Office Memorandum

Mr. Finch
my file

TO: The Managing Director
The Deputy Managing Director

November 18, 1986

cc: Mr. Brau
Mr. Brachet

FROM: A. F. Mohammed

SUBJECT: Colloquium in China

The Colloquium on the theme of "Macroeconomic Management, Growth and the Role of the IMF" was organized in Beijing from November 11-17, 1986 under the joint sponsorship of the Fund, the People's Bank of China (PBC) and the State Commission on Economic Restructuring (SCER). The Deputy Managing Director made the opening address and six staff members presented papers. The staff team consisted of Ms. Koenig (CBD) and Messrs. Brachet (ETR), Crockett (RES), Scott (ASD), Tanzi (FAD), and Mohammed (EXR). From the Chinese side, there were five papers on parallel subjects. The Chinese authorities invited Messrs. Finaish, Fujino, Salehkhou, Sengupta, and Zecchini to China on the occasion of the Colloquium.

About 150 participants from all over the country attended the plenary sessions; they were divided into three discussion groups, with two IMF staff leading the discussions in each group. In addition to middle-level staff from the two sponsors, officials from the State Planning Commission, the Ministry of Finance and its provincial bureaus, the specialized banks and research/training institutes attached to the principal state agencies were present. Each plenary session was chaired by a senior official from one of the sponsoring agencies and several of them also participated in the discussion groups. The opening and closing ceremonies were jointly chaired by Deputy Governor Liu Hongru (PBC) and Vice Chairman An Zhiwen (SCER). Governor Chen Muhua attended the opening session and Mr. Xiang Huaicheng, Deputy Minister of Finance, was present at the last session. The IMF group was received by Vice Premier Tian Ji-Yun, who supervises the economics and finance portfolios. The duration of the Colloquium was shortened by a day by moving the closing ceremonies to November 16 (see attachment).

The Colloquium appears to have been a timely event, this being a period of intense debate on the efficacy, under Chinese conditions, of indirect instruments of macroeconomic management. From the statements made by even rather junior officials during the discussions, it is evident that the debate is not confined to the leadership but is being conducted at all levels in the official and academic communities. Both in the papers presented by the Chinese experts and in the day-to-day interventions, one was struck by a marked absence of cant or rhetoric and by the forthright and probing approach to issues, of which perhaps the most pressing was that of introducing greater rationality into decision-making at the enterprise level. The decentralization of governmental powers from the central planning authorities to local authorities was seen to have resulted in a virtual loss of control over enterprise investment spending as well as over the wage-bill, given the conflicts of interest inherent in the vesting of ownership of many enterprises with the local governments. The spending spree of 1984-85 was accompanied (and made possible) by an accommodating expansion of credit through the specialized banks and through foreign borrowing (typically via trade credits). While this excessive expansion has been brought under control in recent months, participants reported active resistance to the centralizing of decisions on foreign borrowing, foreign exchange allocations or domestic credit extension. That these issues could surface in the presence of IMF staffers suggests the freedom of debate that is now possible in China and (perhaps) a willingness to treat the IMF as part of the "family." On this basis alone, the staff participants would regard the Colloquium as a success. The Chinese authorities were complimentary in their concluding remarks and I would accept these expressions as rather more than politeness on their part.

One caveat is in order. Throughout the discussions, and particularly at the end, when a meeting was held with a Chinese group drafting a report on the Colloquium for their leaders, the staff participants felt dubious as to whether the participants had any genuine understanding of how markets emerge and function or how so-called indirect policy levers can be applied without quite fundamental changes in property relations, the legal infrastructure and without relaxing the rigidities in internal labor or capital mobility. (Indeed, the decentralization process would appear to have reinforced the centrifugal tendencies in the Chinese system, making the emergence of a truly *national* market even harder to visualize.) There is clearly a need for a much expanded educational effort, both with the Fund's normal interlocutors and, also, in a much broader forum, beyond the usual staff contacts, through training and publishing activity. (A separate report is being submitted on the latter subject.)

Attachment

cc: Heads of Departments, Bureaus, and Offices
Mr. Brown

ATTACHMENT

Program for a Colloquium

on "Macroeconomic Management, Growth, and

the Role of the IMF"

Co-Sponsored by the

International Monetary Fund (IMF)

and the

People's Bank of China (PBC)

with the

State Commission on Economic Restructuring (SCER)

November 11-16, 1986

Beijing

ATTACHMENT

November 11

Morning — Opening ceremonies

Address by Governor Chen Mu-hua, PBC

Address by Richard D. Erb, Deputy Managing Director, IMF

Afternoon — Session chaired by Shang Ming, Advisor, PBC

"The Role of the Fund in Bilateral and Multilateral Surveillance"

Speaker: Andrew Crockett, Deputy Director, Research Department, IMF

Discussant: S. Zecchini, Executive Director, IMF

Film, "The IMF at Work," Chinese language version.

Meeting with Tian Ji-Yun, Vice-Premier, China

November 12

Morning — Group discussions

Afternoon — Session chaired by Vice Governor Liu Hongru, PBC

"The Role of Monetary Policy and Instruments"

Speaker: Linda M. Koenig, Deputy Director, Central Banking Department, IMF

"In Transition to a Planned Financial System"

Speaker: Yu Guan-tao, the Institution for Financial Research, PBC

Discussant: G. Salehkhou, Executive Director, IMF

November 13

Morning — Group discussions

Afternoon — Session chaired by Che Peiqin, Director, International Department, PBC

"The Formulation and Monitoring of Fiscal Policy"

Speaker: Vito Tanzi, Director, Fiscal Affairs Department, IMF

"Fiscal Policy in the Macroeconomic Management of China"

Speaker: Ye Zheng-peng, the Institution for Fiscal and Scientific Research

Discussant: H. Fujino, Executive Director, IMF

November 14

Morning — Group discussions

Afternoon — Session chaired by Wang Chunwen, Commissioner, State Planning Commission (SPC)

"Adjustment in Centrally Planned Economies"

Speaker: Christian Brachet, Chief, Stand-by Operations Division, Exchange and Trade Relations Department, IMF

"Exploration of the Reform of Chinese Planning Management Systems"

Speaker: Liao Xi-shun, SCER

"On Comprehensive Balancing in China's National Economic Plans"

Speaker: Yang Ke-gin, Deputy Director, Department of Comprehensive Planning, SPC

November 15

Morning — Group discussions

Afternoon — Session chaired by Gong Zhuming, Commissioner, SCER

"Development Policies in Korea, 1960-1985"

Speaker: Douglas A. Scott, Senior Advisor, Asian Department, IMF

"Questions Concerning Macroeconomic Management in China"

Speaker: Zhu Li, Deputy Director, SCER

November 16

Morning — Group discussions

Afternoon — Session chaired by Gao Shang-quan, Vice-Chairman, SCER

"Aspects of Domestic Stabilization in an Open Economy"

Speaker: Azizali F. Mohammed, Director of External Relations, IMF.

