarios presented in Table 2 nevertheless indicate the difficulty of sustaining rapid growth while avoiding balance of payments and debt servicing problems. Each scenario assumes that the import coverage of reserves is maintained at the early 1986 level; in the event that the mission establishes that part of China's reserves are not readily usable, however, it may be necessary to provide for some additional reserve accumulation.

Scenario 1 assumes 7.5 percent annual growth without measures to safeguard the external position. The current account deficit would increase to almost 7 percent of GDP by 1990 (compared with 4.4 percent in 1985), implying marked increases in external debt (mostly on commercial terms, assuming such finance remained available) and in the

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Table 2. China: Medium-Term Scenarios, 1985-90

(In percent, unless otherwise noted)

	1985	1986	1987	1988	1989	1990
Scenario 1 1/						
GDP growth 2/	12.3	7.5	7.5			
Export volume growth	5.6	3.8	3.8	3.8	3.8	3.8
Import volume growth	61.2	-0.1	-0.6	7.6	7.6	7.6
Current account balance ($ bn.) 3/	-11.8	-15.4	-15.3	-19.1	-23.6	-28.9
Current account balance/ GDP ratio	-4.4	-5.4	-4.9	-5.5	-6.1	-6.8
Debt ($ bn.)	20.3	34.9	48.7	67.3	90.4	118.8
Debt/GDP ratio	7.4	12.3	15.5	19.3	23.4	27.8
Debt service ratio 4/	8.3	11.8	15.1	21.5	29.4	38.5
Scenario 2 1/						
GDP growth 2/	12.3	7.5	0.6			
Export volume growth	5.6	3.8	3.8	3.8	3.8	3.8
Import volume growth	61.2	-15.6	-8.5	1.4	4.5	5.6
Current account balance ($ bn.)	-11.8	-8.4	-4.4	-4.0	-4.6	-5.7
Current account balance/ GDP ratio 3/	-4.4	-2.9	-1.5	-1.3	-1.4	-1.7
Debt ($ bn.)	20.3	25.7	27.5	29.9	33.1	37.4
Debt/GDP ratio	7.4	9.0	9.3	9.8	10.5	11.4
Debt service ratio 4/	8.3	10.7	9.1	9.5	10.0	10.8
Scenario 3 1/						
GDP growth 2/	12.3	7.5	4.0			
Export volume growth	5.6	3.8	7.4	7.4	7.4	7.4
Import volume growth	61.2	-10.6	-2.8	-3.4	6.1	8.6
Current account balance ($ bn.) 3/	-11.8	-10.6	-8.0	-4.6	-4.6	-5.7
Current account balance/ GDP ratio	-4.4	-4.0	-3.2	-1.7	-1.6	-1.9
Debt ($ bn.)	20.3	28.6	34.7	37.2	40.7	45.6
Debt/GDP ratio	7.4	10.7	14.0	14.0	14.3	14.9
Debt service ratio 4/	8.3	11.0	10.7	12.2	12.3	12.7
Memorandum items:						
Assumptions used in scenarios						
Growth of:						
Export markets	3.3	3.8	3.7	3.7	3.7	3.7
Export unit values	-0.9	-1.4	3.5	3.5	3.5	3.5
Import unit values	-1.9	7.3	3.4	3.4	3.4	3.4
Interest rates (LIBOR)	8.6	7.6	7.5	7.5	7.5	7.5

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Scenario 1 assumes that growth is sustained through external borrowing; Scenario 2 that borrowing is held in check through cuts in imports and hence domestic output growth; Scenario 3 that policies of financial restraint and depreciation are adopted in 1986. Each scenario assumes that the reserves/imports ratio is held constant at the level of early 1986.

2/ Annual averages shown for 1987-90.

3/ Current account balance, excluding official transfers.

4/ Total interest payments, plus long-term amortization payments, as a ratio of exports of goods and services.

debt service ratio (from 8 percent in 1985 to 39 percent in 1990). Scenario 2 assumes that through cutting imports, borrowing would be limited to loans from official creditors and bondholders, keeping the debt/GDP and debt service ratios in 1990 to little more than 1985 levels. But imports would have to be cut sharply, implying on the basis of past relationships little growth of GDP over the 1987-90 period.

Scenario 3 assumes policies, including financial restraint and depreciation of the renminbi, which would sustain both a reasonable rate of growth and an improved external position. Under the scenario, China's export volume growth would be raised to a rate that is typical of its competitors and the income elasticity of demand for imports would be reduced over the medium term. Growth of GDP would be sustained at 4 percent per annum, significantly below the Plan target of 7.5 percent; growth could, of course, be faster if the reforms succeed in raising the efficiency of investment. The scenario also shows that additional borrowing (other than those from foreign governments and international organizations) would only be required in 1986 and 1987 (Table 3). On the basis of the staff's estimates of the level and structure of external debt, the debt service ratio would be limited to about 13 percent during the 1986-90 period.

Although in the case of China it is especially difficult to associate a given set of policy measures with a precise quantitative result, the medium-term scenarios have broad policy implications. The reduction in the current account deficit of the order of magnitude set out in Scenario 3 will require further policy adjustments and

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Table 3. China: Balance of Payments, 1983-88

(In billions of U.S. dollars) 1/

	1983	1984	Staff Estimate 1985	Scenario 2/ 1986	1987	1988
Current account	4.5	2.5	-11.8	-10.6	-8.0	-4.6
Exports	20.7	23.9	25.0	25.6	28.5	31.6
Oil	4.3	5.5	6.5	3.8	3.9	4.1
(mn. barrels)	(153)	(200)	(250)	(250)	(262)	(274)
($/barrel)	(28)	(27)	(26)	(15)	(15)	(15)
Non-oil	16.4	18.4	18.5	21.8	24.6	24.5
Imports	-18.7	-23.9	-37.8	-36.2	-36.3	-36.4
Invisibles	2.5	2.5	1.1	—	-0.1	0.1
Capital account (net)	0.3	-0.7	7.4	10.1	8.0	4.6
Direct investment	0.5	1.1	1.5	1.7	1.8	2.0
Borrowing from governments and international organizations	0.7	0.8	0.9	1.3	1.6	2.0
Borrowing through bond issues	--	0.1	0.9	0.9	0.5	0.5
Borrowing from banks 3/	0.3	0.2	6.0	6.2	4.1	—
Other capital	-0.9	-2.0)	-2.2	—	—	—
Errors and omissions	-0.3	-0.9)				
Overall account	4.8	1.8	-4.6	-0.5	—	—
Reserve changes (- increase)	-4.3	-1.8	4.6	0.5	—	—
IMF drawings	-0.5	--	—	—	—	—
Reserves at end-year	16.0	17.8	13.2	12.7	12.7	12.7
(months of imports) 4/	(8.0)	(5.7)	(4.4)	(4.2)	(4.2)	(4.2)
Memorandum item:						
Current account/GDP (in percent)	1.6	0.9	-4.4	-4.0	-3.2	-1.7

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Totals may not add up due to rounding.
2/ Corresponds to Scenario 3 in Table 2.
3/ Estimated as residual for 1986-88.
4/ Of the following year.

flexibility in their implementation over the medium term. Urgent measures are required to increase non-oil exports, to reduce imports (without recourse to additional restrictions), and to increase the efficiency of investment. Debt management should be cautious, with efforts to increase the flow of long-term concessional financing and improve the structure of debt. On the domestic side, measures are needed to ensure that the savings ratio remains high and that aggregate investment is brought under greater control. Toward these ends, the mission will review the authorities' present policies and discuss the need for additional measures encompassing domestic financial policies, restraint on external borrowing, and structural policies.

2. Policies

With increased emphasis on macroeconomic management under the reforms, a key element of the authorities' stabilization efforts should be domestic financial restraint exercised through fiscal and monetary policies. Of course, the effectiveness of such indirect policies, while considerably enhanced by the reforms, is not yet at a level comparable with market economies, and use of more direct measures will still be warranted in certain areas. In particular, for some time to come there is likely to be a chronic excess demand for foreign exchange which will require direct measures to control the availability of external financing; direct restriction of imports will also continue to be needed and direct control of credit may also be necessary.

a. Domestic financial policies

(1) Fiscal policies

Budgetary policies have been cautious for the last several years. Fiscal deficits have been held below 2 percent of GDP, as buoyant revenues outpaced expenditure growth. 1/ Foreign and domestic bank financing were generally kept to modest levels, with an increasing role played by nonbank financing through treasury bond sales. The 1986 budget maintains this cautious stance, projecting a deficit of 0.9 percent of GDP; of total financing, two thirds would be provided by treasury bond sales and the remainder from foreign sources, with no recourse to domestic bank financing.

The fiscal system has undergone in recent years a number of reforms which emphasize incentives and the development of indirect economic levers; as in other areas, the reforms have resulted in new challenges for macroeconomic management. In particular, in the process of reform, enterprise profit retention and increased depreciation rates resulted in a rapid growth of extrabudgetary funds--state enterprise and local government revenues which are outside the state budget--to the equivalent of about 70 percent of budgetary revenues. Expenditures financed with extrabudgetary funds, including investment and wage bonuses, contributed to excess demand pressures and have become of growing concern to the authorities.

The mission will emphasize the importance of maintaining fiscal restraint in the implementation of the 1986 budget. In particular, there is a need to reduce the deficit below the budgeted level. In view of the recent trend for revenue to exceed budgetary projections, the smaller deficit could be achieved by taking advantage of such unexpected revenue gains and restraining expenditures. The mission will also

1/ The state budget in China consolidates the operations of the central and provincial governments.

emphasize that in framing fiscal policies, operations of the extra-budgetary funds should be taken into account. In this respect, the budget for 1987 may well have to target a surplus, together with a reduction in net liabilities to the banking system, if the needed improvement in the balance of payments is to be achieved.

(2) Credit

The reduction (by more than half) in the growth of the monetary aggregates in 1985 represented an important contribution to economic stabilization. The mission will stress the importance of continued restraint and discuss a financial program that is consistent with adjustment objectives. The staff's preliminary calculations would suggest that the growth of net domestic assets of the banking system should be further reduced from 21 percent in 1985 to 17 percent in 1986 and 12-15 percent in 1987, consistent with projected liquidity expansion of 16 percent and 11-14 percent, respectively, and based on GDP growth of 4-7 percent in 1987.

The mission will discuss financial programming procedures and monetary instruments against the background of recommendations of a recent CBD advisory mission. In particular, the mission will stress the importance of maintaining firm control over all forms of central bank credit to specialized banks as a key element in the effective implementation of the financial program. It will also discuss steps to ensure that the apparent overhang of excess reserves held by the specialized banks is not used to fund excessive credit expansion. In addition, the PBC can utilize traditional ceilings on the credit extended by individual specialized banks; these ceilings proved to be still effective in curbing credit expansion in 1985. In this respect, the mission will take the position that the operations of specialized banks should be monitored frequently and if deemed necessary, such ceilings should be reimposed to ensure the strict implementation of the financial program.

b. External borrowing policies

Successful implementation of adjustment policies will require, in addition to domestic financial restraint, limitations on external borrowing. External debt management has now become a major policy issue. As noted earlier, staff estimates indicate that China's external debt may have risen to $20 billion in 1985 and that its structure may have further deteriorated, with a sharp increase in short-term debt, especially to banks. Recent balance of payments developments suggest a further large increase in external debt is likely in 1986. There is a risk that, in the absence of appropriate arrangements for controlling and monitoring external debt, China's debt burden will rise rapidly and result in debt servicing problems.

Against this background, the mission will urge a cautious approach to external borrowing and agree with the authorities on a program of action to establish an external debt management system that will ensure that limits on external borrowing can be fully enforced. The authorities have taken the first step in this direction by designating the State Administration of Exchange Control (SAEC) as the central unit to monitor all external debt. Tasks to be addressed immediately include: (a) establishment of approval procedures by and reporting requirements to the SAEC; (b) announcement of a debt strategy to avoid excessive external borrowing, including limits on the net foreign liabilities of financial institutions, and to improve the structure of existing debt; and (c) the establishment of comprehensive data on external debt outstanding as of end-1985 and the projection of debt service payments for 1986-90.

Data on China's external indebtedness are not satisfactory. While official data have a reasonable coverage of debts to foreign governments and international organizations, as well as those arising from bond issues, these data appear to understate debts to foreign banks and nonbank suppliers; apparently the central authorities do not have adequate arrangements for monitoring borrowing from these sources. Data from the Organization for Economic Cooperation and Development (OECD) (which are based on information from creditor sources) have a better coverage but are not current. The Fund staff estimates are based on (a) estimates derived from official data on borrowings from foreign governments and international organizations and through bond issues ($5.3 billion at end-1985); (b) data on bank loans to China collected by the Fund from international banking centers ($9.4 billion); and (c) estimates of nonbank trade credit based on OECD data ($5.6 billion). The mission will attempt to clarify debt statistics and obtain a better description of current reporting and approval procedures, in particular those related to the Bank of China, enterprises, and joint ventures.

The authorities informed a recent technical mission that they have begun to collect comprehensive debt data. However, this process could take some months and only incomplete data are likely to be available to in the interest rates on new PBC credit which would strengthen overall credit control.

The mission will stress the need to maintain nominal interest rates at levels that adequately compensate depositors for inflation. While acknowledging the difficulty of estimating inflationary expectations in China, the mission will discuss with the authorities the case for a general upward adjustment of interest rates. In addition, the mission will urge the authorities to narrow or eliminate the differential between enterprise and household deposit rates, and encourage the adoption of greater flexibility for specialized banks in setting interest rates.

(2) Exchange rate

A staff mission has recently discussed with the authorities the role of exchange rate policy in China and China's external competitiveness. These discussions indicate that (a) China's export competitiveness deteriorated during 1981-85; (b) but, until the 1984 reforms, the effects of this deterioration were masked by a system of implicit subsidies through foreign trade corporations; and (c) since the reforms, the greater financial accountability of these corporations, along with the increasing share of trade carried out through other channels, has strengthened the impact of the exchange rate on trade performance.

Between 1981 and 1984, China maintained an official exchange rate and a separate internal settlement rate for trade transactions. Following the unification of the two rates at Y 2.8 per U.S. dollar at the beginning of 1985, the official rate depreciated from Y 2.8 to Y 3.2

per U.S. dollar by end-October, and has since remained close to that level. The mission will review developments in the exchange system since the last consultation.

The assessment of export competitiveness is difficult in the case of China, given the nature of its economy and the extent of price controls; however, a variety of indicators shows that competitiveness has deteriorated substantially over recent years, perhaps by as much as 20 percent. A large initial adjustment is required to send a clear signal to the public and to China's creditors; also, in view of the difficulty of judging the precise impact of such an adjustment on trade volumes, continued flexibility would be needed.

Against this background, the mission will argue for an initial exchange rate adjustment of at least 20 percent. The mission will discuss possible mechanisms to ensure that exchange rate policy thereafter remains flexible. Such a mechanism could feature regular monitoring by the authorities of the net foreign assets of the banking system. It could also include the construction of a currency basket of major competitors for the purpose of day-to-day exchange rate management.

It should of course be remembered that the effectiveness of exchange rate policy is limited; it needs to be enhanced through further price and foreign trade reforms. In this respect, the mission will recommend greater flexibility for entities engaged in foreign trade in setting the prices they offer in domestic and international markets.

(3) Price reform

The authorities recognize the prime importance of pricing policies in the overall reform process. So far, they have decontrolled a number of food prices, raised transport charges, and permitted a substantial increase in the volume of enterprise transactions which are conducted outside the plan at flexible prices. The mission will discuss the next steps in price reform, which the authorities have indicated will begin in 1987. In particular, the mission will note the importance of correcting existing major price distortions associated with the relatively low prices of energy and raw materials, emphasize the benefits for exchange rate policy of increasing links between world and domestic prices of traded goods, and point to the desirability of steps to reduce the scope of price subsidies. The mission will point out the implications of such price reform for tax revenue and for the budget and will explore ways in which enterprise taxation could be reformed to improve the allocation of resources and enhance economic certainty for both enterprises and government.

(4) Other structural measures

The mission will discuss other steps which the authorities intend to take to improve the efficiency and performance of state enterprises, including further reduction in the scope of mandatory planning, progress in the implementation of wage reforms, and proposals to introduce a bankruptcy law. The mission will point out that a strengthening of enterprise financial discipline is a key ingredient of efforts at stabilization and improved efficiency.

3. The World Bank

The World Bank has been increasingly active in China during the last few years, both in terms of its lending activity and its economic work. A resident mission was recently opened in Beijing. The Bank has undertaken substantial loan commitments in those sectors--energy and transport--which are being given priority by the authorities in the Seventh Five-Year Plan. The Bank plans to carry out analyses of these sectors during FY 1987 in the context of its lending program. It does not intend in the near future to review overall investment priorities in the Seventh Plan.

Fund and Bank staffs collaborate closely and there are no serious disagreements between the two staffs on major policy issues in China.

4. Statistics

The quantity and quality of statistical information has improved substantially in recent years. Balance of payments data were published in IFS for the first time in late 1985, and the PBC has recently completed the task of separating its accounts from those of the other specialized banks, facilitating a significant improvement in monetary data for financial analysis and programming. Some significant gaps remain, however, notably in the area of external debt data where, as noted above, improvements in monitoring are needed as a matter of priority, and in banking data which exclude the foreign currency operations of the Bank of China. A breakdown of consolidated budgetary data between central and local levels of government would assist in the analysis of fiscal policy.

5. Consultation cycle

The mission will propose that China remain on the standard 12-month consultation cycle.

IV. Use of Fund Resources

The mission will indicate to the authorities that, prior to the presentation to the Executive Board of a request for use of Fund resources by China, the staff will need assurance that the major elements of an appropriate adjustment program are in place. These prior actions would include: (a) an increase in the PBC's lending rates to the specialized banks of at least 3 percentage points; (b) devaluation of the renminbi by at least 20 percent in foreign currency terms (i.e., to Y 4 per U.S. dollar); and (c) compilation of an adequate debt data base and establishment of a functioning unit to control external borrowing.

A first credit tranche stand-by arrangement would not include phasing of purchases or performance criteria. Consequently, the program would incorporate indicative benchmarks for the purpose of monitoring policy implementation. These would include: (a) quarterly limits for net domestic assets of the banking system; (b) quarterly limits for net domestic assets of the People's Bank, net of its deposit liabilities to the specialized banks; (c) limits on contracting of nonconcessional external borrowing; and (d) limits for the net foreign liabilities of the financial institutions. These limits will have to be established for the second half of 1986 and for 1987. The mission will explain to the authorities that performance in relation to these benchmarks, while not affecting their entitlement to purchase under the arrangement once it is in place, would form the basis of a judgment of their commitment to the program.

Regarding China's request for purchase under the compensatory financing facility, the mission will collect the necessary information to enable the staff to calculate the shortfall and assess the case at headquarters. The mission will explain the Board guidelines on cooperation associated with CF purchases, and will indicate that the policy undertakings specified above would be a prerequisite for satisfying the test of cooperation for a CF purchase by China.

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China--Fund Relations
(As of May 31, 1986)

I. Membership status

a. Date of membership: Original member (the People's Republic of China assumed representation on April 17, 1980)
b. Status: Article XIV

A. Financial Relations

II. General Department

a. Quota: SDR 2,390.90 million
b. Total Fund holdings of currency: SDR 2,088.3 million or 87.34 percent of quota
c. Reserve tranche: SDR 302.6 million
d. Current operational budget (March-May 1986): not included
e. Lending to the Fund: None

III. Stand-By or Extended Arrangements and Special Facilities

a. Current stand-by: None
b. Stand-by and extended arrangements in last ten years: Stand-by (first tranche), March 1981; SDR 450 million (25 percent of quota); China repurchased the full amount by end-August 1983
c. Special facilities in last two years: None

IV. SDR Department

a. Net cumulative allocation: SDR 236.8 million
b. Holdings: SDR 452.4 million (191 percent of cumulative allocation)
c. Current designation plan (March-May 1986): not included

V. Administered Accounts

a. Trust Fund
   (i) Disbursed: SDR 309.5 million
   (ii) Outstanding: SDR 309.5 million
b. SFF Subsidy Account: None

VI. Overdue obligations to the Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

The exchange arrangement for China's currency, the renminbi, is a managed float. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi vis-a-vis the U.S. dollar. As of May 31, 1986, the representative rate for the renminbi was Y 3.2111 per U.S. dollar.

VIII. Last Article IV Consultation

The Executive Directors reviewed SM/85/226 on November 8, 1985 and adopted the following decision (excluding the first paragraph):

"China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The Fund welcomes the termination of the bilateral payments arrangement with a Fund member, and notes with satisfaction the intention of the authorities to eliminate the remaining bilateral payments arrangements with Fund members. The Fund also welcomes the elimination of the internal settlement rate for trade transactions. The maintenance by China of an exchange tax on remitted profits of joint ventures, excluding most ventures in designated areas, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The exchange restrictions, multiple currency practice and bilateral payments arrangements that relate to this decision are described in SM/85/266 (9/27/85) and in SM/85/272 (10/24/85)."

IX. Technical Assistance

Since 1980, the IMF Institute has received more than 30 Chinese officials in its courses and seminars. In late 1983, the Institute organized a three-week course in Xian on "Banking and Monetary Policy." The Bureau of Statistics has sent four missions to discuss data presented in IFS, including a mission on balance of payments statistics in November 1985, and has presented seminars in China on balance of payments methodology in 1983 and on government finance statistics (May 1986). A seminar on money and banking statistics is scheduled for late 1986.

Two staff members of the Central Banking Department visited Beijing and Shanghai in May 1985 for discussions and lectures on central banking matters with officials and staff of the People's Bank. A CBD mission visited China in March 1986 for advisory work relating to financial programming methods and monetary policy instruments.

The External Relations Department held a colloquium in China in November 1982. The proceedings of the colloquium were published in 1983 under the title "The Fund and China in the International Monetary System." A second colloquium is scheduled for November 1986 on "Macroeconomic Management, Growth, and the Role of the IMF."

X. Resident Representative/Advisor: None

(CHC) trwbg6ch (6/11/86)

China--Relations with the World Bank Group

Representation: The People's Republic of China assumed China's representation in the World Bank Group on May 15, 1980.

Capital subscription: China holds 25,142 shares or 3.1966 percent of the total authorized capital of the Bank. China voted in favor of the Special Capital Increase under which it would be eligible to subscribe to 1,660 additional shares. No formal action has yet been taken to subscribe for these shares, but the Government is planning to complete subscription before the 1986 Annual Meetings.

Lending activities:

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
	(In millions of U.S. dollars)			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.1	--
1983	150.4	463.1	32.6	0.6
1984	423.5	616.0	100.9	19.6
1985	442.3	661.2	146.2	235.7
Total	1,176.2	1,840.3	279.7	255.9

1986 (Est.; IBRD and IDA): commitments $1,137 million, disbursements $600 million.