Discussant: A. Sengupta, Executive Director, IMF

Closing Ceremony chaired and speech given by An Zhiwen, Vice-Chairman, SCER

Closing remarks by:

Liu Hongru, Deputy Governor, PBC
M. Finaish, Executive Director, IMF
A. F. Mohammed, Director, IMF

INTERNATIONAL MONETARY FUND

November 11, 1986

Mr. Brau:

Ms. Kelly asked us to send this to you.

Copies to: Saito
Kelly

Attachment

G. G. Johnson

Office Memorandum

TO: Mr. Johnson

November 11, 1986

FROM: David Burton DB

SUBJECT: Quarterly Targets in First Credit Tranche Arrangements

In the context of the China request for a first credit tranche stand-by arrangement, you asked whether such SBAs have previously included quarterly targets or benchmarks.

A listing of first credit tranche SBAs or outright purchases since 1980 is shown in Attachment I. Of the nine first credit tranche SBAs approved over that period, five contained quarterly targets of some sort, typically for domestic credit (or NDA) and a fiscal variable (Table 1). 1/ It is perhaps noteworthy that in these cases the language in which the targets were expressed, in both the staff paper and the letter of intent, bore close resemblance to the language traditionally used for performance criteria (an example is provided in Attachment II).

Attachments

1/ The cases of outright purchases in the first credit tranche have not been reviewed.

Table 1. First Credit Tranche
Stand-By Arrangements with Quarterly Targets

Arrangement	Performance Criteria		
	Domestic credit	Fiscal variable	Other
1981			
Zimbabwe	X	X	
Uruguay	X	X	
Guatemala	X	X	
1980			
Uruguay	X	X	
El Salvador	X		X 1/

1/ Gross credit to financial intermediaries.

Stand-By Arrangements in the First Credit Tranche 1980-85 1/

Country	Duration
1981	
China, P.R.	12 months
Zimbabwe	12 months
Uruguay	12 months
Guatemala	12 months
1980	
Uganda	12 months
CAR	12 months
Uruguay	12 months
El Salvador	12 months
Cyprus	12 months

Outright Purchases in the First Credit Tranche 1980-85 1/

Country	Drawn in Context of
1984	
Guinea Bissau	Economic Program 12 months
1983	
Brazil	EFF
1982	
Yemen, P.D.R.	Natural Disaster
Mexico	EFF
1981	
Vietnam	Economic program, 12 months
Ivory Coast	EFF
Morocco	EFF
Jamaica	EFF
Pakistan	EFF
Sudan	EFF
Western Samoa	Economic program, 12 months
Honduras	EFF
1980	
Senegal	EFF
Morocco	EFF
St. Vincent and the Grenadines	Natural disaster
Pakistan	EFF
Haiti	EFF

1/ As of 8/22/85.

Uruguay 1981 SBA: Description of Quarterly Targets for NDA

1. Staff Report (EBS/81/137)

After allowing for these operations and for seasonal variations in public sector deposits, in 1981 the net domestic assets of the Central Bank (defined as the difference between the sum of Central Bank liabilities to the private sector and to the banking system, and its net foreign reserves) will decline by no less than NUr$120 million through June 30, 1981; and thereafter increase by no more than NUr$430 million through September 1981; and by no more than NUr$1,100 million through December 31, 1981.

2. Letter of Intent

Accordingly, none of the cumulative changes in the sum of the liabilities of the Central Bank to the private sector and to the banking system from its level on December 31, 1980 will result in cumulative changes in the net domestic assets of the Central Bank (defined as the difference between these liabilities and the net foreign reserves) from their level on December 31, 1980, except for a cumulative decline of NUr$120 million through June 30, 1981; a cumulative increase of NUr$430 million through September 30, 1981; and a cumulative increase of NUr$1,100 million through December 31, 1981.

INTERNATIONAL MONETARY FUND

November 10, 1986

Personal

TO : Mr. Narvekar

FROM: Eduard Brau EB

China--New Foreign Exchange Arrangements

When Mr. Saito consulted me last Friday on the draft note to the authorities, I suggested, inter alia, that they be reminded that consultations on the matter would be helpful (in fact, Article VIII requires it) and that the authorities have agreed not to implement new multiple rate practices for the duration of the prospective stand-by in paragraph 19 of their letter of intent. In the final note forwarded to the authorities, the consultation point is indirectly referred to in your cover note, but the letter of intent reference is not made. I am concerned that a section of the aide memoire purporting to set out the treatment of multiple rates under the Fund's jurisdiction is less than complete, and could therefore give rise to future misunderstanding. While I understand and appreciate Mr. Saito's concern regarding relationships with the authorities, I do not think the setting out of facts should be affected by such concern.

my file

Office Memorandum

TO: Messrs. Levy and Pohl, World Bank November 10, 1986

FROM: K. Saito

SUBJECT: China--New Foreign Exchange Arrangements

Further to our telephone conversation last Friday, attached please find the final version of the note we sent to the Chinese authorities on this matter. The note stresses that the arrangements being considered will have important implications for the development of China's exchange system and for its obligations as a member of the Fund. It then suggests that the authorities review all these implications very carefully before taking any further action.

We appreciate the continuing close collaboration with the Bank staff on exchange rate issues in China in the manner that has been developed over the years and confirmed through our recent telephone conversations; the Fund staff "does the talking" on immediate policy issues, taking into account the Bank staff's views expressed through close contacts. Collaboration should, of course, cover a wider range of issues, including the issue of how the system of the exchange rate, prices, and more generally, enterprise incentives, should evolve over the longer term as an integral part of reforms. In this context, we are looking forward to discussing the report of the Trade and Capital mission (our comments on the mission's aid-memoire and its back-to-office report will be sent shortly).

Attachment

cc: Mr. Narvekar (without attachment)
Mr. Brau (" ")
Ms. Kelly (" ")

my file

Office Memorandum

November 10, 1986

MEMORANDUM FOR FILES

Subject: China

Mr. Hobart Rowen of the Washington Post phoned me today about whether I could confirm that China has requested a loan from the Fund and that it was currently under consideration by the Executive Board. As Mr. Rowen did not leave any doubt that he had the information from a reliable source within the Fund, I did confirm that a request for the equivalent of China's first credit tranche in the Fund was under consideration and was likely to be acted upon by the Executive Board on Wednesday, November 12.

Mr. Rowen asked a number of other questions relating to policy understandings between the Fund and China which I declined to answer at this point. Instead I referred him to the usual press release that I expect to be issued later this week. During the discussion it became apparent that Mr. Rowen had some misconceptions about the Fund's relations with China, which I corrected. Basically he thought that this would be the first loan of China from the Fund since the question of representation had been decided upon in the spring of 1980. In this connection, I pointed out that a first stand-by arrangement and a trust fund loan were approved in early 1981. I observed further that the 1981 stand-by had been repurchased in full and that part of the trust fund loan had also been repaid. On Mr. Rowen's general question on what basis the Fund would consider a loan application, I answered in the same general terms, namely that Fund financing is available to member countries on the basis of a balance of payments need, provided the member had policies in place to address its problem. On Mr. Rowen's question on what the current account situation of China was, I quoted the most recent figures contained in IFS (+ \$2.5 billion for 1984, and -\$11.4 billion for 1985).

Hellmut Hartmann

Hellmut Hartmann

cc: Mr. Mohammed (o/r)
Mr. Narvekar
Mr. Gardner
Mr. Saito
Mr. Brown

Mr. Bran

Office Memorandum

TO: The Deputy Managing Director (in Beijing) November 7, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--New Foreign Exchange Arrangements

Attached for your information are (i) a note to Mr. Dai and (ii) a draft statement by the staff for the forthcoming Board meeting, both on the subject of the measures to promote foreign direct investment which were announced by the Chinese authorities on October 11. As indicated in my memorandum of November 3, it appears that one of these measures--permission for foreign investment enterprises to trade foreign exchange among themselves--may constitute a multiple currency practice.

We understand that detailed regulations relating to these new foreign exchange arrangements are still being drafted by the State Administration of Exchange Control. The attached note to Mr. Dai stresses that in light of the importance of the matter, the authorities should review its implications very carefully before taking any further action.

Attachment

cc: Mr. Mohammed (in Beijing)

Office Memorandum

TO: Mr. Dai

November 7, 1986

FROM: FG P. R. Narvekar

SUBJECT: New Foreign Exchange Arrangements

The attached note addresses the new foreign exchange arrangements for joint ventures and foreign-owned enterprises which were announced on October 11. As you will see, our understanding of the scheme is still limited, and we would welcome any additional information that your authorities can provide. It does seem likely, however, that the scheme would raise issues of considerable importance relating to China's exchange arrangements, and we feel that its implications should be considered very carefully before any further action is taken.

In light of the importance of this matter, you may wish to forward the attached note to Beijing at an early juncture. We will be pleased to discuss these and other related issues with the authorities at an early stage and enhance our cooperation through such consultation.

Attachment

cc: Mr. Jiang Hai (in Beijing, sent through the courtesy of Mr. Crockett)

CHC--gs61105ch1--11/7/86

China--Proposed Foreign Exchange Arrangements for Joint Ventures and Foreign-Owned Enterprises

I. Introduction

New provisions concerning incentives for foreign direct investment in China were promulgated by the State Council on October 11. Article 14 of the new provisions states that "under the supervision of the foreign exchange control departments, enterprises with foreign investment may mutually adjust their foreign exchange surpluses and deficiencies among each other." While detailed regulations relating to the implementation of this scheme are apparently still being worked out, this note attempts to envisage how it might operate, and to assess its implications for the enterprises concerned and for the economy as a whole. The last section includes some general considerations relating to the disadvantages of multiple exchange rates, as well as their treatment under the Fund's jurisdiction over exchange rate matters.

II. The New Scheme

Salient features of the new scheme appear to be as follows:

(i) Joint ventures and foreign-owned enterprises (enterprises with foreign investment, subsequently referred to as EFIs) would be permitted to trade foreign exchange among themselves;

(ii) although article 14 of the new provisions makes no reference to the exchange rate to be used in these foreign exchange transactions, it seems likely that they would be conducted on the basis of an exchange rate negotiated between the parties involved in the transaction;

(iii) enterprises and individuals other than EFI's on banks would not be allowed to participate in these transactions; and

(iv) banks would not be permitted to be involved in these transactions on their own account.

While available information, in particular information relating to the exchange rate(s) at which these transactions would be conducted, does not permit a definitive assessment, the scheme could give rise to a multiple currency practice.

III. Implications

1. For the investing enterprises

For those EFIs with surplus foreign exchange (mainly hotels), the scheme would raise profitability by increasing the purchasing power of foreign exchange earnings in terms of their renminbi expenses (e.g. wages of local staff). EFIs which purchase foreign exchange under the scheme for productive use may also find it beneficial compared with the present system under which foreign exchange availability from official sources is strictly limited and subject to a considerable amount of red tape. Those EFI's which do not have productive user for the foreign exchange would be encouraged by the new exchange rate to sell it to others.

2. For the economy

a. Advantages

(i) In view of the advantages for EFIs described above, the new scheme would be likely to assist in stimulating an increased inflow of direct investment to the most productive user with attendant benefits for China's balance of payments and the transfer of technology.

(ii) The transaction of foreign exchange between EFIs under the scheme would be a concrete example of the operation of market mechanisms which the authorities are promoting under the reforms, and could provide useful experience, both for the introduction of market mechanisms in other areas, and for the establishment of such an exchange rate mechanism for the economy as a whole.

(iii) In the meantime, exchange rates negotiated under the scheme would constitute a useful additional indicator to guide the operation of a flexible official exchange rate policy.

b. Disadvantages

(i) The proposed scheme would confine the benefits of greater exchange rate flexibility to a relatively small part of the economy, and could encourage the establishment of the EFIs as a foreign enclave sector. While the scheme may improve resource allocation within the EFI sector--by making foreign exchange available to the enterprises in that sector with greatest need for it--it would not necessarily benefit resource allocation for the economy as a whole. It might also redirect foreign exchange from some more productive user outside EFI sector, as surplus foreign exchange earned by EFIs would now be channeled to other EFIs for their use rather than held on deposit in the banking system, where it would be available for other uses.

(ii) Enforcement of the bar against participation by the rest of the economy in the scheme would be bound to create significant administrative problems. The likely incentive for illegal participation could give rise to problems similar to those experienced with the system of foreign exchange certificates. These problems would be particularly serious if the market determination of the exchange rate was not generalized to the entire economy within a relatively short period of time, as channels for illegal entry into the EFI exchange market became more widely exploited.

IV. Policy Issues

The proposed scheme has as its main objective the promotion and rationalization of foreign direct investment, which in view of its potential economic benefits is justifiably accorded high priority by the authorities. The scheme would also introduce a new exchange arrangement which, as noted above, would have both advantages and disadvantages. Its implications could be far-reaching, and would need to be reviewed with great care before any further action is taken. In its discussions with other interested government departments, the People's Bank would in particular have to weigh the need to promote direct investment with that of maintaining an appropriate exchange arrangement. The Fund staff is prepared at any time to cooperate with the authorities in discussing these and other related issues; in any event, such discussions may be held during the staff visit envisaged for early 1987.

From the standpoint of establishing an appropriate exchange arrangement, the advantages of the scheme (which would also accrue to a unified market exchange rate) would be outweighed by the disadvantages cited above, which are familiar examples of the drawbacks associated with multiple exchange rate systems. Fund experience with these systems in other countries indicates that they often do not achieve their objectives, entail high economic costs, and further distort resource allocation and hinder balance of payments adjustment. Multiple rate systems tend to become complex and result in a fragmentation of the exchange system that is often difficult to reverse. The systems also disrupt foreign trade activities, and pressures to tighten quantitative exchange and trade controls in support of a nonviable official exchange rate which in turn stimulates parallel market activity and capital outflow. Moreover, the economic costs of multiple exchange rates tend to be higher the longer they are maintained, compounding administrative burdens and corruption incentives.