Approved projects: FY 1981, University Development; FY 1982, North China Plain Agriculture; FY 1983, Three Ports, Agricultural Education and Research, China Investment Bank I, Petroleum I and II, and State Farms I; FY 1984, Polytechnic/TV University, Technical Cooperation, Rubber Development, Lubuge Hydroelectric, Railway I, Rural Credit I, Rural Health/Medical Education, Petroleum III, China Investment Bank II, and Agricultural Education II; FY 1985, Agricultural Research II, Power II, University Development II, Changcun (Luan) Coal Mining, Seeds, Rural Water Supply, Highway I, Railway II, Fertilizer Rehabilitation and Energy Saving, Forestry Development, PiShi Hang-Chaohu Area Development, and Weiyuan Gas Field Technical Assistance; FY 1986, Rural Credit II, China Investment Bank III, Technical Cooperation II, Provincial University, Railway III, Tianjin Port, and Freshwater Fisheries.

Economic Development Institute:

Since May 1981, the Economic Development Institute has held several courses a year for China, making it EDI's largest country program. Nine courses were given by EDI in FY 1984, ten in FY 1985, and 13 are planned for FY 1986, using UNDP funds. Chinese participants have also been attending EDI regional courses and programs in Washington. In June 1985 a three-week seminar on development policy and management was held in Washington and New York for senior Chinese officials.

Economic missions:

The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, China: Recent Economic Trends and Policy Developments (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984 an economic mission visited China to focus on long-term economic issues and options. A Fund staff member participated in this mission. A report by this mission (No. 5206-CHA) entitled China: Long-Term Issues and Options was discussed with the Chinese authorities in March 1985 and approved by the Bank's Executive Directors in June 1985. In October the report was published in book form by the Johns Hopkins University Press. A Chinese translation was published concurrently in China. In February/March 1986 a mission which included a Fund staff member examined finance and investment issues. The report is expected to be discussed with the authorities in the second half of 1986.

Resident mission:

A resident IBRD office in Beijing was formally opened in October 1985.

BF

Office Memorandum

TO: Mr. Saito

June 10, 1986

FROM: Eduard Brau

SUBJECT: China: Briefing Paper

The brief captures well the many complexities we face in approaching the issue of use of Fund resources by China, and clearly outlines some of the major current weaknesses in policy formation. However, the seeming absence in China of integrated policy control over balance of payments issues does not come through fully.

On the level of diagnosis and analysis, I doubt the attribution (on page 5) of lack of immediate effectiveness of recent stabilization measures "mainly due to time lags." Based on experience in other planned economies and as long as key administrative controls continue in China, I strongly doubt that it is a question mainly of time lags, but rather a question, for some time to come, of chronic excess demand for foreign exchange which, for the time being, will have to be controlled in final effect from the financing side. Thus, the most immediate and important issue for discussion will be how to arrest the fall in reserves and the rise in short-term debt.

My second general point is that the brief does not discuss what the level of a sustainable current account deficit would be in the near future (a probably impossible task at this stage) and, therefore, also does not indicate the possible level of external borrowing limitations to control the size of the current account deficit from the financing side.

It would, of course, be crucial, as noted in the brief, that, with staff assistance, the Chinese authorities only make undertakings vis-à-vis the Fund and the international financial community on which they can deliver. Therefore, a fully functioning borrowing control unit seems to me of the essence (as stated on page 16) and not merely "improvements" (as stated on page 21).

As regards the exchange rate, the brief justifies the 20 percent devaluation on the basis of real effective exchange rate index numbers, etc. Too much emphasis on these indices in China's case appears dangerous because the figures are very soft indeed and subject to challenge. It is, of course, difficult to determine the appropriate level of China's exchange rate, but the key point seems to be to send a clear signal to the Chinese public and to creditors. For this reason, the change should be fairly large and, importantly, should be preserved. I would place particular importance on concrete arrangements (not now identified in the brief) to preserve exchange rate flexibility. In addition, entities engaged in foreign trade should be allowed to set freely the prices that they offer in the domestic market and in the international market, except for few selected products of social and political importance.

The brief is unclear, at present, as to the envisaged program period, and whether the staff would be in a position in mid-1986 to assure the Board of the concrete policies underlying targets for 1987. This issue leads me to the point flagged in the brief that more than one visit may be required to conclude discussions. As you know, I believe that a staged approach is highly desirable and necessary, not only because the brief necessarily has to leave significant issues unanswered at this time, but also because of the possibility of significant potential use of the CFF. I would consider it important that management have an opportunity to make a judgment on use of Fund resources by China in light of all available data, before discussions with the authorities are finalized. Access to CFF resources of up to 50 percent of quota alongside a first credit tranche operation would involve a purchase as large as $1.8 billion. At this stage, one must have doubts whether so much potential financing is desirable, certainly in the absence of a clear debt strategy, and it is for consideration whether potential use of the CFF should be encouraged by the staff.

cc: Ms. Kelly

cc: Mr. Finch
Ms Kelly

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

June 9, 1986

FROM: P.R. Narvekar PRN

SUBJECT: China--Mr. Hino's Back-to-Office Report

In the attached report, Mr. Hino conveys the authorities' request for a paper that identifies issues on which the authorities should focus in establishing a debt management system in China. Given the limited staff time available, we plan to respond to this request by suggesting an alternative, viz. that a CBD debt expert with experience in designing a comprehensive system of external debt management be sent to Beijing in August. We also plan to discuss the matter further with the authorities during the forthcoming consultation/use of Fund resources mission (June 23-July 9, 1986).

Attachment

cc: Mr. Brown
Mr. Brau
Ms. Koenig

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

June 5, 1986

FROM: Hiroyuki Hino HH

SUBJECT: China--Staff Visit to Discuss External Debt Management and Exchange Rate Policy

In response to a request from the Chinese authorities, Mr. Fetherston and I visited Beijing during May 27-30, 1986 to discuss steps to establish a system of external debt management and key indicators of exchange rate policy in China. The discussions were held with officials of the People's Bank of China (PBC) and the concluding meeting was chaired by Mr. Shang Ming, Council Member, PBC. In your meeting with Deputy Governor Liu on April 4, 1986 on China's request for use of Fund resources in the first credit tranche, you suggested that the recommendations of my March visit on debt management be implemented and that the Chinese officials review exchange rate policy with the staff in this visit. The discussions reported below reflect the views only of the PBC as, contrary to expectations, we did not meet other concerned agencies.

External debt management

The Chinese officials informed us that the State Council deliberated last April on the report of the March staff visit and designated the State Administration of Exchange Control (SAEC), which is part of the People's Bank, as the central agency responsible for monitoring external debt. The officials are now more aware of the danger of excessively rapid accumulation of short-term debt, and have adopted a more cautious attitude toward borrowing from commercial banks. Mr. Shang Ming asked us to convey the authorities' appreciation for the contribution that the Fund staff has made in attaining such a quick action by the State Council on this matter.

The SAEC is exercising the newly acquired authority to launch an effort to establish a comprehensive system of debt management. To this end, they plan to send a high-powered delegation in September to study the debt management systems in Sweden and Thailand. To facilitate effective preparations for these visits, the officials requested the Fund staff to prepare a paper that identifies issues on which they should focus in establishing a system for China.

Recognizing that it would take some time to have a comprehensive debt management system operational and noting that the current account deficit continued at the annual rate of about US$12 billion in the first four months of 1986, we stressed that there are three areas where immediate action would be appropriate: (i) to compile provisional data on external debt outstanding as of end-1985 and projections of debt service payments in 1986 and over the medium term; (ii) to improve procedures for approving external borrowing so that all forms of new borrowings could be controlled directly or indirectly so as to limit total borrowing within a targeted amount; and (iii) to set a limit on the net foreign liabilities of the Bank of China, whose foreign borrowing amounted to about US$4 billion in 1985. Mr. Shang Ming said that while progress is hampered by the lack of trained personnel, the compilation of the necessary data is already underway in response to a request from the State Council; however, in view of the complexity of the task, it seems unlikely that improved debt statistics will be available for some months. Also, it appears that concrete steps to improve approval procedures have yet to be formulated. Conspicuous absence of reaction met our suggestions on foreign borrowing of the Bank of China, whose foreign exchange activities have so far been largely unsupervised by the People's Bank of China.

Exchange rate policy

On the basis of papers prepared for the visit, we presented our analysis that the available indicators all point to a substantial deterioration over recent years in China's underlying export competitiveness and in the financial position of export-oriented manufacturing sectors. Price competitiveness in the international markets was apparently maintained until 1984 through financial losses of foreign trading corporations, but this process could not continue after the recent economic reforms. Much of the foreign trade now takes place outside of the corporations, and the corporations themselves are accountable for their own finances in an environment where they have to compete in the domestic markets to acquire goods for exports. Thus, export volume of manufactured products declined considerably, resulting in serious losses in market shares. The exchange rate, therefore, has become an important determinant of export volume.

The PBC officials said that although information is incomplete, the above analysis, in their view, correctly represents the present situation in China. While some in the Government believe that the renminbi has depreciated enough, the People's Bank of China is of the view that the currency is still overvalued. The questions are by how much and when to adjust the exchange rate, and whether to adjust in one step or gradually in several steps. The issue is complex as it involves investment feasibility, taxation, tariffs, pricing policies and reform of the foreign trade system, and the officials stressed the need for further study.

We said that while the need for careful study is appreciated, action is called for to reduce the present large balance of payments deficit. If the exchange rate is to be adjusted, a one-shot adjustment appears, on balance, a more efficient means of bringing about an improvement in the trade position and avoiding uncertainties which might result from a series of gradual adjustments. We emphasized that for an exchange rate change to be effective, it needs to be accompanied by tight fiscal and monetary policies, continuation of the reform of the foreign trade system, and greater flexibility in domestic prices.

We emphasized the importance of establishing a system of monitoring balance of payments developments closely and of formulating exchange rate and macroeconomic policies in the light of balance of payments prospects. At present, overall balance of payments developments and prospects are not assessed by any agency, partly on account of insufficient technical capabilities. We suggested that (1) an appropriate exchange rate level be maintained by pegging to a basket of currencies of competitor countries; (2) a minimum level be established each quarter for the net foreign assets of the banking system, breach of which would trigger a review of policies by the State Council; and (3) a report be made each quarter to the State Council on balance of payments developments and prospects. The officials expressed interest in these suggestions and in particular in continuing discussions on the currency basket and quantitative indicators for the management of exchange rate policy.

cc: Mr. Narvekar
Mr. Brau
Mr. Brown

cc: Mr. Bean
Mr. Hino

Office Memorandum

CONFIDENTIAL

August 14, 1985

TO: The Acting Managing Director

FROM: P.R. Narvekar PRN

SUBJECT: China--1985 Article IV Consultation 1/

RECEIVED AUG 15 1985 EXCHANGE & TRADE RELATIONS

The Chinese economy continues to be marked by rapid growth and change. More than before, however, the authorities are now faced with serious financial imbalances. Since mid-1984, economic growth has accelerated further, but strong excess demand pressures have contributed to faster inflation and a sharp weakening of the external payments position. This year's discussions focused on present financial policies, possible additional measures, and on the authorities' plans for further economic reforms.

A number of senior personnel changes are taking place in the People's Bank. The new governor, Mme Chen Muhua, who took office in April, is a State Councillor with a strong political base; she received the mission toward the end of our stay and indicated her firm determination to restrain credit expansion. Mr. Shang Ming, Advisor to the People's Bank, who has headed the Chinese delegation for each consultation to date, is to retire shortly as Advisor but reportedly will continue as member of the Council of the People's Bank and as Chairman of the Insurance Board.

The evidence of economic change over a relatively short period is impressive, even to the visitor's superficial eye. Beijing is the scene of increased commercial activity and now boasts almost ten thousand taxis, up several fold from just a year ago. Dozens of high rise apartment buildings are transforming the city skyline. The emphasis on responsibility systems under the reforms has led to a more customer-oriented approach in shops, hotels, and restaurants. Moreover, the accumulation of wealth through individual initiative is possible to a much greater extent than before. Overall, the economy has been enjoying a remarkable boom, with industrial production growing at a rate of more than 20 percent per annum since mid-1984. On the supply side, this performance is attributable to the increased autonomy granted to enterprises under the urban economic reforms announced last year, together with a sharp increase in imports of raw materials to alleviate domestic shortages. Agricultural output was also buoyant, as the impact of the reforms of the last several years continued to be felt.

1/ In Beijing, July 19-August 2. Staff team: Messrs. Narvekar, Saito, Hino, Goldsbrough, Fetherston, Sassanpour, and Ms. Rosario. Mr. Zhang was present.

The growth of output was also a response to rapid expansion in demand, facilitated by easy availability of credit. Credit conditions reflected both an accommodative attitude towards loan requests, which increased sharply as enterprises sought to take advantage of their increased autonomy, and also technical difficulties with the implementation of credit control under the more decentralized banking framework established in 1984. Although budgetary policies remained cautious, credit expansion accelerated to over 40 percent by the first quarter of 1985, and wages, consumption, and investment all surged ahead. At the same time, price increases reached 7 percent in the first half of 1985, partly on account of price adjustments under reforms. Shortages and bottlenecks became more acute, especially in energy and transportation. The external payments position deteriorated sharply, largely on account of rapid growth of imports of raw materials, capital equipment, and consumer goods, and a substantial weakening of exports. Reserves declined from US$18.1 billion at end-July 1984 to US$12.7 billion at end-April 1985, although about half of this decline appears to be attributable to purchases of longer-term foreign securities.

The authorities' policy response has involved a mix of administrative measures and macroeconomic instruments; they remain firmly committed to increased use of the latter as an essential part of the process of economic reform. So far, they have tightened up the enforcements of specialized banks' credit ceilings; strengthened controls on extrabudgetary investment spending; and successively raised interest rates by a total of about four percentage points. On the external side, the more liberal approach to import licensing and exchange control which had been in effect since early 1984 was put into reverse in March 1985; more recently, import duties were raised on luxury items.

We found it difficult to form a precise judgment on the likely impact of these measures, in part because of the uncharted nature of the present path of the economy. In our remarks we urged sharp restraint of credit expansion and close monitoring to determine the need for additional measures. Our suggestions in this area included: reductions in PBC lending to the specialized banks; continued flexible use of interest rate policy; improvements in financial programming; and making use of the buoyant revenue performance to achieve a budget surplus. The authorities fully acknowledged the need for a more stable financial environment, especially in support of price and wage reforms, which are getting underway in earnest this year.

The need for quick acting restrictive measures to strengthen the balance of payments is understandable; although as noted above it is difficult to judge their precise impact, we tentatively projected that the measures taken would serve to halt the recent decline in reserves during the rest of 1985. We stressed, however, that the balance of payments would be more efficiently managed by flexible exchange rate policies coupled with closer links between domestic and international prices. In this connection, the authorities themselves expressed concern at the recent weakness of exports, partly due to the lack of competitiveness of Chinese products. I discussed exchange rate policy privately with Mr. Shang Ming, pointing to the benefits of early and substantive action to improve trade performance; he indicated that the role of exchange rate policy under the reforms is currently under close study. The early stages of the process of opening the economy, which had previously been effectively closed, have witnessed--not surprisingly--a substantial volume of irregular transactions in foreign exchange and imported goods. These are likely to be effectively reduced only as the economy is opened substantially further and the price system reformed.

Our discussion of medium-term balance of payments prospects and external debt was cursory, reflecting the authorities' inexperience in analyzing these issues and in assembling suitable information. China has recently tapped various sources of foreign borrowing; the authorities stated that their active but prudent approach in this area is unchanged. The People's Bank has just been made responsible for both approval and monitoring of external borrowing; at this stage, they are still finding their feet, and told us that Fund technical assistance with external debt management would be helpful. According to official data, medium-and long-term external debt was $7.2 billion at end-1984, although we are not yet certain that the information provided to us is complete. The authorities agreed that assistance in the area of medium-term balance of payments analysis would also be useful.

For the first time, we were able to meet with senior officials of the State Commission for Restructuring of the Economic System. They emphasized the authorities' intention to maintain the pace of economic reform through further measures to decentralize decision making, strengthen incentives, and rely on indirect means of economic regulation. It seems likely that further significant progress in China's economic reforms will be made during the coming years. While the basic objectives remain unchanged, the uncertain impact of reform measures may continue to necessitate short term policy adjustments.

What will happen in the coming years will be fashioned ultimately not just by the impact of the reforms in economic terms but by political changes; what these will be is beyond our competence to forecast. It is clear, however, that the likely turn of events after Deng has been a matter of concern and speculation throughout Asia.

Despite the apparent success of his reforms it is not universally accepted among observers that after him, power would stay with his chosen men and not go to some of the elderly who are not so favorably inclined to the reforms. Whether such a return to the Old Guard would be enduring or be only an interregnum as in the case of Russia's Chernenko remains to be seen.

cc: The Managing Director (o/r)
AFR
CBD
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WHD
Mr. Collins

Office Memorandum

cc: Mr. Guitian
R. Maciejewski

CONFIDENTIAL

RECEIVED
AUG 13 1984
EXCHANGE AND TRADE RELATIONS

TO: The Acting Managing Director August 10, 1984

FROM: P.R. Narvekar PRN

SUBJECT: China--1984 Article IV Consultation 1/

There is continuing evidence that the economy is undergoing systemic change. Decision-making is being decentralized, incentives provided for better performance at both the individual and enterprise levels, and the scope for private enterprise slowly enlarged. The authorities are shedding some of their direct operational responsibilities and concentrating more on policy formulation: the reorganization of the People's Bank into a central bank without commercial banking functions is the best example. The scope of mandatory planning is being reduced, while that of indicative planning and free market forces is being enlarged. Public bidding is being introduced in construction contracts.

The scope of all this must not be misunderstood--China is still a centrally planned economy, a professed adherent to the basic tenets of socialism, including especially ownership of the means of production by the State or by collectives. But change there has been and is continuing to be. There is plenty of evidence of change and liberalization: hawkers on the street, private restaurants, color in the dress of people and in flower pots. Elements of the responsibility system in agriculture involves some compromising, even of the principle of public ownership.

In our remarks we supported and encouraged the broad thrust of these changes: their full ramifications and implications are too complex to give an outsider enough confidence for detailed comments. One cannot also help but think how delicate the entire liberalization process is; one false step and a brutal reversal by those against liberalization is clearly possible. It behooves outsiders, then, not to be too aggressive in pushing the pace of reform and leave the determination of proper speed to those insiders who are committed to change.

That the reforms in the agricultural sector have been successful is generally well known, but the extent of the transformation brought about by the responsibility system may not be fully appreciated. The system now covers virtually the entire rural sector and the large increases in agricultural, especially foodgrain and cotton, production that have recently taken place have been attributed to it. These increases in agricultural production have had pervasive implications ranging to storage needs, income levels, housing construction,

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1/ In Beijing, July 23-August 4. The staff team: Narvekar, Saito, De Wulf, Goldsbrough, Maciejewski, Fetherston, and Francis.

demand for currency and bank deposits, import needs and the foreign trade position, and shifts in the pattern of employment.

What with the agricultural growth and an impressive industrial output growth partly attributable to it, national income increased by 9 percent in 1983, after having increased by 7 percent in 1982, and may well increase by another 8 percent this year.

You will recall that extrabudgetary investment was a serious problem a year ago--in that it led to excess demand pressures and also, by forcing the Government to cut back its own investment in the priority sectors of energy, transportation, etc., distorted the pattern of investment. The authorities have had a degree of success in dealing with this problem; equally important, they have dealt with it by developing financial policy instruments. Increased investment in the priority sectors--simultaneously with relatively small budget deficits--have become possible.

It is not easy to form a judgment on the state of the macroeconomic balance, i.e., the strength of excess demand pressures, if any. Shortages are endemic in a poor country like China, of course, and, in addition, relative price distortions result in some shortages along with other excess supplies. Besides, the country is large and the market fragmented so that there are always shortages in some areas. In any event, systematic information on shortages and the like is difficult to come by. Occasional reports and anecdotal evidence suggested no worsening of the situation over the past year. This, together with the large institutional changes resulting from the agricultural transformation, made it difficult for us to judge to what extent the rather high rates of liquidity expansion now occurring should be a cause of concern. Nonetheless, we advised the authorities to err on the side of caution and assess carefully whether some restrictive measures would not be necessary. We suggested some possible ways of restraining monetary expansion.

The external payments position continues to be strong. Total international reserves, increased from $11.8 billion at the end of 1982 to $17.3 billion at the end of May 1984. The current account showed a surplus of $4.5 billion in 1983, smaller than the one of $5.7 billion in 1982, and equivalent to 1.6 percent of GDP. Export volume has been growing strongly in 1983 and 1984. The remarkable change was in imports, which, after having stagnated for the last two years, increased by 29 percent in volume in 1983 and a further 11 percent in the first half of 1984. A significant change occurred in the composition: imports of foodgrain, cotton, edible oils declined while those of manufactures increased, both markedly.

To some extent these import figures took the wind out of our sails in urging the authorities to import more. They stressed again that they were carrying out careful feasibility studies of a number of projects which, once initiated, would require large amounts of foreign exchange. While not disagreeing, we suggested that the large reserves could be partially used in the meanwhile for modernizing plant and equipment--for which, it is generally agreed, the need is urgent--and for alleviating shortages. A vigorous export promotion policy and a somewhat more active but still prudent external borrowing policy would help finance the major investment projects. The authorities are also trying to increase the inflow of foreign direct investment. As you know, external debt is small, representing less than 3 percent of GDP, and the debt service ratio is also small (less than 4 percent). Our projections show that these figures are unlikely to rise much in the coming years.

The authorities again emphasized that they had only one exchange rate--the internal settlement price was not a rate. We spoke in terms of the need for an appropriate exchange system in the context of a price reform. The study of this subject, which the authorities had said last year they had started, is not yet finished. In the meanwhile, the official exchange rate, which is linked to a basket, has depreciated from Y 2.00 per U.S. dollar a year ago, to Y 2.33 per U.S. dollar; the internal settlement rate remains at Y 2.80. We alerted the authorities to the likelihood that by June 1984 the yuan had depreciated in real effective exchange rate terms by more than 10 percent since the last consultation so that a paper would have to be presented to the Board in August.

It seems to us that the newly established central bank has not quite found its feet yet. Also, in the process of its reform, the tax system has become complicated. We, therefore, indicated, in very general terms, the availability of technical assistance from the Fund in the banking and fiscal fields. The response was quite positive--the first positive expression of interest by the Chinese. The authorities said they will get in touch with us in due course.

In the last few years, China has come a long way in publishing economic statistics. We have benefited from this, of course. In addition, the coverage and quality of information specifically supplied to us has improved remarkably, even over the position just a year ago. Progress is also being made in the coverage of IFS data: series on employment, earnings and foreign trade prices are to be added soon.

Also, quarterly price statistics are going to be supplied to the staff for internal use.

cc: The Managing Director (o/r)
CBD
ETR
EXR
FAD
RES
SEC
BUR
TRE
Mr. Collins (o/r)

Mr. Guitian

→ BJF
cc. Mr. Maciejewski

Office Memorandum

TO:	The Managing Director The Deputy Managing Director	DATE:	July 2, 1984
FROM:	P.R. Narvekar and Manuel Guitián		
SUBJECT:	People's Republic of China--Briefing Paper: Article IV Consultation		

Attached for your approval is the briefing paper for the forthcoming Article IV consultation discussion with China. It has benefited from comments by Ms. Bierman (FAD), Ms. Lachman (LEG), Mr. Chandavarkar (TRE), Mr. Hood (RES), Mr. Brimble (STAT), Mr. Sundararajan (CBD), and Mr. Teyssier (INST).