In terms of Fund jurisdiction over exchange rate matters, multiple currency practices are subject to approval under Article VIII. Approval of multiple currency practices has been granted in limited circumstances, if the practice is clearly of a temporary nature and is part of a well conceived plan (including appropriate pricing measures) to re-establish unified exchange rate at an appropriate level within an agreed specified time period. In the context of China, the Fund could be willing to approve a measure that conformed with these guidelines and introduced a desirable element of market determination into exchange rate policy. Whether the proposed scheme for EFIs would constitute such a measure would have to be determined on the basis of additional information from the authorities.

CHC--gsc61107ch 11/7/86

Statement by the Staff on China
Executive Board Meeting 86/...
November 12, 1986

On October 11, the Chinese authorities announced measures designed to improve the climate for foreign direct investment, especially in export and high technology sectors. The new measures include additional tax incentives, reductions in nonwage labor costs and land rents, steamlined export and import procedures, autonomy in operational and personnel matters, and permission for foreign investment enterprises to trade foreign exchange among themselves.

Regarding the arrangements for trading foreign exchange, Article 14 of the new provisions states that "under the supervision of the foreign exchange control departments, enterprises with foreign investment may mutually adjust their foreign exchange surpluses and deficiencies among each other." The staff understands that detailed regulations relating to the implementation of this scheme are being drafted by the State Administration of Exchange Control. The staff is presently seeking additional information from the authorities concerning details of the proposed scheme.

Mr. Braun
my file

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE November 4, 1986

TO Distribution

FROM Gerhard Pohl, AEACH

EXTENSION 61975

SUBJECT **CHINA - External Trade and Capital Mission**

This is to confirm that we will meet on Thursday, November 6, at 2:00 p.m. in Room I-5-201. The main purposes of the meeting are to brief Mr. Levy on the outcome of the mission, and to plan for the report writing. To this end, please find attached:

(i) the Back-to-Office Report and Aide Memoire; and

(ii) copies of annex/chapter outlines received to date.

Copies of the mission minutes and the Yellow Cover Finance and Investment Report will follow within the next few days.

Distribution:

Messrs. Levy, Harrold (AEACH); Kavalsky (CPDDR); Bergsman (CDD);
Voljc (INDSP); Kim (EDI)(o/r)
Mses. Wallich (AEACH); Nishimizu (INDSP); Kelly (IMF/ETR)

PHarrold:mac

P-1866

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE November 4, 1986

TO R. Nickles Anderson, Acting Chief, AEACH

FROM Gerhard Pohl, Senior Economist, AEACH

EXTENSION 61975

SUBJECT China - External Trade and Capital Study - Back-to-Office Report

Introduction

1. The mission visited China as scheduled, from October 3 to 25, 1986, and its work program closely followed that outlined by the pre-mission issues paper, dated August 29, 1986. The mission conducted approximately 80-90 interviews with government agencies, foreign trade corporation and managers of enterprises in Beijing, Zhengzhou (Henan Province), Shanghai, Fuzhou and Xiamen Special Economic Zone (both in Fujian Province).

2. On the first two days of the mission, we conducted a seminar on external trade and capital issues which was attended by about 30 officials from a variety of ministries, agencies and research institutes. During the following interviews in Beijing, and the field trip (October 8-23), we were joined by an eight-member interagency counterpart team led by Mr. Zhu Ang, Deputy Director of the International Trade Research Institute of the Ministry of Foreign Economic Relations and Trade (MOFERT), our host agency. Arrangements in the field were well organized, and cooperation was very good. Mr. Ji Jongwei, Standing Member of the State Council's Research Center, joined the mission in Beijing and Shanghai and led the wrap-up discussions. The mission was also hosted by Mme Zhu Youlan, Vice Minister, MOFERT.

3. As in the case of the Investment and Finance mission earlier this year, having a permanent counterpart team proved to be very useful, as this provided us considerably more insight, not only into the current situation and problems, but also into the current thinking in China about reforms of external economic relations and trade. Informal and relatively free-wheeling discussions were held frequently with the counterpart team and in smaller groups. As most of the counterpart team members were relatively young, their views on reforms were considerably "ahead" of the more senior (and more influential) advisors and policy-makers. There was a surprising degree of agreement between the mission and the counterpart team on the need for, and the direction of, further reforms. The wrap-up meeting revealed the rather different views held by more senior officials.

4. As the mission's preliminary conclusions and recommendations are contained in the attached Aide-Memoire to the Government (Annex II), this cover memorandum only adds a few impressions on the present situation and comments on key issues. A proposed outline of the report is attached as Annex III. A yellow cover draft is expected to be ready by end February as agreed at the Issues Meeting.

Present Situation

5. While there have been many steps in the direction of trade decentralization and greater role of market forces, the system is still dominated by administrative controls. Export and import decisions are still largely made through administrative decisions, and on the basis of domestic, rather than international prices. To promote exports, the foreign trade corporations continue to use substantial cross-subsidies between profitable and unprofitable export products. Although the recent devaluation has reduced the budgetary impact of foreign trade, increased domestic currency revenues have not been passed-on to domestic producers, thus providing no incentives for efficient producers to increase export volume. While China has officially adopted a unified exchange rate, the trade regime is in practice still operating under a myriad of exchange rates. Only foreign joint ventures and a few enterprises with direct foreign trade rights are facing international prices. Consequently, exchange rate policy is not yet a very effective tool of balance of payments management. Further microeconomic reforms are urgently required.

ok

6. Although Chinese policy-makers now accept the idea that vigorous competition among domestic enterprises is an essential part of economic reforms to ensure efficient resource allocation under decentralized decision-making by enterprises, the need for competition in export production is not equally recognized. Many senior officials feel that China can improve her terms of trade by restricting competition among domestic enterprises and using foreign trade corporations as export monopolies. While this may be correct for some agricultural and primary commodities, it is also applied to exports of diversified manufactured goods and is probably hampering export performance in this sector quite substantially.

Major Issues

7. There is presently considerable danger that administrative controls could multiply and tighten in response to continued balance-of-payments difficulties as recent and further changes in the exchange rate are likely to remain relatively ineffective. There is a wide-spread view among senior Chinese officials that the generalization of enterprise foreign exchange retention rights in early 1985 has been a main source of the continued balance-of-payments deficits. By contrast, many senior officials rarely make the connection between recent, overly expansionary monetary and credit policies and balance of payments performance. Recentralization of controls over foreign exchange allocation in the hands of the State Planning Commission, rather than tighter monetary and credit policies, are often proposed as a way to regain control over balance of payments problems, and there is considerable consensus among senior officials about the need for, and benefit of, the recently intensified import and export licensing requirements.

8. An important area where China needs encouragement and help is in the establishment of a foreign exchange market. Although rarely admitted, foreign exchange retention rights are occasionally traded, usually at a one yuan (30%) premium over the official exchange rate. The premium appears not to have markedly changed compared to the period before the 15% devaluation (to Y3.70/US$) in July 1986. Most enterprises with accumulated foreign exchange retention rights that we interviewed were unwilling to trade their foreign exchange retention quotas, indicating an even higher scarcity premium. Policy-makers seem reluctant to expand the role of the foreign exchange market, and encouragement and assistance should be provided by both the Bank and the Fund. In view of the unfinished enterprise reforms, the large gap between domestic and international prices, and the Chinese preference for gradual domestic price reform, it is unrealistic to assume that Chinese policy-makers would be willing to move in one step to a single, market-clearing exchange rate. At best, a gradual introduction and expansion of a foreign exchange market would be considered. An extended transition period towards a foreign exchange market will probably be needed, with gradually improving but less than perfect mechanisms being adopted, as Chinese decision-makers become comfortable with moves towards establishing a foreign exchange market.

9. Only if recentralization of foreign exchange allocation can be averted will it be useful to talk about, and assist in, other elements of external trade reform. An important initial step will have to be in the direction of passing on international prices to export producers and eliminating cross-subsidies. This could, however, result in a short-term reduction of exports, unless compensating incentives are given at the same time to exporters (e.g. enlarged and tradeable foreign exchange retention, further exchange rate adjustment, automatic access to credit for export production, etc.). This could then be followed by a longer-term program of licensing and tariff reforms. Clearly, any such program would have to be carefully dovetailed with domestic economic reforms and the Bank could be of assistance, not only through the report, but possibly also through policy based lending in support of a consistent reform package.

ok—

10. In the area of foreign capital flows, one of the more interesting mission findings is that many joint-ventures in the manufacturing sector have primarily the objective of circumventing the cumbersome external trade regime for domestic enterprises. Joint-ventures enjoy considerably more autonomy than Chinese enterprises and have, among other things, direct foreign trade rights and full control over their foreign exchange earnings. In view of their autonomy (which Chinese enterprises will gain only after full implementation of the enterprise reforms) and their favorable tax treatment, there are quite a number of export-oriented joint ventures that are joint-ventures between China and China (typically between a domestic enterprise and a Hong Kong subsidiary of a Chinese organization). Even the most impressive and successful joint venture visited by the mission was apparently of such a nature. This gives reason for considerable optimism with respect to China's economic and export performance, once domestic enterprises become similarly autonomous as a result of enterprise reforms. At the same time, the number of

"true" joint ventures in import-substituting high-technology fields has fallen far short of Chinese expectations. The primary obstacle is again the application of the foreign exchange balance requirement to which only a small number of ad-hoc exceptions have been made.

11. With respect to other capital flows, the good news is that there is now an agency in charge of foreign borrowing and debt management (the State Administration of Foreign Exchange Control) and that it appears to be moving fast to fill this potentially dangerous void. Further improvements needed in this area are thus of a technical nature.

cc: Messrs. Karaosmanoglu, Yenal (AENVP); Turnham (AEPDR); Hope (AEPID);
Kaji, Linn (AEADR); Merghoub (o/r), Levy (AEACH); Lim (AEACH);
Colaço (INDDR); Narvekar, Saito (IMF).
Mission Members
AEACH staff

GPohl:hk

Annex I

Mission Team Members

Gerhard Pohl	AEACH	Mission Leader
Peter Harrold	AEACH	manufactured export prospects
Christine Wallich	AEACH	external capital flows
Joel Bergsman	CDD	foreign direct investment
Basil Kavalsky	CPDDR	foreign exchange regime
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Annex II

EXTERNAL TRADE AND CAPITAL STUDY MISSION
Aide Memoire

October 27, 1986

1. This Aide-Memoire summarizes the preliminary impressions and conclusions of the World Bank mission on external trade and capital.[1] Upon its return to Washington, the mission will draft a more detailed report which we hope to send to the Government by late March/early April 1987. In view of the short time available to the mission in drafting this Aide-Memoire, the recommendations set-out below are preliminary and only indicate our views on the broad directions and necessary elements of foreign trade reform. The timing and sequencing of specific reform measures and their relation to reforms of domestic economic policies require further study and can only be addressed in the more detailed full report.

Introduction

2. The "open door" policy adopted at the end of 1978 has already brought substantial benefits for the Chinese economy. Since 1978, exports have more than doubled and this has made possible a very large increase in imports of capital goods and raw materials. These have contributed to the introduction of more advanced technology and to reduce bottlenecks in production and infrastructure. This has helped to increase the efficiency of the economy. While the rural economic reforms were probably more important in raising the overall efficiency of the Chinese economy, the open door policy has clearly made a significant contribution, particularly in the urban sector. The emphasis on modernization (or "technical transformation") of enterprises has been beneficial on balance as small technical improvements in existing enterprises have often yielded substantial overall improvements in efficiency and product quality. Imported machinery and know-how have been critical in the technical transformation of enterprises, and have become more easily accessible to enterprises, as exporting enterprises have now easier access to foreign exchange.

3. While the open door policy has brought substantial improvements, the gains have--in our opinion--not been as large as they could have been if reforms of enterprises and foreign trade policies had already been carried further. Of particular importance is the isolation of enterprises from world markets, the uncertain availability and somewhat arbitrary administrative allocation of foreign exchange, and the cumbersome administrative regulation of imports and exports. Together, these policies tend to reduce the volume of exports relative to what could be achieved, and consequently to reduce the volume of imports and the pace of technical, economic and managerial transformation of enterprises. These policies also tend to raise the domestic costs of exports and imports, as for some commodities more domestic resources are used per dollar of exports than for others. One of the most important benefits of international trade is to

1/ The mission has benefitted very substantially from many discussions with the counterpart team, led by Mr. Zhu Ang and discussions with Mr. Ji Jongwei and many other officials from the central government, provincial and local administrations, for~~eign trade~~ corporations, and enterprises.

transmit the information in the world market--information on cost quality, technology, etc.--to domestic enterprises, forcing them to make competing reductions in costs, and improvements in quality and productivity, to upgrade technology and to undertake research and innovation. But in the case of China, this link between enterprise decisions and world markets is still very weak and needs considerable strengthening.

4. The need for further reforms also becomes clear when considering China's future export prospects. For China's main exports--textiles and garments, petroleum and fresh food--prospects are limited because of, respectively, protectionist tendencies in industrial countries, depressed world market conditions, and saturation of the main export market, Hong Kong. Together, these products account for fully 63% of China's exports at present. Thus, China must look to other manufactured exports for further growth. The main constraint to export growth in this sector is imposed by internal factors, such as inefficient enterprises and inappropriate products because of the continued isolation of enterprises from world markets. To achieve further growth in this sector without reforms will be--in the mission's view--increasingly difficult to achieve. However, we do believe that given China's natural resource endowment and abundant, and increasingly well-trained labor, the prospects for such exports are bright, given an appropriate policy environment.

The Need for Policy Coordination

5. Over the past seven years, reforms of China's socialist economic system have been introduced in a courageous trial and error process and very often, adjustments and corrections had to be made as difficulties occured. Overall, the result have been good, and it would have been clearly impossible to plan this reform process in advance. However, as reforms have progressed, interrelations between the various elements of reform (of domestic as well as external economic policies) have become more complex, and there is an increasing danger that further uncoordinated reforms could lead to inconsistencies and large macroeconomic imbalances as in 1984/85 when excessive credit creation occured simultaneously with trade decentralization and the generalization of the foreign exchange retention system for enterprises. This led to a large balance of payments deficit that would be unsustainable if it were to continue. There is a danger that such an unfortunate constellation of events could lead to the reversal of desirable and needed reforms.