Attachment

cc: Mr. Collins

INTERNATIONAL MONETARY FUND

China

Briefing Paper--1984 Article IV Consultation

Prepared by the Asian and
Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Research,
Legal, and Treasurer's Departments)

PRN   MG
Approved by P.R.Narvekar and Manuel Guitián

July 2, 1984

The 1984 Article IV consultation discussions will be held in Beijing from July 23 to August 4, 1984. The staff team will consist of Messrs. Narvekar (head), Saito, De Wulf (all ASD), Goldsbrough (RES), Maciejewski (ETR), Fetherston (FAD), and Mrs. Francis (ASD).

I. Economic Background

1. China's principal economic policy objective since the late 1970s has been to improve the standard of living of its people through sustained productivity and output growth and a reorientation of resources toward consumption. The target is to quadruple output between 1980 and 2000 (implying an average annual growth of 7.2 percent), with investment being kept below 30 percent of national income.

2. An important element of the economic policies adopted to achieve these objectives is the continuation of economic reforms. In rural areas, the production responsibility system has been introduced in place of the traditional commune and brigade arrangements, and price and distribution arrangements have been liberalized for selected products.

These changes have strengthened the link between individual productivity and remuneration and contributed to a sharp rise in rural output. Reforms are also being implemented in urban areas, with a view to stimulating output by providing greater autonomy and incentives to public enterprises and individuals. However, these have proved to be more difficult to implement and progress has been slow.

3. Another important policy element has been the cautious budgetary management followed beginning with the successful implementation of a stabilization program in 1981 (which was supported by a one-year stand-by arrangement in the first credit tranche). The budgetary deficit has since been contained at 1-2 percent of GDP, with domestic bank borrowing limited to modest amounts (Table 1). During 1981 and 1982, this was achieved by a retrenchment of budget-financed investment in energy, transportation, and other key sectors--subsidy and other current expenditures continued to rise, while revenues stagnated following a decentralization of public finances that allowed public enterprises to retain a greater share of profits. In 1983, public finances were partially recentralized 1/, enabling the Government to increase its investment considerably, while containing the overall deficit and domestic bank borrowing at low levels.

Partly reflecting the Government's limited borrowing, the growth of domestic credit and total liquidity slowed beginning from 1981.

1/ During 1983, a 10-15 percent tax was introduced on extrabudgetary funds of enterprises and local governments and another 10 percent tax, on extrabudgetary investment. In addition, as the first phase in a comprehensive tax reform, an income tax scheme was introduced for public enterprises to replace the system of profit remittances (and subsidies to enterprises operating at a loss).

Nevertheless, over the period 1981-83, credit growth averaged 13 percent per annum and with large balance of payments surpluses, currency in circulation rose at an average annual rate of 15 percent and total liquidity at 18 percent. Although this expansion was accompanied by a rapid rural monetization arising from the reforms, it probably contributed to an increase in excess demand pressures.

4. Overall economic developments during 1981-83 were favorable (Tables 1 and 2). Over this three-year period, real GDP rose at an average annual rate of 7 percent, substantially exceeding the plan target of 4-5 percent, while recorded inflation remained at 2-3 percent per annum. The balance of payments yielded large surpluses, with imports declining during 1981 and 1982 but recovering considerably in 1983 (imports are closely linked to budget-financed key investments, which have a high import content). International reserves rose fivefold to US$15 billion (equivalent to 9 months' imports) at end-1983, while outstanding external debt remained low (about US$6 billion or 2 percent of GDP at end-1983), as did the debt service ratio (about 5 percent in 1983).

5. Despite these generally favorable overall economic developments, sectoral weaknesses and imbalances remained: (i) While agricultural productivity rose considerably, productivity improved little in the industrial and commercial sectors in urban areas where progress in implementing economic reforms was slow. (ii) The growth of energy, transportation, and a few other key sectors lagged behind the rapid overall economic expansion, mainly because of stagnant investment in these sectors. (iii) Nevertheless, total public investment was

strong, as extrabudgetary investment by public enterprises and local governments rose sharply during 1981-82 and continued to grow despite the recentralization measures in 1983. (iv) Household investment (mostly residential construction) and consumption (especially for high-quality goods) also rose in response to a sharp rise in household incomes. These developments, accompanied by the rapid credit and monetary expansion, resulted in increasingly severe shortages of energy, transportation services, construction materials, and high quality consumer goods. Although the shortages have not so far been reflected in increases in the overall price indices, they have caused delays in implementation of investment projects and associated cost increases.

6. Economic developments in the early months of 1984 suggest that overall economic trends remain favorable, while sectoral weaknesses and imbalances persist.

II. Issues for Discussion

1. The authorities' current policy priority is to complete their economic reforms by focusing on areas where progress has been slow. Having successfully implemented rural reforms, 1/ they have recently announced that the next stage will focus on urban areas and a further opening up of the economy to the outside world. The renewed emphasis on urban reforms would further extend the autonomy recently granted to public enterprises and encourage individuals to engage directly in production and distribution activity. The reforms would help increase

1/ Almost all households in rural areas now work under the production responsibility system, compared with 10 percent in January 1980 and 67 percent in March 1982.

output and, more important, efficiency in the industrial and commercial sectors. The resulting improvement in the financial position of these sectors, combined with an appropriate tax system, would help strengthen government revenue and thus help meet more of the pressing expenditure needs. The further opening up of the economy is expected to enhance urban economic reforms by facilitating greater imports of capital goods and technology, with increased recourse to foreign borrowing and direct investment.

2. In proceeding with urban reforms, the authorities are faced with the immediate task of eliminating sectoral bottlenecks and shortages, and with the related issue of controlling more effectively the level and composition of demand. In particular, it is necessary to restrain extrabudgetary investment in order to alleviate demand pressures in the short run and to provide room for more investment in energy, transportation, and other key sectors to enable them to expand their output in the longer run. Successful accomplishment of this task is essential to sustain the growth momentum emanating from the reforms.

3. The traditional means of addressing this task and, more generally, overall economic management, has been through the planning and controlling mechanism, i.e., allocating greater resources for the production and investment activity of priority sectors, while restraining the activity of nonpriority sectors through administrative directives. However, this mechanism has become less effective as decision-making has become decentralized under the reforms and as the economy has become more complex. The scope of centralized planning is gradually being reduced, and market forces are being allowed to play a

greater role. In light of these developments, during the last consultation, the authorities shared the staff's view that the planning mechanism should be supplemented by macroeconomic policy instruments. In particular, the staff suggested more flexible financial and price policies and use of increased imports. This year's discussion will again focus on these policies; the mission will review the progress that has been made so far and will assess the extent to which further progress is needed.

4. Since the last consultation, the authorities have taken two important steps to strengthen the role of financial policies in dealing with economic problems. First, they have decided to proceed with the second stage of the tax reform, by completing the replacement of the system of profit remittances by enterprises (and subsidies to enterprises making a loss) with income taxation accompanied by a number of other tax adjustments. 1/ The authorities expect that these tax changes will help make enterprises more responsible for their operations, absorb their surplus funds (and thus restrain extrabudgetary investment), and ensure adequate revenues for the Government. Second, the opening of the central bank from the beginning of this year is expected to provide additional power to the central authorities to regulate investment and production through credit control. The central bank is empowered to control credit through its loans to other specialized banks and through

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1/ The product tax for some highly profitable commodities will be raised while that for low profit commodities will be reduced; a resource tax will be levied on enterprises benefiting from favorable natural resources; the scope of the value added tax will be expanded; several local taxes will be introduced or adjusted.

the imposition of redeposit requirements. The mission will review with the authorities these new tax and monetary arrangements and financial policies in general, stressing the importance of continued budgetary restraint and a slowdown in the growth of domestic credit and liquidity in the immediate future.

5. A price reform remains a prerequisite to the resolution of many current economic problems, including sectoral imbalances and large budgetary subsidies, and to the successful implementation of the economic and financial reforms. Nevertheless, the authorities remain reluctant to expose the public simultaneously to the twin shocks of reforms and higher prices, and have made only a few price adjustments during the past year. However, perhaps in preparation for eventual adjustments, they have begun to refer publicly to the irrationality of the present price structure and to the associated problems of budgetary subsidies and inefficient resource allocation. The authorities have also intensified their review of required adjustments (including the merits and demerits of an overall reform versus piecemeal adjustments) under the supervision of the newly established Commission for Economic Reforms. The mission will review the alternatives being considered, emphasizing the importance of early action.

6. Imports of capital goods play a crucial role in China's modernization efforts. After two years of stagnation, imports rose substantially in 1983 and would continue to rise rapidly, according to the authorities' reform strategy. To finance increased imports, the authorities plan to raise large foreign loans (reportedly US$50 billion over the next ten years), encourage direct investment from abroad, and

use part of their large reserves. The staff's tentative projections indicate that such a strategy could be sustained over the medium term, provided that exports rise at least as fast as required to maintain China's present share in world markets, and direct investment from abroad increases substantially from its present low level (Table 2). The staff team will review with the authorities this and other medium-term balance of payments scenarios, including the likely impact of alternative scenarios on other countries. The review will also cover the incentives for exports and direct investment that are required to maintain a viable external position.

In this context, the staff team will review the authorities' exchange rate policy, including the present exchange rate arrangement consisting of an official rate and an internal settlement rate. The authorities consider this arrangement experimental and are undertaking a study with a view to introducing an arrangement that corresponds to China's evolving needs. The staff team will review the progress made in this study and stress that an early unification of the rates is essential for efficient resource allocation and orderly economic management.

7. The amount of <u>statistical information</u> published by the Chinese authorities has expanded substantially in recent years, but lacunae remain. The mission will follow up the recommendations made by a recent mission from the Bureau of Statistics, and will try to obtain more information, especially in respect of statistics on prices, budget, and balance of payments. The mission will also stress the importance of improving external debt monitoring arrangements and statistics.

8. In the light of the prospective payments position over the next several years, it seems unlikely that China will need the use of the Fund's resources over this period. Under the circumstances, the Fund can develop a constructive role in China mainly by encouraging the current movement in the direction of reforms aimed at improved economic efficiency and allocation of resources. This can be done in a general way during the consultation discussions. If requested, support can also be provided through technical assistance, especially in the fiscal and monetary policy areas.

9. The World Bank's loan commitments have increased substantially in the last few years, and the Bank staff projects this trend to continue over the medium term, on the basis of the findings of a recent economic mission (in which a Fund staff member participated). The two staffs cooperate closely and have no disagreement on major policy issues (Annexes I and II).

10. The mission will propose that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. China: Macroeconomic Indicators, 1980-84

	1980	1981	1982	1983		1984	
				Plan	Outcome	Plan	First Quarter 1/
				(Annual percent changes)			
Real GDP	6.1	4.8	7.4	4-5	9.0	4.6	...
Gross industrial production	8.8	4.1	7.7	4-5	10.5	5.0	12.0
Heavy industry	1.4	-4.7	9.9	3.9	12.4		12.0
Light industry	18.4	14.1	5.7	4.1	8.7		11.9
Gross agricultural production	3.9	6.6	11.0	4.0	9.5	4.0	...
Urban cost of living index	6.0	2.5	2.0	2.0-3.0	2.0	...	...
Total fixed investment 2/	7.1	-9.2	18.7	...	14.1	...	...
Budget-financed capital construction	-16.7	-28.0	9.9	17.1	24.9	...	...
Other	23.2	-0.1	21.6	...	10.8	...	...
Government revenue	4.2	-5.6	2.9	6.6	8.3	6.2	20.8
Expenditure	--	-1.2	3.7	6.9	9.4	5.2	...
Deficit (in percent of GDP)	3.5	1.3	1.4	1.5	1.7	1.7	...
Domestic credit	27.3	13.5	11.9	10.8 3/	14.5 4/	...	...
Total liquidity	32.9	19.7	14.9	16.5 3/	19.0 4/	...	...
Currency in circulation	29.6	14.5	10.8	15-20 3/	20.7	...	...
Individual savings deposits	43.3	28.3	28.1	25.0 3/	32.1 4/	...	31.6 4/
Exports, 5/	35.4	19.1	2.0	1.8	-2.1	...	13.1 6/
Imports, 5/	36.0	-4.5	-15.0	40.6	10.5	...	19.7 6/
				(In billions of U.S. dollars)			
External current surplus	-3.2	1.4	5.7	6.4 3/	3.6	...	...
(In percent of GDP)	(-1.1)	(0.5)	(2.1)	(...)	(...)	(...)	(...)
External overall surplus	0.4	1.9	6.3	7.7 3/	3.8	...	...
Total reserves	3.1	5.6	11.8	19.0 3/	15.3	...	16.4 6/
(In months of imports)	(1.7)	(3.2)	(8.0)	(12.4) 3/	(9.3)	...	(13.2) 6/

Sources: Data provided by the Chinese authorities; and staff estimates.

1/ First quarter 1984 over first quarter 1983.
2/ Fixed investment by public enterprises, central, provincial and local governments, collective enterprises, and individuals.
3/ Staff estimates.
4/ Coverage differs slightly from earlier years, because based only on the balance sheets of the People's Bank of China and Rural Credit Cooperatives, while data for previous years are based on the full Monetary Survey.
5/ In terms of U.S. dollars and f.o.b. basis.
6/ January and April 1984 over same period in 1983.

Table 2. China: Medium-Term Balance of Payments Projections, 1982-88

(In billions of U.S. dollars)

	Assumed Change Percent	1982 Actual	1983 Prel.	1984 Est.	1985 Proj.	1986 Proj.	1987 Proj.	1988 Proj.
Balance of payments								
Exports	7 1/	22.48	22.00	23.00	24.38	26.09	27.91	29.87
Imports	15	17.83	-19.70	-23.00	-26.45	-30.42	-34.98	-40.23
Invisibles (net)	10	1.08	1.25	1.36	1.50	1.65	1.81	1.99
Of which: service credit	(10)	(3.51)	(3.80)	(4.15)	(4.57)	(5.02)	(5.52)	(6.08)
Current account		5.73	3.55	1.36	-0.57	-2.69	-5.26	-8.37
Gross borrowing	15 2/	2.10	1.70	1.96	2.25	2.59	2.97	3.42
Amortization		-1.80 3/	-0.80	-0.68	-0.82	-0.98	-1.16	-1.36
Direct investment	20	0.41	0.50	0.60	0.72	0.86	1.04	1.24
Other capital (net)		0.93	-1.16	-0.50	-0.50	-0.50	-0.50	-0.50
Capital account		1.64	0.24	1.38	1.65	1.97	2.35	2.80
Overall account		7.37	3.79	2.74	1.07	-0.71	-2.90	-5.56
Total reserves (end of year)		11.80	15.30	18.04	19.11	18.40	15.49	9.93
In months of imports		7.94	9.32	9.41	8.67	7.26	5.32	2.96
External debt								
End-year stock		6.00	6.10	7.38	8.81	10.41	12.23	14.29
Debt service		2.80	1.40	1.35	1.63	1.94	2.29	2.68
Principal		2.20 3/	0.80	0.68	0.82	0.98	1.16	1.36
Interest		0.60	0.60	0.67	0.81	0.96	1.13	1.33
Debt as percent of GDP		2.30	2.14	2.38	2.61	2.83	3.05	3.26
Debt service ratio		10.77 4/	5.43	4.98	5.63	6.23	6.85	7.47

Source: Data provided by the Chinese authorities; and staff estimates and projections.

1/ Assumes that non-oil exports (about 80 percent of the total) will rise by 8 percent per annum (or no change in China's market share) during 1985-88; oil exports are assumed to rise by 4 percent per annum during the same period, exclusively on account of price increases.
2/ This rate of increase implies a total borrowing of US$45 billion in the 10-year period beginning 1985.
3/ The balance of payments and external debt data on amortization are not fully reconcilable for 1982.
4/ The debt service ratio was unusually high in 1982 because of advanced repayments of commercial debts.

China--Fund Relations
As of May 31, 1984

I. Membership status

a. Date of membership: Original member (the People's Republic of China assumed representation on April 17, 1980)
b. Status: Article XIV

A. Financial Relations

II. General Department

a. Quota: SDR 2,390.90 million
b. Total Fund holdings of currency: SDR 2.2 billion or 92.39 percent of quota
c. Reserve tranche: SDR 181.7 million
d. Current operational budget (June-August 1984): Maximum use of SDR 76.9 million
e. Lending to the Fund: None

III. Stand-by or Extended Arrangement and Special Facilities

a. Current stand-by: none
b. Stand-by and extended arrangements in last 10 years: Stand-by (first tranche), March 1981; SDR 450 million (25 percent of quota); China repurchased the full amount by end-August 1983
c. Special facilities in last 2 years: none

IV. SDR Department

a. Net cumulative allocation: SDR 236.8 million
b. Holdings: SDR 382.98 million (161.73 percent of cumulative allocation)
c. Current designation plan (June-August 1984): SDR 30.8 million

V. Administered Accounts

a. Trust Fund
 (i) Disbursed: SDR 309.5 million
 (ii) Outstanding: SDR 309.5 million
b. SFF Subsidy Account: None

VI. Overdue obligations to the Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

China's currency, the renminbi, is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi to the U.S. dollar. As of May 30, 1984, the representative rate for the renminbi was Y 2.2118 per U.S. dollar. China maintains an internal settlement rate of Y 2.8 per U.S. dollar for all trade and trade-related transactions. This constitutes an unapproved multiple exchange practice.

VIII. Last Article IV Consultation

The Executive Directors reviewed SM/83/213 on November 21, 1983 and adopted the following decision (excluding the first paragraph):

China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The Fund notes with satisfaction the termination by China of two bilateral payments arrangement with members of the Fund and the intention of the authorities to eliminate the remaining arrangements with Fund members. The maintenance by China, in addition to the official rate, of an internal settlement rate for trade transactions and an exchange tax on remitted profits of joint ventures, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The exchange restrictions, multiple currency practices and bilateral payments arrangements that relate to this decision are described in SM/83/213 (10/25/83) and in SM/83/221 (11/3/83).

IX. Technical Assistance

Since 1980, the IMF Institute has received 28 Chinese officials in its courses and seminars. Also, in late 1983, the Institute organized a three-week course in China (Xian) on "Banking and Monetary Policy".

The Bureau of Statistics has sent two missions in the last three years to discuss data presented in the IFS. In addition, in 1982 a staff member from the Bureau visited China to familiarize the officials with the various computer tapes issued by the Bureau. In 1983 the Bureau held a seminar in Beijing on balance of payments methodology.

X. Resident Representative/Advisor: None

Relations of China with the IBRD

Representation: The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.

Capital subscription: China's authorized capital is 23,482 shares or 3.28 percent of the total authorized capital of the Bank (25,142 shares and 3.20 percent after the proposed increase).

Lending activities:

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
	(In millions of U.S. dollars)			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.6	--
1983	150.4	463.1	24.6	0.6
1984	423.5	616.0	97.8 1/	9.7 1/

Approved projects: FY 1981, university development project; FY 1982, North China Plain agricultural project; FY 1983, port facilities, agricultural education and research, China Investment Bank, two oilfields, and a land reclamation project; FY 1984, rural credit, rubber development, polytechnic/TV university, agriculture education, rural health and medical education, railways, hydropower, oilfield development, second credit for China Investment Bank and a technical cooperation credit.

Economic Development Institute: Beginning in May 1981, the Economic Development Institute has held five courses a year for China, making it EDI's largest country program. Five additional courses were given by EDI in FY 1984 and are planned for each year in FY 1985 and FY 1986, using UNDP funds. Chinese participants have also been attending EDI regional courses and courses in Washington.

1/ As of May 11, 1984.

Economic missions:

The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, "China: Recent Economic Trends and Policy Developments" (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984 an economic mission visited China focusing on long-run economic issues and options. A Fund staff member participated in this mission. It is presently planned to send a draft report to the Chinese authorities by September 1984, in time to permit them to consider the major conclusions when preparing the Seventh Five-Year Plan (1986-1991).

BF/ETR file MG
cc: Mr Allen

Office Memorandum

TO : The Acting Managing Director

DATE: August 12, 1983

FROM : Hubert Neiss HN

SUBJECT : China - 1983 Article IV Consultation

The 1983 Article IV consultation discussions were held in Beijing from July 20-30, 1983. The staff team included Messrs. Saito, De Wulf (both ASD), Allen (ETR), Feltenstein (FAD), Goldsbrough (RES), and Miss Murell (secretary, ASD). Mr. Zhang attended the discussions as an observer.

China's economic performance during the past two years was impressive in many respects: a high rate of growth was achieved, particularly in agriculture; price stability was maintained; and the balance of payments was strengthened substantially. In the mission's assessment, these trends are continuing in 1983 (our forecasts for important variables are contained in the attached Table).

Despite these achievements and the progress made in economic stabilization since 1980, severe imbalances between supply and demand persist as competing claims of consumption and investment outstrip available resources. These imbalances are not primarily reflected in rising prices or import growth, since prices of all key commodities are controlled and all imports need licences, which have been issued restrictively. Rather, pressure on resources is felt in shortages of consumer goods as well as industrial inputs and construction materials and wasteful delays in completing investment projects. The authorities expressed considerable concern about these developments during the discussions.

The economic system, which since the late 1970s places considerable emphasis on consumption, does not provide an effective means of controlling the overall level and direction of investment. On the one hand, that part of economic activity subject to direct detailed control by the central authorities has declined considerably (e.g., to about 40 percent of fixed investment). On the other hand, provincial and local governments, as well as individual enterprises, energetically use the increased decision-making authority and financial resources granted by the economic reforms. The steady stream of regulations issued by the central authorities to influence decisions of lower level authorities are frequently ignored. As a result, the actual outcome for major economic variables tends to differ substantially from the overall plan targets set down by the central authorities.1/ In

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1/ E.g., investment in plant and housing construction in 1982 was planned to decrease by 14 percent against an actual increase of 25 per cent, and industrial production rose almost twice as fast as planned. We forecast similar discrepancies in 1983.

general, the pace of economic activity in 1982 and 1983 is considerably faster than implied in the overall plan targets. In analyzing developments, we have found the standard model of a centrally planned economy less and less useful as a point of reference; moreover, in de-emphasizing the plan, we have experienced no communication difficulties with the authorities.

Developments in the first half of 1983 illustrate the situation described above. Provinces, local governments, and enterprises spent substantially more than expected out of their "own" funds (i.e., retained tax revenue and profits) for investment and wage bonuses. As a result, currency in circulation rose almost twice as fast (by 20 percent) as planned, and substantially faster than the supply of consumer goods. The People's Bank of China is coping with the problem of excess purchasing power by making intensified efforts to stimulate savings1/ and by sending circulars to its branch offices (which perform the commercial banking functions) requesting stricter scrutiny of credit demands by enterprises. The use of fiscal policy to dampen aggregate demand is also quite limited. The present leadership is committed to an increase in living standards through higher consumption and increased supply of housing--areas which had been badly neglected in the past. This makes limiting budgetary outlays for wages, consumer subsidies (amounting to over a quarter of total revenue), and residential construction politically difficult. There is also little room for reducing expenditures for large infrastructure projects (mostly in transportation and energy), as these expenditures are vital for economic development and had already been severely cut during the 1980-81 stabilization effort.