6. It is therefore important that reform implementation be more carefully planned and coordinated than in the past. This is not to say that all errors can be avoided. Unforeseen side-effects will always occur and policy measures will have to be adjusted flexibly to make corrections. However, many of the elements of foreign trade and capital reform measures discussed below are closely interrelated and should be seen as a "package". Furthermore, reforms of the external sector are closely related with domestic reforms, particularly the transformation of enterprises into independent units responsible for profits and losses and subject to competition from other enterprises elsewhere in China and abroad. In some sense, reforms of external economic relations and trade can be seen as just one element of enterprise reform and need to be phased in with such domestic measures as increasing autonomy in pricing and enforcement by the central government of fair competition and trade between all kinds of enterprises in China (and abroad). Reforms of financial institutions, taxation and the social security system will have to be implemented at the same time.

7. The following sections describe the mission's views on three key elements of needed reforms of the open door policy--foreign exchange allocation and exchange rate policy, decentralization and enterprise autonomy, and administrative and price (tariff) regulation of imports and exports. This is then followed by a short discussion of issues relating to agricultural trade, technology transfer, foreign direct investment and other capital flows. There are close linkages between the three key issues mentioned above and policy issues in these other areas. Without a resolution of the key issues, relatively little progress can be made in these other areas.

8. The first two of the three key elements mentioned, namely, reforms of foreign exchange allocation towards a foreign exchange market, and decentralization of foreign trade responsibility to production enterprises are in many ways the most urgent and could be carried out over a relatively short period of time (say 2-3 years), while the third element, reform of administrative and tariff regulation of external trade, could be phased in over a longer period. However, the timing of these measures will also depend on progress of domestic economic reforms, particularly price reform and increased enterprise autonomy and responsibility. Appropriate macroeconomic stability (particular monetary and fiscal restraint) will be essential in deciding on the timing of reform measures. While the introduction of economic reforms should be gradual in view of uncertainties involved, there are also dangers in stretching the reforms over too many years. Large investments may be made on the basis of distorted prices and incentives, and could create vested interests against further reform implementation.

I. Foreign Exchange Allocation and Exchange Rate Policy

9. An important element of the present trade system is the provision for provinces and enterprises to retain part of the foreign exchange they earn from exports and use it for imports. By comparison with the previous system where all foreign exchange was allocated by the central government, the system has brought some important benefits. It has created substantial interest in exporting at the provincial level and led to the setting up of new export-oriented enterprises, while at the same time providing enterprises with flexibility in obtaining foreign exchange for improvements in productivity, product quality and marketing.

10. It is important to recognize, however, that the retention system also brings with it significant disadvantages. The system induces all provinces to set up direct exporting capacity, often duplicating capacity which exists in another province, and not taking into account whether the product can be efficiently exported. It encourages "balance" at the provincial level and weakens the benefits of specialization which China should be deriving from its large domestic market.

11. The retention system also causes distortions at the enterprise level. For an efficient exporter in industries such as garments for example, which have little import needs, the retention system provides little inducement to increasing exports. If anything, the availability of exchange at the official rate may push them into buying nonessential imports. At the same time, efficient import substitution projects are placed at a disadvantage in getting access to foreign exchange beyond their planned raw material requirements. The current policy framework, including the foreign exchange retention system, the policy requiring

local governments or projects entities to service foreign debt in foreign exchange, and the requirement of foreign exchange balance for foreign direct investment, neglect the fact that saving foreign exchange through efficient import substitution can be just as beneficial to the economy as earning foreign exchange through exports.

12. The objective of the foreign exchange allocation system is to achieve balance between the availability and use of foreign exchange and allocate it according to national priorities. In practice the system is not achieving this. It is cumbersome and time-consuming, imposing heavy costs on enterprises and the evidence of the last two years clearly is that the objective of balance is not being achieved. Nor are national priorities for use being effectively transmitted to economic agents as demonstrated, for example, by the recent imposition of additional controls on imports of vehicles by provincial governments and enterprises.

13. There are a number of reasons why the system has failed to achieve its goals. First, there is the difficulty of accurate prediction of foreign exchange availabilities and the slow response of the administration when the rapid change of world prices or demand means lowered export earnings. Second, since retention quotas can be accumulated from year to year, the degree to which they will be used in any one year is uncertain and depends on the availability of renminbi for this purpose. Given the lax credit policy of the recent past this has not constrained the use of foreign exchange. Third, there are strong pressures from provinces and enterprises to increase foreign exchange allocations given the high premium which results from being able to get foreign exchange at too low a price (i.e. a price at which demand exceeds supply).

14. The consequence of these failures of the retention system has been an increasing number of institutions and activities which are mainly geared to finding ways around the system. Yet the introduction of strengthened and more complex control procedures will simply be to increase the costs in delay and make it even more profitable for provinces and enterprises to find ways of getting around the system.

15. The eventual objective should be to substitute the retention system with an exchange rate which clears the market, i.e. at which enterprises are encouraged by profitability to export in total as much as China requires to meet its import needs. The first element of this is the creation of a market which allows for trading of foreign exchange and the second element is the price which prevails on that market. At present, foreign exchange quotas can be traded between enterprises, but these are irregular and ad hoc transactions. While they almost certainly involve some sort of premium this may differ from one transaction to another. One option in the interim would be to regularize this market and allow quotas to be sold at a market-determined price. It would then be possible to move over time to a unification of the market rate with the official rate.

16. By allowing the trading of foreign exchange quotas, it would be possible for import-substituting firms to have the same access to foreign exchange as exporters. In addition, the more efficient exporter would be encouraged to increase exports because of the advantage for renminbi profits relative to sales on the domestic market. With the emergency of some form of foreign exchange market, it would also be desirable to increase the proportion

of foreign exchange retained by enterprises in order to maximize the incentive effects. Reallocation of foreign exchange now undertaken by provincial governments could then be more efficiently handled by the market. The mission's report will offer more concrete options on the creation of a foreign exchange market and the government may also wish to enter into discussions with the IMF on the various options regarding foreign exchange allocation and market which might be considered and their relative advantages and disadvantages.

II. Foreign Trade Decentralization and Enterprise Autonomy

17. Foreign trade in China is still perceived as being separate from decisions on what to produce and how much to produce. The recent decision to expand the number of enterprises with trading rights, while certainly a step in the right direction, has not changed the fundamental divorce between decisions on production and investment on the one hand and trade on the other. The costs of this "airlock" are substantial. Enterprises which could profitably increase their exports do not receive the signal or have the incentive to do so. At the same time, other enterprises which could better serve the domestic market are pushed into exporting at very high cost. Decentralization seems only to have gone halfway in an organizational sense: from the central government to the provinces, particularly to the provincial branches of the national trade corporations. It seeps through to some extent to local foreign trade corporations (FTC's) and to "independent" trade corporations, but hardly at all to the enterprise level.

18. A large part of production for export is captive, i.e. under the control of the FTC's and is separate from production for the domestic market; the signalling functions of international prices and quality standards for exports therefore hardly operate in the direction of producers for the domestic market who also would have the potential to become exporters.