The authorities stressed that the solution to these problems would not be sought through a return to comprehensive directive planning by the center. We pointed to the need to develop more effective instruments of general monetary and fiscal control as a counterpart to the increased importance of decentralized decision-making. We discussed various possibilities that could be considered in the Chinese context. The authorities informed us of various changes in taxation which are under consideration, and told us, on a strictly confidential basis, that major changes in the financial system will be implemented, aimed at increasing the central banking powers of the People's Bank of China. It is our impression, however, that in the short run, they will endeavor to achieve macroeconomic balance through continued use of administrative directives and "moral suasion".

Administrative directives will also be mainly relied upon to correct the allocative deficiencies of the existing price system. We were told of

1/ This worked well in the past three years when savings quadrupled; however, it may be difficult to sustain such a rapid growth in savings.

studies being carried out for a comprehensive price reform. The principles that have evolved to guide such a reform represent a useful beginning, although they seem to pay insufficient attention to international prices. However, achieving a political consensus in this area would seem to be a lengthy process, and in the short run we may only see isolated and relatively minor price adjustments.

We had lengthy discussions on import policy, which in our view should be used to relieve domestic pressure on resources as well as to slow down a further accumulation of reserves which are already more than adequate ($13 billion, equivalent to nine months of imports as of end-May). The authorities indicated that the recent reserve accumulation was unintended and temporary. There are large import requirements for replacement of industrial equipment which is largely obsolete and for major infrastructure projects. Despite the Government's frequently proclaimed intention to meet these requirements, we believe that present policies are not sufficiently geared to facilitate a sustained import expansion. Combined with the expected continuation of relatively rapid export growth, we would, therefore, expect continued balance of payments surpluses over the next few years.

The authorities informed us that all necessary steps to implement the increase in quota under the Seventh review have been completed.

The next Article IV consultation discussions will be held in 12 to 15 months.

Attachment

cc: The Managing Director (on return)
Mr. Tun Thin
ETR
EXR
FAD
LEG
RES
TRE
ASD Senior Staff
Area Departments
Mr. Carter

China: Selected Macroeconomic Variables, 1980-83

	1980	1981	1982	1983 Mission Forecast
	(Change in percent)			
Real GDP	6.1	4.8	7.4	6-8
Retail price index	5.9	2.3	1.9	2-3
Industrial production	8.8	4.1	7.7	8-9
Investment in plant and housing construction 1/	11.8	-20.2	25.3	10-15
Currency in circulation	29.1	14.5	10.9	15-20
State budget deficit (percent of GDP) 2/	(3.5)	(1.3)	(1.4)	(1.5)
Exports (in US$ terms), f.o.b.	35.4	19.1	2.0	4-5
Imports (in US$ terms), c.i.f.	36.0	-4.5	-15.7	3-4
	(In billions of U.S. dollars)			
Current account balance of payments	-2.5	2.1	6.4	5-6
(percent of GDP)	(-0.9)	(0.8)	(2.4)	(1.9-2.3)
Overall balance of payments	0.4	1.9	6.3	6-7
Level of international reserves (end of year)	3.7	5.6	11.8	18-19
(In months of imports)	(1.4)	(3.3)	(8.3)	(12-13)

1/ State budget and "extra budgetary" investment

2/ GFS definition.

7/15 MD+DMD note

JUL 6 1983

INTERNATIONAL MONETARY FUND

July 5, 1983

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE WBD

SUBJECT: China - Briefing Paper for 1983 Art. IV Consultation

I found this a most interesting and informative one, from which I learned a lot. I recommend approval.

M

B/F

Office Memorandum

cc: BF

TO : The Managing Director
The Deputy Managing Director

DATE: July 5, 1983

FROM : Tun Thin and Manuel Guitián

SUBJECT : China--Briefing Paper for 1983 Article IV Consultation

Please find attached for your comments and approval the briefing paper for the forthcoming mission to China. It has benefited from comments by Messrs. Chandavarkar (TRE), Tait (FAD), Knight (RES), and Ms. Lachman (LEG).

Attachment

cc: Mr. Carter

INTERNATIONAL MONETARY FUND

CHINA

Briefing Paper--1983 Article IV Consultation

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Research, Legal, and Treasurer's Departments)

Approved by Tun Thin and Manuel Guitián

July 5, 1983

The 1983 Article IV consultation discussions will be held in Beijing from July 20 to August 1, 1983. The staff mission consists of Messrs. Neiss (head), Saito, De Wulf (all ASD), Allen (ETR), Feltenstein (FAD), Goldsbrough (RES), and Miss Murrell (ASD, secretary). Mr. Zhang will attend the discussions as an observer.

I. Economic Background

The overriding economic policy aim of China's post-Mao Government has been to achieve an improvement in the living conditions of the country's one billion people, whose per capita income remained one of the lowest in the region. Thus, after a policy of rapid investment expansion, objectives were shifted drastically toward raising consumption. However, this further increased pressure on resources (and imports), as the momentum of investment spending could not be slowed sufficiently. Stabilization measures were introduced at the end of 1980, and a slower pace of development was planned over the medium term, during which structural imbalances were to be corrected and the efficiency of the economy increased through various economic reforms.

The stabilization effort, which was supported by a stand-by arrangement in the first credit tranche in 1981 and which was continued in 1982, was broadly successful. A substantial reduction in investment expenditure was achieved, and the restoration of near balance in the State budget contributed to a reduction in inflationary pressures as well as to a sharp turnaround in the trade account from a moderate deficit to a large surplus. 1/ Nevertheless, retrenching investment and changing the composition of output proved to be much more difficult than expected. As described below, serious imbalances remain, and the economic reforms, except in agriculture, have not yet been consolidated. For these reasons, a cautious policy is again being followed in 1983, and the rather modest targets of the only recently finalized Sixth Five-Year Plan (1981-85) indicate a continuation in the medium-term of the strategy of moderate growth with structural change. Through this process the Government intends to create the base for a resumption of rapid growth during the later eighties so as to realize the widely proclaimed target of quadrupling the level of output between 1980 and the end of the century.

II. Recent Developments

Output growth in 1982 was substantially faster than planned (7.4 per cent versus 4 per cent), as agriculture achieved a record output increase and industrial expansion accelerated markedly. The distribution of national output between consumption and investment developed contrary to plan. The budgetary position remained close to balance, but remained basically weak both because of a shrinking of the revenue base following decentralization and a heavy share of consumer subsidies in expenditure. Public investment ("Capital Construction"), after falling in 1981, rose

1/ Because of the consequent buildup of reserves, early repurchases of the drawing under the stand-by arrangement began in the March-May 1983 period and are expected to be completed in the June-August period.

sharply rather than declining further as planned, and this led to a resumption of strong heavy industry growth at the expense of further progress in light industry output. Because of the unplanned increase in investment, mainly undertaken by provinces and local authorities, scarcities of raw materials and energy persisted. The lack of investment control 1/ has been of considerable concern to the authorities since it has prevented the desired change in the investment-consumption balance which they regard as necessary to achieve a rise in living standards. Furthermore, they regard part of this investment as misallocated, resulting in inefficient and redundant plants; in their view, excessive investment activity by provinces and local governments diverts resources from priority investment in transportation and energy--to be undertaken by the central government--the most important bottlenecks to growth in the medium term. On the other hand, output of consumer goods fell behind planned growth, and the continuous shortage of consumer goods was manifest in another large increase in household savings deposits, despite moderate income growth. In view of these developments, demands at the recent National People's Congress for "recentralization" of investment decisions have become stronger. Although no further export gains were achieved in 1982, a spectacular swing occurred in the current account, from a $2 billion deficit to a $6 billion surplus, mainly due to a large, unplanned drop in imports which was a consequence of the cuts in the large import-intensive investment projects under the

1/ Under the 1981 program, "Capital Construction" was to be reduced by 40 per cent, whereas the actual reduction was only 20.7 per cent. In 1982, instead of a planned reduction of 14.2 per cent, there was an increase of 25.4 per cent. For 1983, a reduction of 8.6 per cent is planned.

central government and the better than expected harvest. Although sizable debt repayments were made in advance of schedule, international reserves more than doubled.

Some of the 1982 trends continued into the first months of 1983: strong expansion of investment and heavy industry output, rapid growth in household savings; moderate monetary expansion; and a small budget deficit. Exports remained weak, but imports started to recover. Nevertheless, the reserve position strengthened further and by the end of March 1983, international reserves had risen to over $13 billion, equivalent to nine months of imports. 1/

While the amount of statistical information published by the Chinese authorities has expanded substantially in recent years, large lacunae remain. The mission will try in particular to obtain further information in the fields of investment, pricing, and the response of the economic system to incentives, as requested by some Executive Directors, and on the nature, scope, and impact of consumer and other subsidies.

III. Policy Issues

Despite the strengthening of the external position, developments in the domestic economy, in particular in the investment area, seem to have convinced the authorities that their cautious approach is appropriate. They have set modest plan targets and have shifted the emphasis from the

1/ The authorities have indicated that they would like the staff to make a thorough study of China's external reserve statistics to ensure that they are calculated on a basis comparable to that used for other members. In particular, they would like to see if it is possible to identify a "working balance" component, which in a market economy would be held by the commercial banks and therefore be excluded from official reserves. The staff will also collect information on the external reserve management policies and practices of the Chinese authorities.

quantity to the quality and composition of output. Income and monetary expansion is being constrained, and the deficit in the State budget kept at a low level. However, it has become apparent that the existing planning mechanism is inadequate for attaining the desired overall developments, and the authorities are searching for ways to improve their macroeconomic management. In order to get a firm grip on investment activity they have tightened the central approval system (last year's introduction of this system was apparently ineffective), and have decided to increase the flow of funds to the central budget through changes in the tax system, including additional taxation of enterprise profits and a 10 per cent tax on extrabudgetary funds of provinces and local governments. Their efforts to assert greater central control over investment decisions runs to some extent counter to the objective of the economic reforms. Nevertheless, political support for the underlying principles of these reforms--provision of material incentives and decentralization of economic decision-making--continues, although the prevailing mood seems to favor consolidation rather than new initiatives in this area. While the reforms have already proved successful in agriculture, success in industry will be more difficult to attain, given the low level of technical efficiency, the shortage of managers, the pressure to maintain and increase the level of employment, and, most importantly, an inadequate price structure. 1/ In the absence of a clear blueprint of the economic system eventually to emerge, these reforms must necessarily remain experimental in nature.

1/ In general, the prices of raw materials and energy are extremely low relative to those of manufacturers, and most prices have remained unchanged since the early 1950s.

To modernize and re-equip plants, the Government had announced a program last year of accelerated equipment imports. However, this program seems to have gained momentum only recently since the large increase in international reserves has become apparent. Although imports have begun to rise again with the restarting of some major investment projects, the absence of a rational or effective foreign exchange allocation system still appears to be inhibiting their growth. The unexpected decline in exports, which is partly due to recession in partner countries and the diversion of supplies to reduce domestic bottlenecks, may also indicate the existence of export restrictions and inadequate export incentives.

The staff team will review current policy issues with the authorities and discuss possible measures for improving economic performance within the framework of the existing political and social system. While there are good grounds for giving strong support to the continuation of the reform process a few points should be emphasized. (1) The difficulty in keeping investment and heavy industry activity in line with Plan targets points to the need to develop instruments of macroeconomic control pari passu with decentralization, rather than resorting to a reversal of this process. Both the budget and the system of credit allocation remain rather rigid policy instruments. 1/ In this respect, the authorities' decision to change the tax system and to explore the idea of creating a central bank (the PBC combines central banking and commercial banking functions) is of special interest, as this could make the State budget

1/ Indeed, budgetary rigidity has increased as a consequence of the reforms which caused the budget to spend almost a quarter of its revenue on consumer subsidies and led to an erosion of the revenue base following the introduction of a profit retention scheme for enterprises and greater financial autonomy for the provinces.

and credit policy more flexible instruments. (2) To ensure that decentralization and production incentives lead to allocative efficiency, a major revision of the existing price structure and exchange and trade systems will be required. While there are frequent official references to the "irrationality" in the existing pricing system, and the exchange system has been described as "experimental," the authorities appear reluctant to subject the economy and society to the shock of a major price and exchange reform. Piecemeal reform would be the alternative, but after adjustments of the textile prices last December, there seems to be little concrete action under way in the area of prices, and nothing in the area of the exchange and trade system. (3) To contribute to the much needed increase in the efficiency of enterprises, large-scale technological transfers through expanding imports and various forms of cooperation arrangements are required. In this context, the staff team will reiterate its position that such a policy, combined with adequate export incentives and better debt monitoring, would not imply an unsustainable external position.

The mission will inform the authorities of the intention to place China on the regular twelve month consultation cycle. The mission will inquire of the authorities what legislative or administrative steps need to be taken for China to consent to the increase in quota under the Eighth Review and to make appropriate financial provision for payment of the increased quota subscription; and will seek details of the timetable the authorities have in mind for completing the necessary steps that would help to bring their quota into effect by November 30, 1983.

Table 1. Macroeconomic Indicators, 1979-82

(Changes in per cent, except where otherwise indicated)

	1979	1980	1981	1982 Plan	1982 Outcome	1983 Plan	1983 First Quarter 1/
Real GDP	7.0	7.8	3.0	4.0	7.4	4-5	...
Gross industrial production	8.5	8.7	4.1	4.0	7.7	4.0-5.0	6.3
Heavy industry	7.7	1.4	-4.7	1.0	9.9	3.9	11.7
Light industry	9.6	18.4	14.1	7.0	5.7	4.1	2.5
Gross agricultural production	8.6	2.7	5.7	4.0	11.0	4.0	...
State capital construction 2/							
Total	4.0	8.0	-17.8	-14.2	25.4	-8.6	...
State budget	-13.9	-19.3	-21.2	5.1	-6.3	17.1	...
Overall balance in state budget (Y billion)							
GFS definition	-20.6	-15.0	-5.8	-7.7	-7.9	...	...
(In per cent of GDP)	(-5.3)	(-3.5)	(-1.3)	(-1.6)	(-1.6)	...	...
National definition	-17.1	-12.8	-2.5	-3.0	-3.0	-3.0	-1.7 3/
Currency in circulation	26.3	29.1	14.5	11.9	10.9	...	14.7 4/
Individual savings	41.5	43.3	30.9	18.6	28.8	...	23.8 4/
Domestic credit	15.1	27.3	13.5	10.7	11.2	...	9.7 4/
Cost of living index	2.1	7.3	2.5	...	2.0	...	...
Exports, f.o.b. 5/	42.2	35.4	19.1	3.1 6/	—	1.8	-5.4
Imports, f.o.b. 5/	45.4	36.0	-4.5	22.2 6/	-14.5	40.6	11.1
Current account (US$ bn.)	-1.6	-2.5	2.1	-0.1	6.1	1.9 7/	...
(In per cent of GDP)	(-0.7)	(-0.9)	(0.8)	...	(2.4)	...	...
Overall balance of payments (US$ bn.)	0.6	0.4	1.9	-0.3	6.3	2.9 7/	...
Total reserves minus gold (US$ bn.)	2.1	2.5	5.0	...	11.3	...	13.2 3/
(In months of imports)	(1.7)	(1.4)	(3.0)	(...)	(7.8)	(...)	(9.0) 8/

Sources: Data provided by Chinese authorities.

1/ First quarter 1983 over first quarter 1982, except for monetary data.

2/ Fixed investment by state enterprises and provincial and local governments; excludes fixed investment by collective enterprises, communes, and brigades.

3/ As of end-April.

4/ End-March 1982 over end-March 1982.

5/ In terms of U.S. dollars.

6/ From the foreign exchange balance.

7/ Staff forecast.

8/ Average monthly imports for first quarter, compared with total reserves at the end of March.

Table 2. China: Balance of Payments, 1979-83

(In millions of U.S. dollars)

	1979	1980	1981	1982 Est.	1983 Forecast
Exports, f.o.b.	13,658	18,492	22,027	21,910	23,000
Imports, f.o.b.	-15,619	-21,243	-20,292	-17,380	-22,600
Trade balance	-1,961	-2,751	1,735	4,530	400
Services credit	1,693	2,409	3,130	4,000	4,200
Services debit	-1,963	-2,703	-3,336	-3,100	-3,400
Services net	-270	-294	-206	900	800
Net unrequited transfers	626	570	275	670	740
Net invisibles	356	276	369	1,570	1,540
Current account	-1,605	-2,475	2,104	6,100	1,940
Long term capital inflow	1,435	2,524	1,637	1,600	1,800
Long term capital outflow	-613	-756	-1,431	-800	-800
Short term capital net	1,554	76	-959		
Errors and omissions	-168	857	52	-636	0
Capital account	2,208	2,701	-701	164	1,000
Trust Fund	--	--	379	--	--
Allocation of SDRs	--	146	142	--	--
Overall balance	603	372	1,924	6,264	2,940
Reserves and related items 1/	-603	-372	-1,924	-6,264	-2,940
Gold	-6	19	55	27	--
Foreign exchange	-597	-108	-2,511	-6,352	-1,953
Reserve position	--	-191	191	--	-300
SDRs	--	-92	-183	61	-200
Use of Fund credit	--	--	524	--	-487

Sources: Bank of China; and Fund staff estimates.

1/ (-) indicates increase

Table 3. China: Sixth Five-Year Plan

(Annual percentage changes unless otherwise specified)

	1978-80 Actual	Sixth Five-Year Plan 1981-85 Plan	1981-82 Actual	1983-85 Implied by Plan
National income 1/	8.6	4	5.4	3.1
Gross industrial output 1/	10.1	4	5.9	2.7
Gross agricultural output 1/	5.6	4	8.3	1.2
Investment 2/ (as percentage of national income)	(15.1)	(11.2)	(12.2)	(10.4)
Exports 3/	34.0	7.9	8.6	7.4
Imports 3/	39.4	9.0	-7.3	21.1
Budgetary revenue 4/	7.5	3.3	1.8	4.3
Budgetary expenditure 4/	12.8	1.5	-2.5	4.2
Budget deficit (annual average, in billion of yuan)	(9.6)	(3.0)	(2.8)	(3.0)

Source: Extracted from official speech delivered at the Fifth National People's Congress (November 30, 1982).

1/ In constant prices.

2/ Fixed investment by state enterprises, provinces, and local governments.

3/ Data from Ministry of Foreign Trade, in U.S. dollars. The 1985 yuan targets that were published are assumed to have been obtained from the targets expressed in dollars and converted into yuan at Y 1.5 = US$1.

4/ National definition.

Fund Relations with China

(June 30, 1983)

Representation:	The People's Republic of China assumed representation of China in the Fund on April 17, 1980.
Quota:	Presently SDR 1.8 billion; proposed under the Eighth General Review SDR 2,390.9 million, to which the Government has not yet consented.
Status:	China continues to avail itself of the transitional arrangements of Article XIV.
Reserve tranche drawings:	China made a reserve tranche drawing of SDR 218 million effective November 4, 1980 and of SDR 150 million effective January 8, 1981.
Use of Fund resources:	On March 2, 1981, China entered into a stand-by arrangement in the first credit tranche with the Fund equivalent to SDR 450 million. On May 20, 1983 China made an early repurchase of SDR 333.8 million and is expected to make another early repurchase of SDR 116.2 million by August 1983.
Trust Fund loan disbursements: (Second period)	SDR 309.53 million.
Fund's holdings of renminbi:	SDR 1,916 million or 106.5 per cent of quota.
SDR position:	SDR 178 million (75.2 per cent of net cumulative allocation of SDR 236.80 million).
Designation plans:	China was included in the March-May 1983 Designation Plan for SDR 41.2 million, and was designated for SDR 2.6 million. China was included in the June-August 1983 Designation Plan for SDR 150.9 million.
Exchange arrangements:	China's currency, the renminbi, is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi to

the U.S. dollar. As of June 28, 1983, the representative rate for the renminbi was Y 1.9838 per U.S. dollar. China maintains an internal settlement rate of Y 2.8 per U.S. dollar for all trade and trade-related transactions. This constitutes an unapproved multiple exchange practice.

Last consultation: Article IV consultation discussions were last held from April 5-15, 1982. The Staff Report (SM/82/129) was discussed by the Executive Board on August 1, 1982.

IMF Institute: Since October 1980, seven officials of the Bank of China, eight of the People's Bank of China, two of the Ministry of Finance, one each from the State Statistical Bureau and the General Customs Administration have participated in courses organized by the IMF Institute. On October 10-28, 1983, the IMF Institute will organize a course on Banking and Monetary Policy in Xian, China.

Colloquium held in China by External Relations Department: The External Relations Department organized a colloquium in Beijing on October 20-28, 1982. The proceedings of this colloquium were recently published in a book, The Fund and China in the International Monetary System, edited by A.W. Hooke.

Relations of China with the IBRD

Representation: The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.

Capital subscription: China's authorized capital is 23,232 shares or 3.24 per cent of the total authorized capital of the Bank.

Lending activities:

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
	(In millions of U.S. dollars)			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.1	--
1983	150.4	463.1	36.2	0.6
1984	349.9	610.0	...	...
1985	...	900.0	...	...
1986	...	1,200.0	...	...

Approved projects: FY 1981, university development project; FY 1982, North China Plain agricultural project; FY 1983, port facilities, agricultural education and research, China Investment Bank, two oilfields, and a land reclamation project.

Economic Development Institute: Beginning in May 1981, the Economic Development Institute has held five courses a year for China, making it EDI's largest country program. Chinese participants have also been attending EDI regional courses and courses in Washington.

INTERNATIONAL MONETARY FUND

June 30, 1982

Mr. Guitian:

Please let's discuss this.

Attachment

cc: Mr. Allen

TT

Tun Thin

INTERNATIONAL MONETARY FUND

June 28, 1982

JUN 29 1982

TO : The Managing Director

FROM: William B. Dale

Subject: China: 1982 Article IV Staff Report

This seems to me to be a quite full report. I recommend approval.

Mr. Tun

A few remarks

June 29.82

cc: DIV.

From: Office of Managing Director June 29, 1982

To: Mr. Tun Thin A few remarks

Subject: China

Page 4: outcome vis-à-vis program and not outcome vis-à-vis preceding year (4.6%).

Page 20: Should we be telling them to deteriorate their BOP current account with so much insistance ? (look at the pace of the increase of their debt service even under the existing plans (p. 34).

Page 23: are the foreign markets supportive for such policy ?

were reduced substantially and despite increases in other imports, total imports fell. Import policy thus did not contribute to improving the balance of supply and demand as much as had been anticipated. The fall in imports, combined with a much better export performance than the authorities had expected, led to a sharp improvement in the balance of payments. The current account turned into substantial surplus, the swing corresponding to 1.9 per cent of GDP. Despite large debt repayments and relatively modest foreign borrowing, reserves rose by almost $2.5 billion to a level equivalent to over three months of imports.