19. There is a tendency of provincial authorities to translate guidance plans from above into commands to lower levels, and this tends to make the export structure static. This is also reinforced by an administrative organization which permits the responsible FTC's to offset profits and losses internally. As FTC's are not enterprises, and have to return any overall surpluses to the center, there is no incentive to concentrate on competitive commodities and to drop continuously loss-making commodities. Nor is there any incentive to pass profits made on exports of competitive products to their producers, signaling to them what their external market opportunities are; on the contrary, FTC's avoid this as it would in their view reduce their exports since they would no longer be able to subsidize commodities which incur export losses.

20. An important first step in extending the reform of China's foreign trade system will be to permit all enterprises to engage directly in foreign trade activities. The effect of moving this decision to the enterprise level is hard to predict in the short run. Some inefficient exporters will stop exporting while some efficient ones will shift their products out of the domestic market into exports. The net effect of this is unclear. In addition, there will be some institutional problems in the short run as enterprises learn the business of foreign trade. The long-run effects should be positive, however, as firms are able to identify export opportunities and organize their production in response to them.

21. This does not mean that foreign trade corporations will not have a role in future. Many small- and medium-sized firms will continue to rely on trade corporations for both imports and exports, but they should have the freedom to choose their own channels. In addition, the trade corporations can concentrate on building up specialized expertise and carrying out promotional activities on behalf of their enterprise clients. Joint ventures with foreign general trading companies could also be considered as a step toward more competition in the external trade sector.

22. Also important will be a foreign trade information network, and technical assistance (mainly in the areas of quality control, product design, packaging and marketing) for exporting firms. As the number of firms entering export markets grows, ways should be explored as to how best organize these firms to exchange ideas and experiences to and propose improvements in export policies, instruments and practices (similar to exporters' associations and/or chambers of commerce in other countries).

III. Trade Policy Issues

23. There are several striking aspects to the trade system in China. First, there appears to be an unnatural separation between import policy on the one hand and export policy on the other. Second, there exists significant bias against exports, which in turn requires strong administrative measures to promote exports. It is the elimination of such biases that must be at the core of future reform efforts. Third, the trade regime relies to a very significant degree on quotas and other administrative instruments, both in regulating imports and generating exports. These administrative instruments will become increasingly difficult to administer as the volume of trade increases, so a major goal of reform should be to replace these with other, less cumbersome instruments.

Import Policy Reform

24. On the side of trade policy with respect to imports, the principles should be as follows. First, there should be as little variation of the degree of protection as possible among different activities in the economy. Otherwise, incorrect allocation of resources among different activities is likely to take place as the reform of domestic policy advances further. Second, against this background of uniformity, incentives given to promote any specific set of activities should be transparent and limited in duration. Without these principles, there is a stronger possibility that high-cost domestic producers will never grow up to be efficient competitors against imports or succeed as exporters.

25. China relies largely on administrative controls on imports, and import tariffs remain a secondary instrument for regulating imports. Quantitative restrictions create uncertainty on the available flow of imports for production. They also tend to create a wide range in the degree of protection which is often not transparent. Finally, and perhaps most importantly, quantitative restrictions tend to delink changes in world prices from domestic prices. When such conditions persist for a period of time there will be less incentive for domestic producers to improve productivity, quality, and technology, and to reduce costs--an important benefit of trade. They make it increasingly difficult for policy makers to judge who is protected from import competition and by how much.

26. Import policy reform in the medium term should endeavor to eliminate in a phased way the administrative controls on imports, and replace them with import tariffs. The advantage of using tariffs as the primary instrument of protection is that they are price-based, transparent, and easier to administer. The use of tariffs also permits changes in world prices to be passed on to domestic producers, and this preserves a degree of linkage between world prices and domestic prices. But this instrument can also be misused if an excessively high tariff protection is adopted or if a large range of tariffs is used to protect different producers. The level of tariffs in China today is quite high relative to many other countries, including many developing countries as well as socialist economies. The structure of tariffs is higher for consumer products or more processed products and lower for raw materials intermediate inputs, and investment goods. This means that the "effective" rates of tariff protection--combining higher tariff protection on outputs and lower tariff costs on inputs--may be even higher and more variable than indicated by the nominal rates of tariff. Therefore, as quantitative restrictions are being replaced by tariffs, reform eventually should include a phased reduction in both the level of protection and the dispersion of tariff rates with the exchange rate being increasingly used as the main instrument of trade policy.

Export Policy Reform

27. As the overall reforms progress, particularly in the areas of enterprise autonomy and the price system, China will have to rely increasingly on an export incentive system which would use more indirect policy instruments. Such a system will be needed so help to (at least in part) offset the anti-export bias of the import regime. As long as the trade system provides protection to domestic industries an anti-export bias remains as selling to the domestic market will in many cases remain more attractive than to export.

28. The underlying principle of the export incentive scheme is therefore to create a status of "neutrality" for exporters, enabling Chinese firms to compete on an equal basis with foreign exporters in the world market. Such an export incentive scheme has been used successfully in several developing countries. It is based on the principle that all firms participating in exporting activities (i.e., including suppliers of inputs to exports) should have ready and automatic access to the inputs needed for the production of exports. It is particularly important for the success of the export policy, that all firms participating in production for export can avail themselves, in an automatic and administratively easy way, of: (i) foreign exchange, (ii) working capital financing and (iii) material inputs free of import duties and indirect taxes). Several of these elements are already available in the case of joint venture operations and should be expanded to domestic exporters as well.

29. The recent initiative on the part of Chinese authorities to increase export supply by setting up export production bases is a clear indication that the policy makers are committed to promote exports. The system, however, seems to have some flaws. The system may be biased in favor of existing exporters and traditional export products at the expense of other (perhaps more efficient) producers. It appears also that several layers of authority (MOFERT, production ministries, provincial/municipal governments) are getting involved in offering different incentives to producers under their supervision. This leads to multiple incentive regimes and may further increase distortions and waste scarce

resources. A basic export incentive system as outlined in the previous paragraph would most likely be more adequate and cost-effective and should also encourage investment into new export products.

IV. Agricultural Trade Issues

30. International trade in agricultural commodities is in many ways different from foreign trade in manufactures discussed above. In the case of food exports to Hong Kong and Macao, exceptional circumstances prevail as China attempts (and may succeed) to maximize revenues in a virtually captive market. The present trading arrangement for perishables and livestock may therefore have its merits, but there is nevertheless reason to look at alternatives of less direct controls, perhaps through variable export levies, as a transitional device until these markets become more integrated with the rest of China.

31. A crucial question is the decision making concerning investments in agricultural processing for exports. The present system, where FTC's appear to have a major role, should be replaced by one which permits the rural producers to benefit more fully from exports of their processed products. At present, foreign exchange retention rights do not reach them as they are captured by the processors who are not part of the rural economy. In general, the benefits of agricultural processing should reach primary producers to the fullest possible extent. A strong case can be made to establish rural production and marketing cooperatives in which farmers themselves have the main interest, such as the European cooperative processing sectors. For agriculture to adjust its patterns of production to external markets, world prices need to be passed on to the primary producers. The same probably holds true for those minerals where China is not the major world producer/exporter.