The gains in adjustment in 1981 are impressive. However, the authorities expressed some concern that full stabilization has not yet been achieved. The level of liquidity, both with households and with enterprises and provincial and local governments, remained high in relation to output, expenditures outside the State plan rose more than anticipated, and those prices not directly fixed by the State 1/ rose appreciably faster than the measured average price level. The authorities felt the need to intensify controls and supervision over investment and pricing. They were also concerned about the unsatisfactory financial performance of the State enterprise sector, which had retarded budgetary revenue growth. Production was insufficiently geared to demand and partly of poor quality. Despite the improvement in consumer purchasing power, there was a further large increase in unsalable inventories. There was also a large increase in subsidies, which reached a level equal to that of budgetary expenditure on capital construction.

3. Outlook for 1982

Detailed information with regard to the 1982 Annual Plan is not yet available, but the authorities have provided information on the principal macroeconomic targets and their policies. Total investment will be kept at about its 1981 level, with a further drop in State capital construction, and there will be a moderate increase in consumption. The budget deficit will be slightly larger than in 1981, and bank financing of the deficit will be limited to less than 1 per cent of GDP. Since the level of liquidity is still considered relatively high, some further slowdown in the rate of currency and total credit expansion is planned, to 12 and 11 per cent, respectively. Parallel with these stabilization efforts, sectoral balances will be further changed in favor of agriculture, light industry, and consumption, and efforts will be made to limit the accumulation of unsalable inventories. Reform measures are to be continued, and modernization is to be advanced by replacing obsolete machinery with technologically more advanced equipment, partly from imports.

Real national income growth is planned to be around 4 per cent and the authorities expect prices to be basically stable. To achieve price stability, they plan no major increases in State-fixed prices, in addition to continued fiscal and monetary restraint. Because of unfavorable world market conditions, increased domestic requirements for exportable goods, and a resumption of import growth, the authorities expect a significant

1/ "Negotiated prices" and rural market prices.

a strategy, improvements in the efficiency and distribution of investment will be crucial to compensate for its reduced scale. In a similar vein, the potential for increasing growth by shifting resources out of heavy industry into higher productivity sectors would appear to be smaller now than it was two years or even one year ago, and improving productivity within the heavy industry sector itself will be increasingly important. The authorities expect the following policies to play a role in these efforts: continuation of the present profit retention and bonus schemes in order to boost work incentives; a shift in emphasis from the quantity to the quality of output in order to increase marketability of products at home and abroad; and reduced financial support for inefficient enterprises in order to prevent them from siphoning off key inputs needed by more efficient enterprises.

With respect to the energy constraint, the staff team suggested, in addition to utilizing the further scope for energy saving, the possibility of moving temporarily to a lower net oil export position, or even to a net import position. The authorities did not exclude such a possibility if, prior to the coming on stream of offshore oil production and expanded coal output, the imbalance between energy demand and supply became acute. The room for maneuver in varying oil exports was limited, however, by the existence of long-term export contracts with several countries.

The staff team also emphasized the contribution of imports in transferring advanced technology to ease the efficiency constraint by upgrading the level of industrial technology, particularly in the manufacturing, energy, and transport sectors. Since it would take time to build up China's export capacity, imports would, over the next year, exceed exports, but moderate current account deficits would be sustainable. Given China's stage of economic development, the outdated nature of much of its capital equipment, and the moderate level of its current external debt, it was appropriate for China to use foreign savings to help finance some of its import needs. To build up export capacity, the policy of providing incentives to make exporting sufficiently attractive will be continued. The staff team pointed to the importance of identifying new areas for export expansion. In this connection, the authorities' forecasts for declining or stagnant exports of oil and textile products over the medium term imply that other export products will have to be developed or encouraged if overall export growth is to be sustained.

Should we be telling China to run [illegible] BOP current account [illegible] with low [illegible] insufficient? (Look at the pace of increase of China debt even under the existing plans (p. 24))

The overall growth rate foreseen by the authorities over the next few years is 4 to 5 per cent. This is low by historical comparison, but in their view a higher growth rate would not be realistic. They noted that one of the lessons learned from the past thirty years of planning experience was that efforts to implement overly ambitious plan targets soon led to difficulties and actually impeded economic growth. Indeed, the current policy of stabilization and structural adjustment that will guide planning throughout the remainder of the Sixth Five-Year Plan had to be adopted after the pursuit of overly ambitious plan targets in the late 1970s had caused disruptions in the economy. When readjustment has

In view of the constraints of a limited availability of domestic energy over the next few years and a low factor productivity, the authorities' development strategy for the next few years emphasizes measures to raise the efficiency of the economy rather than high overall growth rates. Essential to this strategy are the redirection of investment and output to agriculture and light industry, the replacement of outdated equipment, and improvements in enterprise operation. There is some concern that the composition of the investment cuts in 1981 may have affected the economy's growth potential. In any case, it is important that investment priorities be properly defined in the 1982 and subsequent Plans.

A more active import policy can ease the constraints on growth by ensuring an adequate supply of inputs and increasing the availability of equipment with adequate technology. The energy constraint, in particular, which is expected to last a number of years, could be mitigated by a temporary change in the present net energy export position and even by net imports. The scope for a policy of import expansion would, of course, be circumscribed by the country's export potential. To ensure the maintenance of an appropriate balance of payments position, a faster import growth would have to be accompanied by a further shift of resources into the export sector, which would in turn require the provision of adequate incentives to export producers. While export capacity is being built up, modest current account deficits could be sustainable and appropriate for China's stage of economic development.

use the free markets supported by [illegible] policy

The crucial role of reform policies in promoting efficiency and growth has already been shown by the progress achieved in agriculture. In industry too, enterprises have begun to put more stress on productivity and on the quality and marketability of output. The decentralization has led to some difficulties, and the authorities have found it necessary to strengthen central directives in such areas as investment, foreign trade, wages, and prices. In the longer run, new methods of indirect control may be more appropriate, given that the authorities are committed to the continuation of the reform process. Continuous evaluation of the various measures introduced on a trial basis and the extension of those measures which have proved successful will be important in maintaining the momentum of the reform process. However, it cannot be overlooked that the impact of the reforms is weakened by the existing price structure which has changed little over the past three decades, and indications are that it is not conducive to an efficient allocation of resources. The authorities have already made substantial changes in agricultural producer prices. To reap the full benefits of the emerging system that allows decentralized decisions and markets to supplement central planning, further adjustments in the price structure will eventually have to be allowed for. The authorities recognize the need for such adjustments and intend to implement them in a pragmatic way over an extended period.

The exchange rate system involves two multiple currency practices subject to approval under Article VIII--a dual exchange rate and a tax on remitted profits of joint ventures. The dual exchange rate system, which

D R A F T

6-30-82
HNeiss:jp

TO: The Managing Director

FROM: Tun Thin and M. Guitian

SUBJECT: <u>China - 1982 Article IV Consultation</u>

In response to your comments we have redrafted the relevant passages on pp. 4, 20, and 23 of the staff report. The redrafts and the original pages are attached.

For your approval.

Attachment

cc: The Deputy Managing Director
Mr. Carter

D R A F T
HNeiss:jp
6-30-82

China - Staff Report for the 1982 Article IV Consultation

Suggested redrafts

Page 4, line 6 from top of page: "The current account turned into substantial surplus, the change corresponding to 1.7 per cent of GDP from the preceding year and to 1.9 per cent of GDP from the program."

Page 20, first and second full paragraphs: "With respect to the energy constraint, the staff team suggested, in addition to utilizing the further scope for energy saving, the possibility of moving temporarily to a lower net oil export position. The authorities did not exclude such a possibility if, prior to the coming on stream of offshore oil production and expanded coal output, the imbalance between energy demand and supply became acute. The room for maneuver in varying oil exports was limited, however, by the existence of long-term contracts with several countries.

The staff team also emphasized the contribution of imports in transferring advanced technology to ease the efficiency constraint by upgrading the level of industrial technology, particularly in the manufacturing, energy, and transport sectors. Since it would take time to build up China's export capacity, imports would, over the next years exceed exports. In building up China's export potential, the staff team pointed to the importance of identifying new areas for export expansion. In this connection, the authorities' forecasts for declining or stagnant exports of oil and textile products over the medium term imply that other export products will have to be developed or encouraged if overall export growth is to be sustained."

<u>Page 23, second paragraph</u>: " A more active import policy can ease the constraints on growth by ensuring an adequate supply of inputs and increasing the availability of equipment with adequate technology. The energy constraint, in particular, which is expected to last a number of years, could be mitigated by a temporary change in the present net energy export position. The scope for a policy of import expansion would, of course, be circumscribed by the country's export potential. To ensure the maintenance of an appropriate balance of payments position, a faster import growth would have to be accompanied by a build-up of the country's export capacity to ensure a sustained expansion of exports.

were reduced substantially and despite increases in other imports, total imports fell. Import policy thus did not contribute to improving the balance of supply and demand as much as had been anticipated. The fall in imports, combined with a much better export performance than the authorities had expected, led to a sharp improvement in the balance of payments. The current account turned into substantial surplus, the swing corresponding to 1.9 per cent of GDP. Despite large debt repayments and relatively modest foreign borrowing, reserves rose by almost $2.5 billion to a level equivalent to over three months of imports.

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1/ "Negotiated prices" and rural market prices.

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The overall growth rate foreseen by the authorities over the next few years is 4 to 5 per cent. This is low by historical comparison, but in their view a higher growth rate would not be realistic. They noted that one of the lessons learned from the past thirty years of planning experience was that efforts to implement overly ambitious plan targets soon led to difficulties and actually impeded economic growth. Indeed, the current policy of stabilization and structural adjustment that will guide planning throughout the remainder of the Sixth Five-Year Plan had to be adopted after the pursuit of overly ambitious plan targets in the late 1970s had caused disruptions in the economy. When readjustment has

In view of the constraints of a limited availability of domestic energy over the next few years and a low factor productivity, the authorities' development strategy for the next few years emphasizes measures to raise the efficiency of the economy rather than high overall growth rates. Essential to this strategy are the redirection of investment and output to agriculture and light industry, the replacement of outdated equipment, and improvements in enterprise operation. There is some concern that the composition of the investment cuts in 1981 may have affected the economy's growth potential. In any case, it is important that investment priorities be properly defined in the 1982 and subsequent Plans.

A more active import policy can ease the constraints on growth by ensuring an adequate supply of inputs and increasing the availability of equipment with adequate technology. The energy constraint, in particular, which is expected to last a number of years, could be mitigated by a temporary change in the present net energy export position and even by net imports. The scope for a policy of import expansion would, of course, be circumscribed by the country's export potential. To ensure the maintenance of an appropriate balance of payments position, a faster import growth would have to be accompanied by a further shift of resources into the export sector, which would in turn require the provision of adequate incentives to export producers. While export capacity is being built up, modest current account deficits could be sustainable and appropriate for China's stage of economic development.

The crucial role of reform policies in promoting efficiency and growth has already been shown by the progress achieved in agriculture. In industry too, enterprises have begun to put more stress on productivity and on the quality and marketability of output. The decentralization has led to some difficulties, and the authorities have found it necessary to strengthen central directives in such areas as investment, foreign trade, wages, and prices. In the longer run, new methods of indirect control may be more appropriate, given that the authorities are committed to the continuation of the reform process. Continuous evaluation of the various measures introduced on a trial basis and the extension of those measures which have proved successful will be important in maintaining the momentum of the reform process. However, it cannot be overlooked that the impact of the reforms is weakened by the existing price structure which has changed little over the past three decades, and indications are that it is not conducive to an efficient allocation of resources. The authorities have already made substantial changes in agricultural producer prices. To reap the full benefits of the emerging system that allows decentralized decisions and markets to supplement central planning, further adjustments in the price structure will eventually have to be allowed for. The authorities recognize the need for such adjustments and intend to implement them in a pragmatic way over an extended period.

The exchange rate system involves two multiple currency practices subject to approval under Article VIII--a dual exchange rate and a tax on remitted profits of joint ventures. The dual exchange rate system, which

Mr. Finich
cc: Mr. Guitian
Mr. Allen
I already have it.

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: May 21, 1982

FROM : Tun Thin

SUBJECT : China--Article IV Consultation

After the Heads of the Departments meeting on May 20, I met with Messrs. Tai and Wang to discuss the need for additional data to finalize the Staff Report. As far as official statistics for 1982 are concerned, we have only received the 1982 State Budget and some production targets. I pointed out that the Staff Report would also have to contain the 1982 Plan targets for national income aggregates and official projections for the balance of payments and the monetary survey. Because of the delay in obtaining these data, a date for the Executive Board meeting in July would be unrealistic.

Messrs. Tai and Wang pointed out that the data could not be released until the Standing Committee of the National People's Congress has formally approved the 1982 Annual Plan. They could not indicate, however, when the Standing Committee would meet to approve the Plan. They said they would refer this matter to Beijing and would endeavor at least to have the data transmitted as soon as possible after their release. I pointed out that if the Executive Board discussion were to take place in August we would need to have the data by the end of June.

They noted that a staff visit may be needed to examine the consistency of the Plan targets and projections and to discuss the measures to achieve them, in particular for the external sector. The staff would also need to obtain data on actual developments in the first months of 1982.

It is proposed that the RED paper which does not have to contain 1982 forecasts could be issued earlier.

Mr. Finch agrees with above approach.

I will discuss this with Mr. Zhang after his return next week.

cc: Messrs. Finch
Guitian
Carter

cc: Palmer o/r
Guitián
Allen

Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: April 27, 1982

FROM : Hubert Neiss HN

SUBJECT : China--1982 Article IV Consultation

RECEIVED APR 29 1982 EXCHANGE & TRADE RELATIONS

Discussions for the 1982 consultation, and a review of performance under the first credit tranche program for 1981, were held in Beijing during April 5-15, 1982. The staff team included De Wulf, Le Gall, Kimura (all ASD), Goldstein (RES), Allen (ETR), Heller (FAD), Byrd, Porter (both IBRD), and Pugh (secretary, ASD). Messrs. Zhang (ED for China) and Wang (Advisor to the ED for China) participated in the discussions. An advance team started work on March 22, 1982.

Information

The advance team made substantial progress in constructing budgetary and balance of payments accounts, as well as a monetary survey, according to the Fund's format. In addition, our knowledge of the institutional framework has improved and we have come to a better understanding of the specific features of the economic system. The major area where information is still inadequate is the domestic price structure and its rationale.

Sufficient data for 1981 were made available to assess performance under the Fund program. For 1982, however, only broad indications of trends and policies were given, since approval of the 1982 Annual Plan and the 1982 State Budget by the Standing Committee of the National People's Congress has been delayed; the authorities indicated a further delay of one to three months. Detailed data will be cabled to us as soon as they become available. In any case, we propose to issue the staff report in time to allow the scheduling of the Executive Board Meeting according to the normal time table.

Performance in 1981

Stability had been jeopardized in 1979 and 1980 when, under a new government policy, consumption was expanded at the same time as an ambitious investment program was maintained. In 1981, the Government reacted decisively by a sharp cut in investment (although much less than originally planned), a substantial reduction of credit and currency expansion, and stricter control of those spending and pricing decisions which, under the reforms, were to be decentralized. As a result of this policy, inflationary pressures moderated, growth was maintained at a moderate pace, and the external position was sharply strengthened.

Macro-Economic Indicators, 1980-81

(Changes in per cent, except where otherwise indicated)

	1980	1981 Program	1981 Outcome
Real national income 1/	6.9	4-5	3-4
Capital construction investment	8.0	-40	-22
Overall balance in the State Budget			
(In billions of yuan)1/	-12.7	--	-2.7
(In per cent of GDP)	(-3.1)	(--)	(-0.6)
Currency in circulation	29.2	12.0	14.5
Credit to enterprises	18.4	10.0	14.5
Cost of living index	7.3	--	2.5
Exports, f.o.b. (trade basis)	33.8	--	14.8
Imports, c.i.f (trade basis)	24.7	10.0	-0.4
Current account (billions of dollars)1/	-2.6	-1.9	2.1
(In per cent of GDP)	(-1.0)	(-0.7)	(0.8)

1/ National definition.

The striking improvement in the balance of payments was achieved by a stronger export performance and a more restrictive import policy than had been foreseen when the program was drawn up. The growth of exports, despite low world demand, was attributed by the authorities to vigorous export promotion and was made possible by China's small share in world trade (about 1 per cent). The lower level of imports can be largely explained by the investment cuts and the drop in output of heavy industry. The current account surplus was used to build up reserves (to $5.6 billion or about 3 months of imports) and to make substantial debt repayments. Net capital inflows amounted to only half a billion dollars, compared with a programmed inflow of $3 billion. Thus the balance of payments need expected when the program was drawn up did not materialize.

While the objectives of the stabilization program were broadly achieved, weaknesses remain in several areas. Despite the reduction in credit and currency expansion, there is still excess liquidity in the system and the authorities found it necessary to tighten price controls. The improvement in the budgetary position was achieved mainly by cuts in productive investment, while revenues continued to decline due to the poor overall performance of the State enterprise sector. Subsidies on daily necessities and agricultural inputs increased substantially to a level equal to that of investment expenditures in the State Budget. The authorities are aware of these problems and of the necessity to both continue the stabilization effort in 1982, and to implement policies aimed at improving enterprise performance.

Prospects for 1982

No basic change in policy was indicated for 1982. The growth target is set at a modest rate of around 4 per cent, credit and currency expansion will be further restrained, and the improved overall budgetary position achieved in 1981 will be maintained. Under these conditions, the external position could be expected to remain strong, even with a somewhat less restrictive import policy than in 1981. The authorities, however, anticipate a balance of payments deficit. In their view, exports will expand little due to poor world demand and to higher domestic demand for exportables, and imports will rise substantially, mainly because outdated equipment in enterprises will be replaced on a large scale. We pointed out that a comprehensive assessment of the 1982 balance of payments would only be possible after the details of the Annual Plan are available. However, in our view, exports are likely to remain strong, and a turnaround in the balance of payments position is only likely if there were to be a major change in import policy.

Mr. Shang Ming, Vice President of the People's Bank of China, indicated informally that he expected a current account deficit of $2.5 billion and an overall deficit of $2 billion in 1982. Since he wished to maintain reserves at a level equivalent to two months of imports to ensure creditworthiness, about $1 billion could be financed out of reserves. He was considering approaching the Fund at a later date for the remaining $1 billion of resources. I gave no indication of what the Fund's position would be and he did not pursue this point. We were also informed privately that the authorities hoped to receive disbursements from the World Bank, but were unhappy about the slow progress of their lending discussions. They have apparently become reluctant to permit more detailed studies of microeconomic issues.

Medium-term policy issues

Although the Sixth Five-Year Plan (1981-85) has not yet been finalized, the authorities conveyed the impression that they have opted for a cautious slow-growth strategy over the next few years until major constraints on output growth have eased. These constraints are perceived to be the limited supply of domestic energy and a substantial technological and managerial lag in industry. To mitigate these constraints, we suggested consideration of a temporary change in the energy net-export position (oil exports in 1981 amounted to $5 billion, the equivalent of 5 per cent of domestic energy consumption), and the accelerated import of suitable equipment to help upgrade the technological level of industry. Such a change in import policy would have to be accompanied by appropriate incentives to shift resources into the export sector in order to preserve a viable external position. This could involve moderate current account deficits, which would be appropriate given China's stage of economic development. However, the authorities' foreign borrowing policy has been extremely cautious and is likely to remain so. Outstanding external debt is about $5 billion, and the debt service ratio around 8 per cent. The continuation of the reforms would also be an essential element in overcoming the technological and managerial constraints.

Reform measures and domestic pricing

The reforms introduced in agriculture since 1979, which give production responsibility to smaller groups of farmers and allow for limited marketing of their products outside the State Plan, proved to be well coordinated and successful. This is borne out by the strong growth of agricultural output in 1981, despite natural calamities, and by the substantial increase in rural incomes. Combined with the increases in procurement prices, this has mitigated the urban-rural income imbalance of the past decades.

In contrast, the reforms in industry, providing for a limited scope of decentralized decision-making regarding production, investment, wages, exports and imports, seem to have been less successful. They have led to some undesirable developments, such as unauthorized price increases, excessive bonus payments, and duplication of investment projects. These in turn prompted the authorities to superimpose new and detailed central controls on enterprises. The basic weaknesses--low productivity, lack of financial discipline, accumulation of unsalable inventories--seem to persist.

Despite these difficulties, the reform process is likely to continue but progress will be made difficult by the apparent reluctance to make major changes in the price system. Indications are that the existing structure of relative prices, which has changed little over the past three decades, is distorted and seriously impedes rational allocation of resources. The authorities also appear reluctant to undertake a major reform of the exchange system in the near future, although they described the present system as being on a trial basis. As it stands, it involves two multiple currency practices, a dual exchange rate and a tax on remitted profits of joint ventures, subject to approval under Article VIII.

cc: Mr. Tun Thin (on return)
Mr. Carter
ETR
LEG
TRE
RES
FAD
EXR
ASD Senior Staff

Office Memorandum

TO:	The Managing Director The Deputy Managing Director	March 12, 1982
FROM:	Tun Thin and Manuel Guitian	
SUBJECT:	China--Briefing Paper for the 1982 Article IV Consultation	

Attached is the draft briefing paper for the consultation with China. It has been cleared by Messrs. Cutler (TRE), Yandle (FAD), Liuksila (LEG), and Khan (RES).

For your approval.

Attachment

cc: Mr. Carter

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Briefing Paper for the 1982 Article IV Consultation

Prepared by the Asian and Exchange
and Trade Relations Department

(In consultation with the Legal, Research, and Fiscal
Affairs Departments)

Approved by Tun Thin and Manuel Guitian

March 12, 1982

I. Introduction

A team consisting of Neiss, De Wulf, Kimura, Le Gall (all ASD), Goldstein (RES), Allen (ETR), Heller (FAD), Byrd (IBRD), and Pugh (Secretary, ASD), will conduct the 1982 Article IV Consultation discussions during April 5-15, 1982. The staff team will also review China's performance under the adjustment program for 1981 which was supported by the use of Fund resources. An advance team (De Wulf, Kimura, Le Gall, Allen, Heller, Byrd, and Pugh) will start work on March 22 to collect statistical and institutional information.

On March 2, 1981, a first credit tranche stand-by arrangement in the amount of SDR 450 million (EBS/81/35) and a Trust Fund loan (TR/81/2) were approved by the Executive Board. Immediately after the arrangement was granted, China purchased the total amount of the arrangement. On March 23, 1981, China received a disbursement equivalent to SDR 309.5 million under the Trust Fund loan approved together with the stand-by arrangement.

II. Economic Background

1. Background to the 1981 Adjustment Program

Economic policies and achievements in 1981 must be viewed in the light of China's decision to restore economic stability while continuing to restructure the economy so as to improve living standards and enhance efficiency. In 1979 and 1980, financial stability was imperiled by an overexpansion of public sector investment,1/ both budgetary and extrabudgetary, and consequent large budget deficits. The 1980 overall budget deficit--at 3.6 per cent of GDP--was larger than anticipated, mainly because budgetary investments exceeded by Y 5 billion the budgeted level of Y 37 billion. Some elements of the management reforms to give enterprises and local governments greater financial resources and responsibility made it more difficult to slow down the pace of investment. This failure to contain investment growth contributed to a rapid increase in currency in circulation (29 per cent) and credit (21 per cent). There were various indications that inflationary pressures had intensified. The official consumer price index rose by 7.5 per cent, after years of virtual stability. The current account deficit in the BOP rose to $2 billion (0.7 per cent of GDP), while an overall BOP deficit of about half a billion dollars emerged.

2. The 1981 Adjustment Program and its Implementation

In late 1980 an adjustment program was formulated for 1981 to redress existing macroeconomic imbalances. The core of the program was a large cut in investment by 40 per cent. This involved a cut in budgetary investments

1/ Public sector investment expenditure comprises that which is budgeted (most of general government direct investment along with most public enterprise investment) and extrabudgetary investment expenditure. The latter comprises additional investment by the public enterprise sector along with some additional investment by units of general government financed principally by service charges not remitted to the Ministry of Finance.

by over Y 10 billion from their 1980 level and an attempt to eliminate extra-budgetary investments (Y 12 billion in 1980) by recentralizing all investment decisions. The Government also announced strict enforcement of price controls and halted the extension of the management reforms. Domestic financing of the budget deficit was to be eliminated, and the growth rates of currency in circulation and credit to enterprises were to be reduced to 12 per cent and 10 per cent, respectively. Real national income growth was expected to slow down to a rate of 4-5 per cent, with continued emphasis being given to output and investment in agriculture and light industry as part of the restructuring effort.

Available data allow for only a preliminary description of actual developments in 1981. These data indicate that progress in the short-term stabilization and restructuring effort has been achieved. (Available data are shown in the Table below).

National income growth in 1981 was slightly below the target. Agricultural production grew by 4 per cent, despite droughts in the north and floods in Sichuan. Industrial output growth fell to 4 per cent, with light industry continuing to grow rapidly, but with heavy industry experiencing a drop in output. The official consumer price index rose by 2 per cent, as against 7.5 per cent in the previous year. However, the frequent official calls during the year for stricter price discipline suggest a continuation of inflationary pressures.

While budgetary investments were reduced substantially (by Y 9 billion, or over 20 per cent), the curtailment of extra-budgetary investments was far less successful. As a result, total investment fell only 23 per

China: Selected Economic Indicators, 1979-81

	1979	1980	1981 Program estimates	1981 Estimated actuals
		(Changes in per cent)		
National income and prices				
National income in constant prices	7.0	6.9	4-5	3.0
Gross agricultural output	8.6	2.7	...	4.0
Gross industrial output	8.5	8.7	...	4.0
Light industry	9.6	17.4	...	13.6
Heavy industry	7.7	1.6	...	-4.5
Prices	1.9	7.5	--	2.0
Government budget				
Budgtary revenue	-4.6	-2.3	-5.5	-6.0
Budgetary expenditure	14.6	-6.4	-12.7	-9.7
Money and credit				
Total credit	15.1	21.4	9.3	13.6
Credit to enterprises	16.2	18.4	10.0	14.5
Currency in circulation	26.4	29.3	12.0	14.5
External sector				
Exports (BOP basis in US$)	43.5	28.0	--	(12.2) 1/
Imports (BOP basis in US$)	51.5	21.4	10.0	(8.6) 1/
		(In billions of Yuan)		
Overall budget deficit	20.6	14.9	5.5	9.7
Domestically financed budget deficit	17.1	12.8	--	2.7
		(In millions of US$, unless otherwise specified)		
Balance of payments 2/				
Current account deficit (-)	-1,528	-2,000	-2,900	-1,600
Overall deficit (-)/surplus	673	-600	--	1,300
Gross official reserves 3/	2,744	3,116	...	5,564
(in months of imports)	1.9	1.7	...	2.8
		(In per cent of GDP)		
Overall budget deficit	5.4	3.6	1.3	2.2
Domestically financed budget deficit	4.5	3.1	--	0.6
BOP current account deficit (-)	-0.6	-0.7	-1.0	-0.6
Overall deficit (-)/surplus	0.3	-0.2	--	0.5

Sources: Data provided by the Chinese authorities and staff estimates.

1/ Based on eight months' data.

2/ Highly tentative.

3/ Including foreign exchange holdings of nonresident branches of the Bank of China and gold at national valuation.

cent, in contrast to the 40 per cent cutback that was originally targeted.

The overall budget deficit declined to 2.2 per cent of GDP and domestic financing of the deficit fell sharply from Y 12.8 billion in 1980 (3.1 per cent of GDP) to Y 2.7 billion in 1981 (0.6 per cent of GDP). However, domestic financing was still about Y 2.7 billion larger than programmed (Appendix Table 1).

Monetary policy was aimed at absorbing excess purchasing power of consumers and enterprises. Factors helping to contain the growth of currency in circulation were a 9 per cent increase in retail sales (retail units must surrender their cash proceeds to the banking system), a 20 per cent increase in individual savings deposits, and the apparent absence of major increases in wages and producer prices. Furthermore, enterprises and local governments were required to purchase most of the Y 4.9 billion in Treasury Bonds that were issued in 1981. The transfer within the State budget of Y 7 billion from provinces to the Central Government strengthened central control over investment. Nevertheless, currency in circulation grew by 14.5 per cent, above the 12 per cent programmed rate. In earlier discussions, the authorities indicated that the implementation of reforms in the rural areas (households and individuals can sign contracts with agricultural teams and are now paid in cash rather than in accounting work-points for their work) required a larger volume of currency in circulation for transaction purposes than originally planned. The rate of domestic credit expansion (13.6 per cent) was also faster than programmed (Appendix Table 2). This may have been due to an inventory buildup and the insufficient cutback of extrabudgetary investment.

Data on the balance of payments are particularly uncertain and incomplete, but they indicate a strengthening of the balance of payments in 1981 (Appendix Table 3). On the basis of eight months' trade data, the trade deficit declined from US$4 billion to about US$3.7 billion as exports continued to expand (the program assumed no increase) and import growth was restrained. The current account deficit too registered a decline from US$2 billion to US$1.6 billion, well below the deficit of almost US$3 billion expected when the program was formulated. No information is available about actual capital account developments, but if developments in the capital account were as expected at the start of the year, the capital account surplus would have been twice as large as in 1980. In such a case, the overall balance of payments would have moved from a deficit of US$600 million in 1980 to a surplus of US$1.3 billion in 1981. The consequent accumulation of reserves would not be inconsistent with the large increase in reserves reported by IFS.1/ On these assumptions, the balance of payments need would appear to have been much smaller (if it existed at all) than was expected when the program was formulated. It is possible that in the light of the discussion with the authorities, there may be substantial revisions in all items of the balance of payments for both 1980 and 1981.

III. China's Policy Stance

A preliminary picture of the authorities' policy stance can be pieced together from various published official statements made during the past year. The major uncertainties are related to the fact that the 1981-85

1/ This definition includes foreign exchange holdings of nonresident branches of the Bank of China.

Plan has not yet been finalized and, therefore, the detailed policies for this period have not yet been publicly discussed. It appears that no shift has occurred in the policy orientation formulated at the end of 1980 and that China plans to continue its policy of cautious expansion and structural readjustment of the economy in 1982. Investment will be oriented toward better utilization and improvement of existing productive capacity and the alleviation of energy and transportation bottlenecks. Agriculture and light industry will continue to receive priority, with heavy industry directed toward meeting the modernization needs of both agriculture and light industry. A modest increase in personal consumption will also be aimed at. The authorities anticipate that the readjustment policy will dominate developments over the Sixth Five-Year Plan (1981-85).

Financial stability is expected to be given high priority, and budgetary and monetary policy will be used to this end. The 1982 overall budget deficit is tentatively estimated by the staff to be 1.3 per cent of GDP; domestic financing is to be kept at about the same order of magnitude as in 1981 and it is expected to be accomplished through the issuance of Treasury Bonds. Efforts to ensure the more efficient use of working capital by state enterprises and their transfer of taxes and profits to the budget will receive special attention. It is also posssible that efforts will be made to reduce the budgetary burden of subsidies on basic necessities, which in 1981 are estimated to amount to Y 32.0 billion (or 28 per cent of total budgetary expenditure), compared to Y 7.8 billion in 1978. The policy of providing subsidies for basic necessities has been widely debated in China, and the view has been expressed that reductions in subsidies would have to be matched by wage increases. However, no consensus on this issue has as yet emerged.

The authorities' stance on balance of payments policy is perhaps the most unclear. In view of the cutback and reorientation of the investment program, imports of capital goods will be directed primarily to the projects the economy can absorb (single machines and high technology imports will be favored over turn-key projects). The need for expansion of exports is being stressed, but no details are known about new measures. Foreign borrowing will continue to be subject to close scrutiny so as to ensure its most efficient utilization and to maintain China's repayment obligations within reasonable limits. It is likely that, as a consequence of the re-launching of some import-intensive investment projects, the level of foreign borrowing will be somewhat higher in 1982 than the $3 billion anticipated for 1981. (No actual borrowing data are known.)

The economic reforms introduced on an experimental basis during the last several years will be evaluated and work will start on establishing an overall program for restructuring of economic management. Its major elements are: (1) upholding the central role of planning while relying somewhat on market indicators in determining plan targets and in orienting production outside of the plan; (2) strengthening central control over essential economic decisions while pursuing management reforms that give workers and staff greater incentives and decision-making power; and (3) gradually replacing management of the economy solely by administrative directives with a system that also uses economic incentives such as prices, credit, and taxation. During 1981 experience was gained in the financing of some investment expenditure through loans rather than through budgetary allocations, but prices and taxation have not yet been relied upon to guide resource allocation and participation in foreign trade.

IV. The Staff Team's Approach

The staff team will endeavor to obtain as comprehensive as possible a picture of developments and policies in 1981 and the present situation of the Chinese economy. It will also assess prospects for 1982 and ascertain to the extent possible the policies intended by the Government. Finally, it will make an effort to put these recent and prospective developments within a medium-term context. These tasks will be very difficult, given the limited statistical information and the reluctance of the authorities to discuss policies and forecasts that have not been disclosed publicly. A major drawback is that the 1981-85 Plan will not be available until the end of this year.

Based on the preliminary description of developments and policies presented above, the staff team would stress the following points as important for the purposes of present and near-term policies: (1) The emphasis on financial stability should be continued through budgetary and credit measures. (2) A key element for financial stability remains the containment of investment at levels that are commensurate with available resources. This requires tight control over budgetary investment and an effective means of influencing the level of extrabudgetary investment activity. (3) A further reorientation of investment along the lines pursued in 1981 is essential for raising the efficiency of investment and the growth potential of the economy. (4) Reform measures providing for a greater role for scarcity pricing, a minimizing of the distorting effects of the tax and profit transfer system, an improvement in the allocation of credit, and adequate producer incentives should be expanded where feasible. (5) Investment policy and reform measures should, in particular, be geared toward building up the economy's export capacity in order to sustain large future import requirements. (6) Given the need for large resources for development as well as for their efficient allocation, measures to contain budgetary subsidies to consumers and enterprises should be considered. (7) To promote the efficient conduct of foreign trade, steps should be taken to strengthen the link between domestic and foreign prices. This would involve a gradual change in the domestic price structure and an eventual unification of the exchange rate at an appropriate level. The large price distortions which have gradually accumulated over many years are a major hindrance to adjustment. However, only gradual action in this area can be expected in the near future. The authorities are aware of the far-reaching ramifications of major changes in the price structure and wish to avoid the potentially disruptive effects associated with such changes.

The authorities have repeatedly expressed interest in further use of Fund resources. If this subject is raised again during the consultation discussions, the staff team will state that consideration could be given to use of Fund resources only after it had reported its findings back to

Management and after the Executive Board had concluded the Article IV Consultation. For the briefing to you for such consideration, the staff team will try to get as much information as possible on: (a) the balance of payments, reserve and foreign debt position; (b) general government financial developments, including a more adequate coverage of revenue, expenditure, and financing transactions; (c) the investment strategy and the import requirements associated with it; and (d) the likely external financing needs, possible reasons for them, and the available means of covering them. The information obtained may not be sufficient, and an assessment will be made for you of additional information needed before a program can be considered.

The authorities are also expected to inquire about the possibility of a purchase under the Compensatory Financing Facility. The staff team will explain the data requirements and the other criteria for the use of Fund resources under this facility. A preliminary examination of the presently available data on exports and cereal imports and of tentative projections indicates that a drawing under the Compensatory Financing Facility would be difficult to justify at this time.

V. Task of the Advance Team

The team will try to gain a better understanding of the working of the monetary, price, fiscal, and trade and exchange systems. In addition, it will collect background information on the real sector (agriculture, industry, energy) and on the balance of payments. Progress in these areas is absolutely necessary in view of the limited coverage of our own past work and that of outside experts. Given the large area to be covered, the work of the advance team can only serve as a preliminary.

With respect to the monetary system, the team intends to study the interdependence between the real sector and the financial sector in order to assess the scope and effectiveness of monetary policy variables. The preparation, execution, and monitoring of the credit and currency plans will be studied using 1980 and 1981 data. The reforms in banking practices, as well as the choice between loan versus grant financing of enterprise investment, will be examined.

Turning to pricing policy, the focus will be on analyzing the present price structure and on making international price comparisons. The implications of pricing for resource allocation, budgetary revenue and expenditure, and foreign trade will be assessed. The last mission found it particularly difficult to tackle these issues in the discussions with the authorities. A detailed analysis of the methodology used to construct the major price indices, with special attention given to the weights assigned to state controlled prices, will also be undertaken.

The main topics in the area of fiscal policy are: the determinants of budgetary revenue; the foreign financing of the budget and associated expenditures; the scope of subsidies granted through and outside the budget; and the nature, size, and utilization of extrabudgetary funds. A preliminary assessment of financial reforms as they affect profit sharing between the central authorities, on the one hand, and enterprises and local governments, on the other will be made. If possible, experiments in tax policy and intergovernmental relations will also be reviewed, as will the authorities' system of budgetary and expenditure control.

In the area of the balance of payments, the focus will be on how the foreign trade plan is prepared and implemented and on the nature and scope of foreign trade activities undertaken outside this plan. The various policy tools used by the authorities to contain imports and promote exports, including the structure of incentives in this sector, will be studied. Special attention will be devoted to obtaining comprehensive statistics on foreign trade, the balance of payments, reserves, and foreign debt. As already mentioned, this will be a particularly difficult area where the problems relate not only to the authorities' reluctance to disclose detailed data but also to weaknesses in the collection and compilation of data.

The staff will examine the new legislation governing the exchange system and the introduction of an internal settlement rate for trade and a foreign exchange market. Particular attention will be paid to those multiple currency practices requiring approval under Article VIII, i.e., the internal settlement rate and the tax on the remitted profits of joint ventures. Of the two multiple currency practices, the internal settlement rate has not been approved by the Executive Board both because of lack of information of the way the rate operates and the unwillingness of the authorities to commit themselves to the eventual reunification of the exchange rate. The Fund's approval of the tax on remittances of joint venture profits will expire on March 31, 1982. (In a paper to be issued shortly, we propose that the approval be extended until the completion of the Article IV Consultation).

Appendix Table 1. China: State Budget, 1980-82

(In billions of yuan)

	1980		1981				1982
	Original budget	Outcome	Original budget	Program estimates 1/	Revised budget	Outcome	Budget
Revenue	102.9	104.2	107.5	98.5	97.6	97.9	106.0
Tax revenue	54.4	57.2	59.0	49.5	58.0	60.9	65.0
Nontax receipts	48.5	47.0	48.5	49.0	39.6	37.0	41.0 2/
Expenditure 3/	112.1	119.1	119.5	104.0	104.8	107.6	112.0
Capital construction	37.4	41.9	37.6	30.0	32.3	33.1	...
Other expenditure	74.7	77.2	81.9	74.0	72.5	74.5	...
Overall surplus/deficit	-9.2	-14.9	-12.0	-5.5	-7.2	-9.7	-6.0
Financing	9.2	14.9	12.0	5.5	7.2	9.7	6.0
Net foreign borrowing 3/	1.2	2.1	7.0	5.5	7.0	7.0	3.0 2/
Domestic financing	8.0	12.8	5.0	--	0.2	2.7	3.0
Memorandum item:							
Capital construction	50.0	53.9	...	30.0	...	41.7	...
State budget	37.4	41.9	...	30.0	32.3	33.1	...
Extrabudgetary	12.6	12.0	...	--	...	8.6	...

Source: Ministry of Finance and staff estimates.

1/ EBS/81/35.
2/ Preliminary and tentative staff estimate.
3/ It is assumed that loan amortization payments in 1980 and 1981 were the budgeted amounts of Y 2.2 billion and Y 1.0 billion respectively. Loan repayments in 1982 are assumed to be budgeted at Y 1.0 billion, though this is a very tentative staff estimate.

Appendix Table 2. China: Monetary Survey, 1979-81

	1979	1980	1981 Program estimate	1981 Outcome	1979	1980	1981 Program estimate	1981 Outcome
	(In billions of yuan, levels at end of year)				(Change in per cent)			
Net foreign assets	-1.6	-3.0	...	1.6	...	...	...	...
Domestic credit	212.9	258.4	282.5	293.5	15.1	21.4	9.3	13.6
Government 1/	9.0	17.0	17.0	17.0	...	89.1	--	--
Non-government 2/	204.0	241.4	265.5	276.5	10.2	18.4	10.0	14.5
Total assets	211.3	255.4	...	295.1	14.2	20.9	...	15.5
Money 3/	73.7	91.9	...	109.8	26.9	24.7	...	19.5
Of which: Currency in circulation	26.7	34.6	38.7	39.6	26.3	29.6	12.0	14.5
Quasi money 4/	40.6	52.2	...	63.3	31.4	28.6	...	21.2
Government deposits 5/	46.5	56.3	...	69.9	1.7	21.1	...	24.2
Other liabilities (net)	50.5	54.8	...	52.1	-0.1	8.5	...	-4.9
Total liabilities	211.3	255.4	...	295.1	14.2	20.9	...	15.5

Source: International Financial Statistics.
1/ Central Government.
2/ Includes credit to industrial and commercial enterprises, and credit to agricultural production units.
3/ Cash in circulation plus enterprise deposits.
4/ Individual deposits.
5/ Deposits of the budget, budgetary allocations for investment not yet spent, and deposits of government units, organizations, the armed forces and schools.

Appendix Table 3. China: Illustrative Balance of Payments, 1980-81

(In millions of U.S. dollars)

	1980		1981	
	Estimated outcome			
	Original	Revised	Program estimate	Estimated outcome
Exports	17,900	18,000	18,000	20,200
Imports	-21,000	-22,000	-23,000	-23,900
Trade balance	-3,100	-4,000	-5,000	-3,700
Net invisibles	1,900	2,000	2,100	2,100
Current account	-1,200	-2,000	-2,900	-1,600
Long-term capital (net)	2,100	2,100	2,000	2,000
Other capital (net) 1/	-1,750	-850	750	750
SDR allocation	150	150	150	150
Capital account	500	1,400	2,900	2,900
Total	-600	-600	--	1,300
Memorandum items:				
Fund drawings in the credit tranche	--	--	500	500
Reserves, end of period 2/				
BOP definition	900	900	1,400	2,650
IFS definition	3,116	3,116	...	5,564

Source: Staff estimates based on partial official information.

1/ Including errors and omissions.

2/ BOP definition excludes, while IFS definition includes, foreign exchange holdings of nonresident branches of the Bank of China. Gold is included at national valuation.

Fund Relations with China

(February 28, 1982)

Representation:	The People's Republic of China assumed representation of China in the Fund on April 17, 1980.
Quota:	China's quota was increased from SDR 550 million to SDR 1.2 billion on September 26, 1980. On December 28, 1980 China's quota was further increased to SDR 1.8 billion in connection with the Seventh General Review.
Status:	China continues to avail itself of the transitional arrangements of Article XIV.
Use of Fund resources:	China made a reserve tranche drawing of SDR 218 million effective November 4, 1980 and of SDR 150 million effective January 8, 1981. On March 2, 1981, China entered into a stand-by arrangement in the first credit tranche with the Fund equivalent to SDR 450 million, all of which has been purchased. On March 23, 1981, China obtained a SDR 309.5 million Trust Fund loan.
Fund's holdings of renminbi:	SDR 2,250 million or 125 per cent of quota.
SDR position:	After the allocation of SDR 122.4 million on January 1, 1981, China's total net cumulative allocation was SDR 236.8 million. SDR holdings are 229.3 million, or 96.8 per cent of total net cumulative allocations.
Exchange arrangements:	China notified the Fund on August 15, 1980 of its exchange arrangements. China's currency, the renminbi, is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions and the trends in their relative values. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi to the U.S. dollar. As of December 31, 1981, the representative rate for the renminbi was Y 1.7455 per U.S. dollar.

Last consultation:	Article IV consultation discussions were last held from December 1-10, 1980. The Staff Report SM/81/42 was discussed by the Board on March 2, 1981.
Other Fund visits to China:	There have been four missions to China. The first (March 1980) discussed the various aspects of China's membership of the Fund. The second (June 1980) gathered the information necessary for the quota paper. The third (December 1980) was a consultation mission and discussed the program supporting China's request for a stand-by and a Trust Fund loan. The fourth (February 1981) was a Bureau of Statistics' mission to discuss the publication of China's statistics in the IFS.
IMF Institute:	Two officials of the Bank of China participated in the Balance of Payments course (Oct.-Nov. 1980); two of the People's Bank of China (PBC) in the Financial Analysis and Policy course (July-Nov. 1981); one of PBC in the Government Finance Statistics course (Oct.-Dec. 1981); one of PBC in Techniques of Economic Analysis course (Jan.-Feb. 1982) and one in the Public Finance course (February-April 1982).

Relations of China with the IBRD

Representation:	The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.
Increase in capital:	On August 8, 1979, the Bank's Directors recommended that the Board of Governors approve a resolution authorizing China to subscribe to an additional 4,500 shares of the capital stock. This resolution was adopted on September 3, 1980, and the increase became effective on September 25, 1980, bringing China's subscription to 12,000 shares.

Lending activities: In June 1981, the Executive Board of the IBRD approved a $200 million loan to the university development project (total cost $295 million) to assist China in acquiring computer hardware in 26 universities. The financing of this loan is based on a 50-50 blend of IBRD and IDA funds. The first disbursement is expected to be made during the first half of 1982.

In 1981, the Bank also sent several missions to China to prepare a number of projects in the area of transportation, agriculture, energy, and industrial credit. A $135 million loan to the port development project which comprises port expansion works in Shanghai, Tianjin, and Huangpu will be presented to the Board by mid-1982. The industrial credit project which will assist in establishing the China Investment Bank, the agriculture development project, and the petroleum development project are expected to be presented by the end of 1982.

The tentative plan made by the Bank staff indicates that for the period 1981-86 the Bank's loan commitments to China may amount to $5.8 billion and disbursement may reach $1.1 billion.

	Commitments	Disbursements
	(In millions of dollars)	
FY 1981 1/	200	0.0
FY 1982	265	4.8
FY 1983	335	17.2
FY 1984	1,000	125.0
FY 1985	1,700	310.0
FY 1986	2,300	650.0

Economic Development Institute: During 1981, the Economic Development Institute conducted a three-week seminar for senior officials in Washington and two courses in Shanghai of five-seven weeks each. Six courses are planned to be conducted in Shanghai and Beijing in 1982.

1/ Ending June 30, 1981.

Mr. Guetian

Office Memorandum

cc: Mr. Allen

MB

To: Mr. Hubert Neiss   March 11, 1982

From: Aarno Liuksila AL

Subject: People's Republic of China--Briefing Paper: Article IV Consultation and Possible Use of the Fund's Resources

Our comments are:

1. page 1, second paragraph, last sentence:

"Immediately after the arrangement was granted China purchased the total amount of the arrangement. On [date]* China received a disbursement equivalent of SDR 309.5 under a Trust Fund loan approved together with the stand-by arrangement on March 2, 1981."

2. page 10, first full paragraph, starting on the third line:

". . . the staff representatives will explain the policies followed by the Fund in granting stand-by and extended arrangements. For the briefing . . . ."

3. page 12, add to the last paragraph:

"Of the two multiple currency practices, the internal settlement rate has not been approved by the Executive Board both because of lack of information of the way the rate in fact operates and the staff's difficulty in recommending substitute measures. The Fund's approval of the tax on remittances of joint venture profits will expire on March 31, 1982. [In a paper to be issued shortly we propose that the approval be extended until the completion of the Article IV Consultation]."

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* Verify the date which is "April 23" at page 1 and "March 23" in Appendix I.

cc: ETR
TRE

Office Memorandum

TO : The Acting Managing Director

DATE: February 3, 1981

FROM : Tun Thin

SUBJECT : China - 1980 Article IV Consultation Staff Report
- Request for Trust Fund Loan
- Request for Stand-By Arrangement

Attached please find the draft reports on the above items. Comments by Messrs. Blackwell (RES), Palmer (ETR), Beveridge (FAD), Chandavarkar (TRE), and Liuksila (LEG) have been incorporated, except as noted below.

Difficulties have arisen in three areas: (1) no detailed description of the budget could be given since the authorities could not yet supply detailed data on the 1980 budget outcome and the revised 1981 budget; (2) tentative staff estimates for international reserves had to be used since the authorities have not yet supplied reserves data in line with IFS definitions; and (3) at the beginning of the year, the Government introduced a depreciated exchange rate ("internal settlement rate") for trade and trade-related transactions. This constitutes a multiple currency practice requiring approval under Article VIII, Section 3).

Because of the lack of detailed fiscal data, Mr. Beveridge takes the view that the stand-by paper should not yet be issued. Mr. Palmer also has reservations on proceeding to issue the stand-by and trust fund papers with only global fiscal data and estimated reserves data. In addition, Mr. Palmer suggests that the restriction resulting from the introduction of the internal settlement rate for trade and trade-related transactions not be approved. His suggested wording replacing the penultimate paragraph in the staff appraisal and paragraph 2 of the Decision are attached.

When the staff mission was in Beijing, the Government started discussions on revising the original budget, approved last September, in order to strengthen the stabilization effort in the face of persisting inflationary pressures. The revisions aimed at balancing the budget, entailed cuts in a number of expenditure items, in particular a substantial reduction in "capital construction investment." In our meeting with the Minister of Finance, he was confident that the new budget would be approved by the Standing Committee of the National People's Congress early this year. Mr. Dai stayed in Beijing until the end of January to obtain the information. However, for reasons not entirely clear to me, the Standing Committee has not yet met to decide on the budget, and Mr. Zhang and Mr. Dai think it unlikely that a decision on the 1981 budget would be made within the next few weeks. Without this decision, the data on the 1980 budget outcome could also not be released. Under these circumstances, I see not much purpose in a delay in issuing the papers and in my opinion we could get by with the budgetary data contained in Tables 3 and 8 of the stand-by paper and the information provided in paragraph 9 of the policy statement of the Government.

On the issue of the multiple currency practice, we should recognize the different role of the exchange rate in a planned economy which the description in the report has also tried to bring out. While the distortions arising from dual exchange rates in market economies can be amply demonstrated, it is difficult to see major distortions resulting from the introduction of a separate settlement rate for trade transactions in China. Nor is it likely that this measure would have a significant discriminatory effect or was taken to obtain an unfair competitive advantage. The introduction of this rate was intended to eliminate losses on export transactions and profits on import transactions which arose from the discrepancies between foreign and domestic prices under the official exchange rate. As such, it is a step in the direction of creating a more rational price structure, and the authorities should be encouraged to experiment along these lines. Moreover, the operation of the new rate system will strengthen the Bank of China in monitoring the array of increasingly decentralized foreign trade transactions. On these considerations, I recommend Fund approval of the measure.

For your guidance.

Attachments

cc: The Managing Director (on return)
Messrs. Hood
Palmer
Beveridge
Evans
Williams
Watson

Staff Appraisal

Since the People's Republic of China assumed China's seat in the Fund, two new multiple currency practices subject to approval under Article VIII, Section 3, have been introduced (see pp. 25-29 above). The first practice results from the tax treatment of the remitted profits of joint ventures. Since the Chinese authorities have said that they will seek to replace the present measure with one that does not constitute a multiple currency practice, the staff recommend it be given Fund approval until March 31, 1982. The second measure, a new internal settlement rate for trade transactions, gives rise to a dual exchange rate system, with the official rate still applying to invisible and capital transactions. In the absence of complete information on the reasons for introducing a dual exchange rate system and of the policies which would lead to a unified exchange rate, the staff do not recommend that this measure be approved at the present time.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Section 3, and in concluding the 1980 Article XIV consultation with China, in the light of the 1980 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. China maintains restrictions on payments and transfers for current international transactions as described in SM/81/— (—/—/81) and SM/81/— (—/—/81). The Fund notes that the authorities intend to eliminate the multiple currency practice arising from the tax on the remitted profits of joint ventures and grants approval for the retention of this multiple currency practice until March 31, 1982. The Fund urges China to take early steps to eliminate its bilateral payments agreements with Fund members. The Fund also notes that the introduction of an internal settlement rate for trade transactions gives rise to a multiple currency practice.

1. SMA Approval
2. Proposed Decision } SAR

3. Table on OAS Budget Table 8,
4. Revised pp 9 (by annex) } SBA

cc: Mr. Palmer

Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: December 19, 1980

FROM : Tun Thin

SUBJECT : China--1980 Article IV Consultation and Use of Trust Fund and Fund Resources

A mission visited Beijing from December 1-10 to conduct the 1980 Article IV consultation discussions and negotiate a program for 1981 in conjunction with China's request for a Trust Fund loan (about SDR 307 million) and a stand-by arrangement in the first credit tranche (SDR 450 million). The staff team consisted of Messrs. Neiss, De Wulf, Ms. Le Gall (all ASD), Messrs. Goldstein (RES), Allen (ETR), Heller (FAD), Mrs. DeLaney (ASD), and myself. Mr. Dai, Alternate Executive Director for China, participated as an observer.

The Chinese delegation was headed by Mr. Shang Ming, Vice-President of the People's Bank of China. The opening and closing sessions were chaired by Mr. Li Baohua, President of the People's Bank of China, and the mission also had discussions with the Minister of Finance. Officials of the following other institutions participated in the meetings: People's Bank of China, Ministry of Finance, Ministry of Foreign Trade, Ministry of Commerce, Bank of China, State Planning Commission, State Energy Commission, State Statistical Bureau, State Price Bureau, and General Administration of Customs.

1. Background

Since 1977, when the country's leadership made fundamental changes in economic and political policies, a number of significant achievements have been recorded. The economy, and in particular agriculture and light industry, has moved forward strongly. A start has been made on restructuring the economy through management reform, some reduction in the excessive rate of investment, and a shift in prices in favor of agriculture. China is now more closely integrated with the world economy than at any time in the past 30 years, and resolute steps have been taken toward the goal of "modernization." The initial targets, however, proved to be too optimistic, and a policy of "consolidation" has been followed since mid-1979.

When the mission arrived, the authorities were conducting a critical review of this new policy, and had discovered that policy implementation was being hampered by entrenched interests in the provinces and in ministries. A decision was reached to intensify efforts to readjust the economy, to strengthen central control, and largely eliminate the deficit in the State budget. Special efforts are to be made to cut investment, especially in heavy industry.

2. Policy issues

The immediate issue policymakers face is an imbalance between demand and supply. Currency in the hands of the public has increased sharply as a result of two years' budget deficits financed by the People's Bank of

China. While consumer demand has thus increased, the expansion of supply has been constrained by bottlenecks in energy, transport, and agricultural raw materials. Inflationary pressures have manifested themselves in rising prices of those goods not covered by State control, as well as in the non-observance by enterprises of prices fixed by the State.

There are also formidable medium-term problems: (1) Heavy industry has been overextended at the expense of light industry, agriculture is insufficiently modernized, and the transport system is inadequate. (2) The optimistic views on China's energy potential of only a few years ago both within China and outside seem to have been unfounded. Indeed, the authorities expressed great concern about the limited energy supply, and this was confirmed by the energy team of the World Bank. The major oil field, supplying about half of China's oil output, has already passed its production peak, and so far, newly discovered wells have been few and small. There are large coal reserves, but because of the considerable investments required for mining and transportation, coal is not expected to relieve the energy shortage within the next few years. (3) Because of the isolation of China for two decades (since the withdrawal of Russian technical assistance in 1959) from international technological developments, the level of technology is generally low. Productivity and living standards in China are among the lowest in Asia.

3. Mission's position

We discussed the various policy measures of the Government to deal with these issues. Our comments focused on the role of imports and on investment policy. With respect to imports, we pointed out that, in addition to the measures stabilizing demand, increased imports could contribute to restoring balance between supply and demand in the short run. As many enterprises were working well below capacity for lack of inputs, imports of raw materials and intermediate goods would enable them to expand production and the supply of consumer goods. In the medium term, increased imports would be essential in supporting the process of restructuring and raising the level of technology by making it possible to replace equipment. We expressed the view that China could and should sustain a substantial current account deficit over the next years to modernize its economy and develop its considerable export potential. Presently, the deficit is only about 1 per cent of GNP and ample financing is available.

On the subject of investment policy, we pointed out that the cutting of investment would be beneficial both for stabilization and restructuring, and we expressed the hope that careful selectivity would be applied in such cutting so as to safeguard sustained growth in the medium- to long-run. We pointed out that energy and transportation and import-intensive investment should be cut the least.

We also observed that China's price structure does not adequately reflect relative scarcities. The authorities recognize the undesirable effects of the existing price structure on resource allocation but find it very difficult to implement major price changes in the near future, which would lead to a chain reaction over the whole spectrum of prices. They pointed out that the substantial increase in agricultural procurement prices in 1979 is one of the main reasons for the budget deficit and the recent upsurge in price increases. To improve allocation, we suggested the use of accounting prices reflecting the Government's priorities in making planning decisions.

Our comments were well received by the authorities and they assured us of their basic agreement with our position. They made considerable efforts to meet our data requirements; nevertheless, substantial gaps in our knowledge of the Chinese economy remain, especially in respect of micro-variables.

4. Program

The Government's program for 1981 is aimed at improving the supply capacity of the economy, safeguarding financial stability, and maintaining the external deficit within manageable proportions. In pursuit of these objectives, the Government intends to adopt a package of policy measures that includes: (1) substantial cuts in government expenditure, particularly in investment ("capital construction"), so as to achieve a near balanced budget (versus an estimated budget deficit of Y 10-11 billion, or 2.5 per cent of GNP in 1980); (2) limits on the expansion of cash in circulation (12 per cent) and on bank lending to enterprises (10 per cent), well below the rates experienced in 1980, (22 and 14 per cent, respectively); (3) giving priority to the energy sector in investment expenditures; (4) adoption of a variety of export promotion measures.

As a result of these measures, the Government expects a growth rate of real national income in 1981 of 4-5 per cent (versus 7-8 per cent in 1979-80), a reduced share of investment in national income, no increase in retail prices (versus an average increase of 3-4 per cent in 1979-80), and a deficit in the current account of $3 billion equivalent to about 1 per cent of GNP. The authorities project a balance of payments need of about $2 billion in 1981. However, their export forecast appears unduly pessimistic. Some of the forecasts in the Government's policy statement will be supplied in January, after the decisions on a revised 1981 budget are finalized. The Government's program also includes its intention to avoid the introduction of new multiple currency practices, or the introduction or intensification of other restrictive practices. (A minor multiple currency practice was discussed and will be submitted for Executive Board approval. We are still studying another measure, a new internal settlement rate for trade, which we were told was under consideration.)

5. IFS and Fund technical assistance

The authorities confirmed their intention, expressed privately to me during the Annual Meeting, of having a China page in IFS. For this purpose they will receive a mission from the Bureau of Statistics next February. Technical assistance in preparing a balance of payments statement and in setting up a system for monitoring external debt would be beneficial both to China and to our future work. Since changes in the fiscal system are under consideration, I indicated the possibility of getting technical assistance from the Fund in this area.

6. IBRD relations

While we were in Beijing, the representatives of the IBRD held their concluding discussions with the authorities. The IBRD mission included visits by five teams (agriculture, industry, energy, communications, and general economics) over a period of two months. We have been in contact with the Bank officials and discussed the major issues.

Enclosure: Policy Statement of the People's Republic of China Government.

cc: Mr. Watson
BUR
ETR
INS
FAD
LEG
OER
RES
TRE
ASD Senior Staff

CONFIDENTIAL

December 10, 1980

Statement by the Government of China on Certain Aspects of its Economic Policies

1. Economic policy in China is to realize the four modernizations--of industry, of agriculture, of science and technology, and of national defense--to further the progress of China's socialist economy and to improve the physical and cultural livelihood of its people.

To realize those objectives, since 1979 our country has implemented a policy of readjustment, restructuring, consolidation and improvement of the national economy and has carried out a series of readjustments between various sectors. This policy has achieved a certain degree of success, as is shown by the following facts: the rural economy has gradually revived; the reform of the economic management system has brought about a flourishing of the industrial and commercial sectors; the rate of growth of light industry has overtaken that of heavy industry; the rate of accumulation has begun to fall; trade is thriving in urban and rural markets; and a certain improvement has been registered in the people's livelihood. Because in our work we did not make an adequate appraisal of the difficulties and shortcomings caused by ten years of disruption, many of our efforts have not been fully successful. The insufficient reduction in capital construction, together with the increased procurement prices for agricultural and sideline products, the raising of the incomes of the urban and rural population, and certain other factors have resulted in an undue increase in the volume of currency in circulation. This, the deficit in the State budget, and the expansion of imports for development have caused a deficit in our balance of payments in both 1979 and 1980. Facing the inflationary phenomena which emerged over the last year or so and in order to ensure financial stability, we are determined fully and resolutely to implement the policy of readjustment. This will be done primarily by solving the problem of the over-extension of capital construction, by cutting down various expenditures, by resolutely practicing economy and by cutting waste. Thus we hope that with a stable growth of production, we shall be able to eliminate the budget deficit as soon as possible and control effectively the growth of currency in circulation. These measures, together with export promotion, will also help keep the external deficit within manageable proportions, and strengthen our balance of payments over the longer run. The measures, which are described in detail below, form a basis of the program for which financial support is requested in the form of a loan from the Trust Fund and 12 months' stand-by arrangement in the first credit tranche, equivalent to SDR 450 million.

2. Domestic liquidity--as measured by currency in circulation--rose by 26 per cent during 1979 and by ... per cent during 1980. This increase in money in the hands of the public, which reflects increased payments for agricultural procurement followed by wage increases granted in 1979, resulted in pressure on the prices of other products. However, these pressures were restrained by an increase in consumer goods supplied to the market, by a sharp rise in savings deposits of households, and by strict control over the prices of key commodities. Consumer prices, which rose by 2 per cent in 1979, are expected to rise 5 per cent in 1980.

3. Budgetary operations in 1979 resulted in a deficit of Y 17.09 billion, or 5 per cent of national income. The principal reason for the increased deficit was that several important economic measures were taken; for instance,

the procurement prices of agricultural and sideline products were raised, a part of all workers and employees had their wages increased, a bonus system was introduced, employment was expanded, and some agricultural taxes were reduced or exemptions from such taxes were granted. On the other hand, the target for expenditure on capital construction was exceeded. The State budget for 1980 provided again for a deficit of Y 8 billion, as a consequence of the many important economic measures taken the previous year, the adjustment of the prices of such goods as cotton, medicines, pig iron and coke, an increase in the number of enterprises entitled on a trial basis to retain part of their profits, and an increase in the rate of depreciation in the railway system.

4. Despite a good export performance--exports rose by 38 per cent in 1979 and by an estimated 30 per cent in 1980--the current account deficit widened because of the high import demand. Imports, primarily for development purposes, rose by 42 per cent in 1979 and are expected to increase by 16 per cent in 1980. The current account deficit amounted to $1.3 billion in 1979 and is estimated to be $100 million in 1980. The overall balance of payments surplus of $673 million in 1979 turned into a deficit of about $900 million in 1980.

5. Growth of real national income in 1979 was 7 per cent and is expected to be 6-7 per cent in 1980, compared with an average rate of 10 per cent during 1977-78. Industrial growth has been maintained at 8.5 per cent and 7-8 per cent in 1979 and 1980, respectively, as inefficient production processes have been phased out and some unprofitable enterprises shut down. Agricultural output increased by 8.6 per cent in 1979, but did not increase further in 1980 because of bad weather.

6. During the last two years, various reforms have been adopted which were intended to stimulate greater efficiency both in the agricultural and industrial sectors. Industrial management reforms have been introduced in a selected number of enterprises. They include the granting of a certain degree of autonomy to enterprises in areas of production arrangement, sales of products, distribution of profits, use of funds, etc. The role of banks has also been enhanced on an experimental basis in selected regions whereby bank loans have replaced budgetary allocations for investment in certain capital construction projects. The autonomy of selected local bank branches has also been increased. In agriculture, production brigades under the People's Communes have been given greater autonomy with respect to their production patterns, some procurement prices were increased, and larger amounts of industrial inputs were supplied. To liquidate excess inventories, / some flexibility has been introduced into enterprise pricing, such as allowing the prices of some machines and electrical goods to be lowered within certain limits. However, unjustified price increases, including disguised increases, still occur on the market. Recently the State Council has issued instructions to all localities to exercise strict price control and to limit the number of goods sold at negotiated prices. In foreign trade, imports of high technology goods and raw materials supportive of our export performance have increased. Exports have been given high priority, various new trade arrangements have been implemented, and a foreign investment code was recently introduced. However, the import quotas imposed by the United States and the EEC on some of our exports as well as constraints on domestic energy production have limited the potential for export expansion.

7. During the program period (January 1981-December 1981), the Government of China will continue the policies introduced in 1979-80 for the purpose of improving the supply capacity of the economy, safeguarding financial stability, and maintaining the external deficit within manageable proportions.

8. Real national income is expected to grow by 4-5 per cent, the highest achievable rate within the context of the readjustment policies the Government is undertaking. The share of investment in national income, which still amounted to approximately 31 per cent in 1980, is expected to be reduced to ... per cent in 1981. Total capital construction investment will be substantially reduced to Y ... billion, compared with Y 50 billion in 1980; it will be directed toward improving the efficiency of existing enterprises, postponing and lengthening the construction period of some projects, and inefficient investment projects will be scrapped. As a result, the number of unfinished construction projects should begin to decline. A large part of capital construction will be directed toward agriculture and light industry--both essential sectors for improving living standards. Prices are not expected to increase in 1981.

9. The 1981 State budget reflects the reorientation of output and investment: State capital construction will be kept at a level of Y ... billion, or ... per cent below 1980, with agriculture's share increasing from ... per cent in 1980 to ... per cent in 1981, and that of light industry from ... per cent in 1980 to ... per cent in 1981. The budget deficit will be further reduced. The 1980 deficit is Y ... billion below that of 1979, and the 1981 deficit is expected to drop by Y ... billion. In 1981, revenues are to increase by ... per cent to Y ... billion and expenditures by ... per cent to Y ... billion.

Adjustments will be made in the taxation and revenue sharing systems. The full remittance of profits to the State by the State enterprises will gradually be replaced by a system of partial profit retention, and ultimately by a profits tax on State enterprises coupled with other taxes on business enterprises. Local authorities are to be given greater autonomy with respect to their rights to specific tax revenues and retain a larger share of the revenues raised. The share of revenues transferred from lower level to central authorities will be held stable for longer periods, so as to allow the former more time to plan their medium-term expenditures and give them greater incentives to curb wasteful expenditure and to increase revenue.

10. Consistent with both the expected growth rate of real national income and the elimination of the budget deficit at the earliest possible date, the Government intends to limit the expansion of cash in circulation during 1981 to 12 per cent. To improve the efficiency of financial management, enterprises will finance a larger share of their investments through bank loans rather than through budgetary grants. Banks will be given greater discretion with regard to the allocation of these loans, and their lending to enterprises is expected to expand by no more than 10 per cent in 1981. Enterprises will also be charged a fee for the use of fixed and working capital provided by the State.

11. Inadequate energy supplies have slowed the pace of economic growth in the past few years. Therefore, the Government of China is according priority to the energy sector to permit capacity utilization both in the agricultural and the industrial sectors. Recently, a new State Energy Commission was created to formulate and coordinate the execution of short- and long-run energy policies. These policies will emphasize increased exploration and

exploitation of energy sources, and energy conservation. The conversion of oil-using facilities to coal-using facilities will be encouraged so as to make use of the rich resources of coal and conserve oil. Investment in the energy sector will be given priority. In 1980, offshore exploration, with the assistance in some areas of foreign firms, has yielded economically exploitable reserves. During 1981, joint exploration and development contracts will be signed, but the offshore oilfields are expected to start production only by 1984.

12. In the years to come, China will expand its imports in order to promote the modernization of its economy. At the same time, efforts to achieve a concomitant increase in exports will be intensified, so as to maintain a viable external position. When these policies have taken their full effect, foreign trade will assume a substantially greater role in China's economy than it presently has.

The emphasis on export expansion is embodied in a variety of measures: New export enterprises are being established; all levels of Government are being required to give priority to export work, and supporting measures include preferential allocation of credit, raw materials, fuel, power, labor, and packaging materials, priority in domestic purchasing, and the coordination of transport facilities and schedules; greater autonomy is being given to lower levels of Government and enterprises in the management of foreign trade; a number of special export zones have been established; finally, more flexible international trade practices have been introduced, such as cooperative production with a foreign partner.

During 1981, a current account deficit of $1.9 billion is expected. Because of normal repayments on capital account, new borrowings of about $3 billion will be required to finance the overall deficit. All foreign borrowing will remain subject to intense scrutiny to ensure that the terms are reasonable and that the loans are put to effective use. The Government will continue its policy of prudent debt management.

13. During the period of the program, the Government of the People's Republic of China does not intend to introduce new multiple currency practices, or to introduce new or intensify existing restrictions on payments and transfers for current international transactions, or to introduce new or intensify existing restrictions on imports for balance of payments purposes, or to conclude new bilateral payments agreements with Fund member countries.

14. The Government of the People's Republic of China believes that the policies set forth in this memorandum are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. China will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultation.

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: November 7, 1980

FROM : Tun Thin and Donald K. Palmer

SUBJECT : China - Briefing Paper

Attached is the briefing paper for the 1980 Article IV Consultation with China and the possible Use of Fund Resources (Trust Fund loan and drawing of regular Fund resources in the first credit tranche). The paper has been cleared by Messrs. Evans (LEG), Williams (TRE), and Yandle (FAD).

Mr. Tun Thin's last day in office is Wednesday, November 12.

cc: Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Briefing Paper for the 1980 Article IV Consultation and Possible Use of Fund Resources

Prepared by the Asian and Exchange and Trade Relations Departments

(In consultation with the Legal, Treasurer's, Research, and Fiscal Affairs Departments)

Approved by Tun Thin and Donald K. Palmer

November , 1980

I. Introduction

A staff team consisting of Tun Thin, Hubert Neiss, Luc De Wulf, Francoise Le Gall (all ASD), Morris Goldstein (RES), Mark Allen (ETR), Peter Heller (FAD), and Merle DeLaney (ASD, secretary) will conduct the 1980 Article IV consultation discussions and negotiate ad referendum a financial program in connection with China's request for a Trust Fund loan and possibly for a first credit tranche drawing during December 1-12, 1980. An advance team will start work in Beijing on November 20 to collect and clarify the statistical material.

The People's Republic of China assumed representation of China in the Fund in April 1980, and China's quota was increased to SDR 1.2 billion in September 1980. In connection with the Seventh General Review, China may consent to a quota up to SDR 1.8 billion. After a reserve tranche drawing of SDR 218.1 million in November 1980, Fund holdings of renminbi are equivalent to 100 per cent of quota. China used SDR 110.5 million to pay for the quota increase in September 1980, and present holdings amount to SDR 222.0 million, or 194 per cent of net cumulative allocations of

SDR 114.4 million. (China will need up to SDR 150 million to pay for the quota increase in connection with the Seventh General Review).

China has requested to be made eligible to receive a loan from the Trust Fund (TR/80/27, to be discussed by the Executive Board later this month). China's loan from the Trust Fund would amount to about SDR 300 million. China may also request a drawing in the first credit tranche. Its access to regular Fund resources under the first credit tranche is equivalent to SDR 300 million at present, but would be be SDR 450 million when China's quota is increased to SDR 1.8 billion.

II. Economic Background

During the past few years, the Chinese economy has undergone sharp changes: widespread disruptions of activity led to a decline in growth during 1975-76: an overambitious development program aimed at rapid expansion during the following two years (1977-78) resulted in overheating--supply bottlenecks, a large volume of unfinished construction, and a widening trade deficit; efforts at stabilization and consolidation since 1979 under a three-year transitional program (1979-81) have resulted in a slowdown of growth and investment.

During 1979-80, GDP growth moderated to about 7 per cent per annum from the 9 per cent rate achieved during 1976-77. Price stability has been maintained, but because of large adjustments in the structure of agricultural prices, the cost of living index rose by 6 per cent in 1979, compared with its historical trend of 1 per cent per annum. The opening of the economy to international trade has proceeded vigorously. The rapid growth of exports has continued into 1980, while the very high growth of imports has recently slowed down, reflecting the moderation in investment growth. The current account deficit is, nevertheless, expected to widen to $1 billion in 1980, and according to a recent official forecast, will be $2 billion in 1981. The authorities have initiated various structural and administrative reforms aimed at modernizing the economy and at alleviating a number of fundamental problems associated with the pattern of development over the past decades.

III. Current Policy Issues

The authorities are currently concentrating on two principal concerns: safeguarding financial stability in the face of inflationary pressures that have emerged in the last two years; and improving the long-run development performance.

Official concern about financial stability was heightened by the large expansion of cash in circulation, the most relevant monetary aggregate (26 per cent during 1979), and the emergence of a sizable deficit in the State budget (Y 17 billion, or 4 per cent of GDP in 1979). Efforts are being made to reduce the expansion of cash in circulation which is mostly held by households and the spending of which is not controlled. Budgetary expenditures are being tightened to achieve a substantial reduction in the budget deficit (to Y 8 billion in 1980 and Y 5 billion in 1981). Various official statements make clear the authorities' view that the process of longer-run structural change and reform has to take place under conditions of financial stability in order to be successful.

Despite the impressive results recorded since the establishment of the PRC in 1949--high growth and price stability, building of an industrial base, the large expansion of agriculture, provision of basic needs to a population of 1 billion--the authorities believe that serious flaws in the development process have emerged, which, if uncorrected would jeopardize the continuation of rapid and stable development. Their critical analysis, which has been extensive and quite frank, emphasizes three major interrelated distortions: (1) sectoral imbalances resulting mainly from overexpansion of heavy industry at the expense of light industry and from underinvestment in agriculture; (2) an unsustainably high investment ratio (up to 36 per cent of GDP in 1978), which permitted little or no expansion in per capita consumption; and (3) low productivity as a result of outdated technology, inadequate incentives, and administrative inefficiency.

The efforts of the authorities to remedy these fundamental problems aim at: (1) a restructuring of the economy through shifting investment resources to light industries and agriculture, as well as to transportation and energy to relieve bottlenecks; (2) a downward adjustment of investment through the elimination of unprofitable and low-priority projects; and (3) an increase in productivity through various reforms in the system of planning and economic management and through the introduction of new technology, in particular a greater utilization of advanced technology, where appropriate, as embodied in imports and foreign investment; the reforms which are still being evolved and gradually extended to a large number of enterprises and regional entities have attracted the world's attention during recent months. They encompass inter alia the use of an inter-enterprise market for trade in products above the plan targets, bonus schemes for employees, greater financial accountability by firms for their use of capital resources, profit-retention schemes for state enterprises, revenue sharing by provincial and municipal authorities, and greater regional decentralization in the management of state financial resources. All of these will provide for more flexibility and greater incentives than the system has provided in the past.

IV. The Staff's Approach

While a comprehensive analysis of the Chinese economy in its present transitional stage is beyond the scope of a single mission, the staff team will undertake a macroeconomic analysis of economic growth and stability in the context of China's command economy, and thus endeavor to gain a broad understanding of how the economy works, its recent development trends, and the likely direction it will take in the near future. It will also study the foreign trade and exchange system and assess its significance for external and domestic developments. As required under the Article IV consultations, the staff team will gather material on exchange rate policy for inclusion in the staff report. Furthermore, the staff team will closely cooperate with the IBRD mission (50 staff members are visiting Beijing between mid-October and mid-December 1980) which will assess China's longer-run development and borrowing potential. An agreement on a modest loan for education, the first World Bank loan, is planned before August, 1981.

The policy discussions will focus on the development strategy being formulated by the authorities and the reforms in economic management currently being implemented and expanded and on the implications for growth, financial stability, and external sector developments.

The new direction being taken by the development strategy and the reforms, if implemented on an extensive scale, could lead to substantial changes in the operation of the economic system, as well as to a closer integration with the world economy. Under these changed conditions, policies to increase the efficiency of resource allocation, ensure external equilibrium, and preserve domestic financial stability will become increasingly important. On particular aspects, the following points merit emphasis in the staff's tentative view: (1) With respect to improving resource allocation, attention will need to be given to the usefulness of changing the degree of decentralization of decisions in key areas and of changing the role accorded to various incentives and control instruments including prices. The role accorded market-related prices is insignificant, but will be enhanced by the introduction of "negotiated prices" between enterprises for certain goods and the greater scope for decision-making by enterprises in general. A review of the whole structure of controlled prices may also be appropriate. (2) On external policies, the expansion of imports, within the constraints of the economy's absorptive capacity, should be encouraged as an essential element in introducing modern technology and reorienting investment. At the same time, the expansion of the economy's export capacity should be vigorously pursued. In promoting exports, the role of foreign trade corporations and of market related prices should be reviewed with a view of providing strong incentives. (3) The role of budgetary and monetary policy in the past has been mainly to assist and monitor the implementation of the "real" plan. However, with the decentralization of decision-making, the implementation of financial reforms, and with more activity taking place outside the strict planning framework, continued price stability will require policies for the effective control of overall financial aggregates.

V. Financial Program

Assuming that the Executive Board decides that China is eligible to receive a loan from the Trust Fund for the second period, the staff team will assess the balance of payments need and if sufficient need exists, negotiate a one-year program with first credit tranche conditionality starting November 1, 1980. If the authorities also request access to regular Fund resources, the program would at the same time be in support of a drawing in the first credit tranche. The program would have to be aimed at sustaining China's domestic and external stability during a period when efforts to restructure the economy and reform the system are likely to be accompanied by increased pressure on domestic resources and high import requirements. Borrowing from the Fund would thus support China's increasing integration in the world economy.

The authorities are in the process of implementing a reasonably tight stabilization effort, concentrating on moderating investment expenditures, reducing the deficit in the State budget, and restraining the growth of cash in circulation. Under these circumstances, they should have little difficulty in formulating and agreeing on a policy program with the staff team. Complementary to the stabilization effort, the program should be focused on the expansion of the economy's capacity to supply exports to assure external viability in the longer run in light of increasing import demand. The main elements of the program would be: (1) output and investment targets consistent with the envisaged structural changes; (2) an import program which is compatible with the economy's absorptive capacity and a sustainable current account deficit; (3) effective export promotion measures; (4) fiscal and monetary measures consistent with the real targets so as to ensure financial stability, in particular limits for the deficit in the State budget and for cash in circulation; and (5) a continuation of the reform efforts at a pace the authorities consider appropriate in light of the emerging results of the initiatives taken over the recent past.

Foreign indebtedness is not a problem; China secured large credit lines with foreign banks in 1979 (about $27 billion), but has been extremely cautious in making disbursements. The intention to continue the prudent debt management policies would be part of the policy statement of the authorities. The program will also contain the standard obligations with respect to the restrictive system.

Fund Relations with China
(November 4, 1980)

Quota:	On April 17, 1980 China's quota was SDR 550 million but was increased to SDR 1.2 billion on September 26, 1980. China may consent to a quota increase up to SDR 1.8 billion in connection with the Seventh General Review.
Status:	China continues to avail itself of the transitional arrangements of Article XIV.
Use of Fund resources:	China made a reserve tranche drawing of SDR 218 million effective November 4, 1980.
Fund's holdings of renminbi:	SDR 1.2 billion or 100 per cent of quota.
SDR position:	Total net cumulative allocations SDR 114.4 million; holdings 222.0 million or 194 per cent of total net cumulative allocations. (China will need up to SDR 150 million to pay for the quota increase in connection with the Seventh General Review.) On January 1, 1981, China will be allocated SDR 122.4 million if present quotas are then in effect or if the quota increases under the Seventh General Review were to be proportional.
Exchange arrangements:	China notified the Fund on August 15, 1980 of its exchange arrangements. The RMB is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions and their trends in their relative values. The representative rate is determined as the mid-point between the buying and selling rate of the RMB to the U.S. dollar. As of November 7, 1980 the representative rate was RMBY 1.5279 per U.S. dollar.
Fund visits to China:	There have been two Fund missions to China. The first mission (March 1980) discussed the various aspects of China's membership of the Fund. The second mission (June 1980) gathered the information necessary for the quota paper.

Mr. Allen

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: June 6, 1980

FROM : Tun Thin and R.J. Familton

SUBJECT : People's Republic of China--Briefing Paper

Attached for your approval is the draft briefing paper. It has been cleared with Messrs. Hood (RES), Nicoletopoulos (LEG), Palmer (ETR), Beveridge (FAD), and Williams (TRE).

Attachment

cc: Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

People's Republic of China

Briefing Paper--Request for Quota Increase

Prepared by the Treasurer's, Asian, and Exchange and Trade Relations Departments

(In consultation with the Legal Department)

Approved by Walter O. Habermeier and Tun Thin

June 6, 1980

A staff team consisting of Messrs. Hubert Neiss (Head of Mission, ASD), Luc De Wulf (ASD), Morris Goldstein (RES), Mark Allen (ETR), Ms. Francoise Le Gall (ASD), Laszlo Garamfalvi (FAD), Teizo Taya (TRE), and Mrs. Clementina J. Colliflower (Secretary, ASD) will visit the People's Republic of China for about two weeks to gather data and information in connection with the request of the Chinese authorities to increase its quota outside a general review of quotas. The date of the visit has not yet been determined. It is estimated that a paper for the Executive Board can be prepared in five weeks after that date.

I. Background

The Executive Board decided on April 17, 1980 that, with effect from that date, the Government of the People's Republic of China would represent China in the Fund and would exercise all its rights and meet all the obligations of China as the member of the Fund and the participant in the Special Drawing Rights Department. China's quota has remained unchanged since it joined the Fund as an original member in 1946. The intention to request an increase in China's quota was referred to in the memorandum of April 4, 1980 (EBS/80/78) that was attached to the letter from China on its representation in the Fund. The request for a quota increase was expressed formally in a letter dated May 28, 1980 by the Governor for China to the Managing Director.

II. Issues to be Discussed

1. Procedures for a special quota increase

The staff team will explain the procedures to be followed for a quota increase as was done by the previous mission. It will note in particular that an increase in a member's quota requires an 85 per cent majority of the total voting power of the Board of Governors', that the increase in quota must be fully paid before it can go into effect, and that under the guidelines, a portion amounting to between 20 and 25 per cent of any increase will be paid in reserve assets. The staff team will also explain that there can be no assurance that a quota increase can come into effect in time for it to be taken into account in the next election of Executive Directors.

2. Data required for quota calculations

If the request for the increase in quota is handled by the Executive Board before the quota increases approved under the Seventh General Review of Quotas come into effect, the quota calculations would be made on the basis used in calculating quotas under the Sixth Review of Quotas. However, the staff team will obtain the data required for calculating quotas under both the Sixth and Seventh Reviews:

	Sixth Review Period	Seventh Review Period
National income	1972	1976
Reserves	end-1972	end-1976
Imports (c.i.f.)	1968-72	1972-76
Exports (f.o.b.)	1960-72	1964-76
Current receipts	1960-72	1964-76
Current payments	1968-72	1972-76

The staff team will also obtain information on the definition, coverage, etc. of these data as necessary for their interpretation.

In addition to the above data, the staff team will also need to obtain (1) the latest available figures of external reserves (gold and holdings of convertible foreign exchange), (2) annual (arithmetic) average U.S. dollar/Chinese yuan ($/Y) exchange rates for 1960-79, and (3) $/Y exchange rates at end-1972, end-1976, and the date for which the latest reserves figure is available. In the event that U.S. dollar/yuan exchange rates are not readily available, the staff will request data on the exchange rates for other major convertible currencies, in particular sterling.

3. Seventh General Review of Quotas

In the event that the increase in quota for China is handled on the basis of the present quotas of members, which were determined under the Sixth General Review, the staff mission will point out that a recommendation will be made to permit China to increase its quota further on the same terms as the quota increases that have been approved by the Board of Governors under the Seventh General Review and to come into effect when the Seventh Review quotas will come into effect, i.e., an increase of up to 50 per cent of which 25 per cent will be paid in reserve assets.

4. Economic background

In order to be able to provide an overview of the structure and development of the economy in the paper to the Executive Board, the staff team will review with the authorities the planning system, national income and product, prices, foreign trade, the balance of payments, public finance, money and banking, international reserves, and external debt. It will inform the Chinese authorities that basic statistical data in a sufficiently disaggregated form in these areas would be needed to provide an adequate background to the deliberations by the Executive Board on the quota increase.

5. Exchange arrangements and restrictive system

The staff team will discuss the form of an Article IV notification of exchange arrangements and will urge the Chinese authorities to submit their notification as soon as possible. The team will obtain a full description of the restrictive system and will request all regulations governing the restrictive system.

6. Other matters

China has not yet informed the Fund of a representative rate of exchange for the yuan. The staff mission will raise this matter with the Chinese authorities, pointing out that the determination of a representative rate is essential for the conduct of all operations and transactions with the Fund, including the payment of any quota increase. Agreement on authentication of communications with the depository has to be reached before effective payment can be made.

Mr Allen

Office Memorandum

TO : The Managing Director

DATE: March 14, 1980

FROM : Tun Thin

SUBJECT : People's Republic of China - Briefing Paper

Please find attached the briefing paper for the forthcoming mission to the People's Republic of China.

For your approval.

Attachment

cc: The Deputy Managing Director
Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Briefing Paper: Staff Mission to the People's Republic of China

Prepared by the Asian, Legal, Secretary, and
Treasurer's Departments

(In consultation with Exchange and Trade Relations, and
Research Departments)

Approved by Tun Thin, George P. Nicoletopoulos, Leo Van Houtven,
and Walter O. Habermeier

March 13, 1980

At the invitation of the Chinese authorities, relayed by Mr. Cao Guisheng, Counselor, at the Embassy of the People's Republic of China (P.R.C.) in Washington, a staff mission will visit the Bank of China for a period of about two weeks during late March and early April. The staff members will be: Mr. Tun Thin (ASD), Mr. James G. Evans, Jr. (LEG), Mr. David Williams (TRE), Mr. Joseph W. Lang, Jr. (SEC), Mr. Morris Goldstein (RES), Mr. Luc H. De Wulf (ASD), Mr. Mark Allen (ETR), Ms. Francoise Le Gall (ASD), and Ms. Elizabeth Howe (secretary, ASD).

The purpose of the mission is to explain the technical aspects of membership in the Fund, to describe the rights and obligation of membership in the Fund, to assess the availability of economic statistics and gather economic information and data for any future background paper on the P.R.C. and to answer questions on these and other technical matters raised by the P.R.C. authorities. The premise on which the Fund views the succession of the P.R.C., as the government representing China in the Fund in place of the Republic of China (R.O.C.), is that the consequence of such a change includes the succession to, and assumption of all the rights and obligations of the member China at the time of the succession. The terms of reference for the visit do not include the negotiation of issues that might arise with respect to (i) an increase in the quota for China, or the indication of any alternative size of quotas, (ii) representation on the Executive Board, and (iii) the pending restitution of gold.

As regards the issue of the quota, the staff will explain the procedures followed for quota increases (as indicated in Section 2(c) below), including those needed in the event that the P.R.C. authorities would request, after assuming the membership for China, an increase in quota that was outside a general review of quotas. In this latter connection, the staff will state that there are grounds to support a higher quota and will explain that the process to effect an increase is unlikely to be concluded quickly.

The technical aspects of membership that will be covered will include the items below.

1. Exchange arrangements, surveillance and provision of information

The obligations of members under Article IV and Articles VIII and XIV, will be reviewed, including the requirements that a member supply the necessary information on its exchange arrangements, exchange controls and other controls on imports and exports. The Principles and Procedures for Surveillance will be presented, including the consultation process. The mission will explain that the economic information the Fund requires members to provide is not limited to the items specified in Article VIII, Section 5. The information the Fund deems necessary for its activities, including that required for conducting surveillance, for operating the Fund's accounts, and for the consultation process will be set out. The need for information to be included in an IFS country page will be explained and stressed. Be specific. v. important that China do not disregard the provision of figures for a IFS page.

DTID [illegible]

MD Board precedent is Romania — We are too weak

This would be solved + time by time

The P.R.C. has had an uneven record of publishing statistics about its economy. While in the 1950s statistics were systematically compiled and published, a virtual blackout on such statistics that started in 1960, was only partially lifted in June 1979. No monetary statistics, no data on debt and foreign reserves, and no elements of the balance of payments, other than statistics on exports and imports, have as yet been released. The staff will inquire from the PRC representatives the extent to which the information that is required for Fund membership is being collected at present, and will seek to determine if there are any limitations on the ability of the P.R.C. to collect and supply such information.

2. Financial relations and quota

a. Status of account

At the time of succession, financial relations and the status of China's accounts with the Fund will be noted and explained (details in Annex).

b. Fund facilities

The staff mission will describe the various facilities of the Fund and the principles and policies governing access, including the concept of conditionality. The Fund's policies on repurchases will also be described.

c. Quota

Factual information regarding Fund quotas, including China's quota, will be provided if requested by the Chinese authorities. The Fund's policy as regards the payment of subscriptions, including that part paid in reserve assets, will be outlined and appropriate documentation left with the authorities. If requested, the mission will outline the procedures regarding increases in quota, including those under a general review of quotas and the information needed to make quota calculations.

The functions of quotas in the Fund will be described. It will be pointed out that a decision on an increase in quota must be taken by the Board of Governors with an 85 per cent majority of the total voting power. The staff would note that the Resolution on the Seventh General Review of Quotas has been approved by the Board of Governors.

d. Operational and technical matters

The staff will explain the Fund's operational procedures in the General Resources Account and the Special Drawing Rights Department. In this connection, the technical and operational steps which need to be taken by members will be described and appropriate sample documentation, including those needed for requesting use of the Fund's resources, will be left with the Chinese authorities. The discussion will cover the currency unit, the determination of the representative rate of exchange for the currency, the establishment of the Fund's depository and fiscal agency, the payment of subscriptions, especially the timing in relation with the change in representation to the P.R.C. and the procedures related to the exchange of currency. The establishment and operations of the Fund's accounts with the depository will be discussed. The information to be supplied and actions to be taken in connection with effecting transactions with the Fund will be described.

The working of the Special Drawing Rights Department will be explained. Procedures regarding the allocation of SDRs and participation in allocations, assessments, use of SDRs and the reconstitution provisions, and the payment of charges and receipt of interest on SDR use will be outlined and appropriate documentation left with the Chinese authorities.

3. Organizational and administrative matters

The structure of the Fund will be explained, including that each member appoints its Governor and Alternate Governor, that the Executive Board is normally composed of five Executive Directors appointed by the five members with the largest quotas but that there are now six because of the operation of Article XII, Section 3(c), and that the remaining 15 are elected by constituencies of other members. It will be noted that China (R.O.C.) did not participate in the 1978 election of Executive Directors and no Executive Director looks after the interest of China at the Executive Board. It will be noted that an election will be held at the next annual meeting this fall, with those elected taking office on November 1, 1980. If asked about how constituencies are made up for the election of Executive Directors, the staff will state that this is a purely political question that is settled among the members themselves but will explain the rules for elections as adopted in the past, subject to the caveat that the rules for the election this fall will not be considered until the summer. The staff will also explain the right to representation at meetings of the Executive Board of a member not entitled to appoint an Executive Director.

The requirement of Article IX, Section 10, that a member take all action necessary in its territories to make effective in terms of its own law the status, privileges and immunities set forth in Article XX, and to inform the Fund in detail of the action taken will be noted and explained.

The authorities will be informed that the recognition of P.R.C. as the Government representing China in the Fund will require a decision by the Executive Board.

The form of communication that the P.R.C. authorities might send to succeed to the membership of China may be discussed, and a draft will be left behind.