32. International Markets. Passing on agricultural world prices to farmers in China should take account of the extent to which these prices are distorted and may remain so in the coming years. Industrial country policies result in world market prices at which efficient producers elsewhere find it hard to stay in the market, and this situation will at best improve very slowly. Excessively low prices prevail in most years for wheat, sugar, red meat and dairy products. Recent developments make it likely that in the near future the same will apply to oils and fats.

33. When world prices for these products are compared with domestic prices at the Chinese border, the latter appear even lower, particularly for unprocessed products. China can therefore export several of these commodities, but it would result in a further decline of world prices and an increase of domestic food prices. Such price increases may be desirable in order to reduce the rural/urban income gap, but further declines in world prices could have significant repercussions in China's trade relations with the rest of the world. Also, the benefit to China from these exports may not be long-lasting as it is doubtful whether the country can maintain significant surpluses of production over domestic consumption. It appears more sensible, therefore, to maintain a relatively low export volume of those (mainly unprocessed) agricultural products, even if surpluses occur which can be exported at a profit.

34. For a number of these commodities--particularly animal feed--China may become a major importer and it would be wise to ensure that in the long run these imports, by being available at prices well below long-run marginal costs

of efficient producers, will not operate as a disincentive to agriculture. Border levies which compensate for the low international price level are to be considered.

35. <u>Geographic Extension</u>. Most Chinese agricultural exports go to overseas "Chinese" markets; Hong Kong provides an important service by extending the geographic reach to more countries, through its re-exports of Chinese goods. For the longer term it is essential that considerably more attention is paid to market research and other measures to promote exports to new markets.

V. Technology Transfer

36. Even the most advanced industrial countries cannot rely exclusively on domestic technology development if they want to stay competitive. Importing technology is essential even for them. However, there are many channels to transfer technology, and the "visible" channels, such as imports of machinery and equipment, technology licensing and joint ventures, are only one part of an effective technology transfer strategy. Informal channels of technology transfer, such as overseas education, training and work experience, overseas marketing and information trips, contacts with foreign buyers of export products and suppliers of equipment and technology are at least as important, if the experience of other successful development countries is a guide.

37. The "airlock" of China's trade system--the almost complete absence of direct contact between production enterprises and foreign sellers and buyers--still prevents a considerable amount of technology transfer. Too much emphasis is placed on the acquisition of hardware, and very often too much, or inappropriate, hardware is acquired and is not used efficiently. There are, of course, deficiencies in domestic economic policies which account for part of this such as the bottlenecks in material and energy supplies resulting from administrative allocation at prices that do not cover the full cost of production. But foreign economic policies also play a larger role. While enterprises are free to use their resources to make business trips domestically, this does not apply in the case of foreign purchases or sales. Business trips abroad are strictly rationed and are even frowned upon as conspicuous consumption. Very often, however, a few thousand dollars for a business trip by the responsible enterprise managers could save a few hundred thousand dollars in equipment imports, or could lead to export opportunities that would otherwise have never occured. Instead, the Foreign Trade Corporations are believed to act as the perfectly knowledgeable intermediary--but they are far from that. This "airlock" even exists in the case of joint ventures. Very often, the foreign partner undertakes marketing and business contacts alone, often through a Hong Kong subsidiary of the joint venture to circumvent restriction on overseas travel. Important opportunities for Chinese staff of joint ventures to learn marketing and business skills in working together with the foreign partner thus get lost.

38. One of the most important elements of an effective technology transfer strategy is to strive to "unbundle" the technology package as much as possible by increasing the domestic content in procurement, erection, detailed engineering and so one. However, this has to be a gradual process and will depend on the kind of technology involved and domestic capabilities. Enterprises will clearly have to play the key role in this process and direct contacts with overseas suppliers and buyers are essential to accelerate this process. In order to permit rapid domestic diffusion of these skills, the

strengthening of the domestic engineering and consulting industry is of utmost importance, as is considerably higher labor mobility for technical and managerial personnel. Financial institutions could also play an enlarged role in this process, and some investment and trust companies have already started to do so. In addition, as pointed out earlier, a new role could be played by the technical import-export corporations in becoming service and information agencies. These services could in part be financed by a small levy on international trade. Another function that needs strengthening is quality assurance and quality control for export and domestic production.

VI. External Capital

39. The use of foreign capital permits an increase in the volume of imports now against payment later. If used skillfully, this will permit accelerated technology acquisition and, therefore, higher growth. Apart from loans from aid agencies and multilateral institutions, the two main forms of external capital available to China to fund desired imports that cannot be met by current foreign exchange earnings are foreign direct investment and debt. Both are being used extensively at present, but it should be recognized that those represent alternative ways to acquire desired imports, and particularly technology imports. The use of foreign direct investment can bring with it not only technology and finance, but also better management skills and access to export markets. The use of debt permits Chinese enterprises to acquire both hard and soft technology and may allow more control over the choice of technology, and to permit more rapid diffusion to other Chinese enterprises. However, at this stage, Chinese enterprises may find it difficult to procure the best technology available, and, of course, China would be responsible for its own debt service. The balance of these arguments can change over time, and the policies need to be constantly reevaluated. In the following paragraphs, the mission's views on the current situation with respect to these two issues is discussed.

Foreign Direct Investment

40. Of the various forms of foreign direct investment in China, the equity joint venture is the one preferred by the authorities as it appears to be the only form which can capture the four above-mentioned benefits (technology, skills, finance and export markets). However, results to date have fallen short of expectations, in terms of composition (too many hotels relative to manufacturing), volume, and sources (mostly Hong Kong). Therefore, there have been disappointing results in terms of, in particular, technology acquisition and export marketing. There is disappointment on the side of investors as well, in particular with respect to interference in management and the application of the foreign exchange balance requirement. With respect to this latter issue, the authorities have been flexible in solving problem cases but the fundamental issue remains.

41. The new 22 articles published on October 11, 1986, attempt to address these problems and represent a good faith statement by the Chinese authorities of their interest in stimulating foreign investment. They are indeed a positive step forward, but investors that we have visited are holding judgement until they see the detailed regulations on how the articles will be applied, especially with regard to independent management and foreign exchange balance.

42. The fundamental resolution to the foreign exchange balance issue lies not, in our opinion, in further regulations but in the establishment of a foreign exchange market. We consider that the benefits of foreign direct investment would be substantially increased if a foreign exchange policy of the type we have discussed earlier were to be applied as joint ventures require access to foreign exchange for their import needs. This is, therefore, a further reason to consider seriously those options. Just as it is our view that Chinese enterprises will not export without appropriate incentives, so the same is true of foreign enterprises, and there is considerable evidence that the present policies of promoting exports through rigid application of the foreign exchange balance requirement does not work. In areas with more advanced technology, joint ventures cannot immediately become internationally competitive because of the need to learn and achieve an efficient scale of operations. In some cases, the Government is now permitting sales in the domestic market for foreign exchange, and permitting enterprises a number of years to achieve foreign exchange balance, or outright sale of foreign exchange to joint ventures. But these measures are applied unsystematically and create considerable uncertainty. As a result a considerable number of potential joint ventures are not concluded because of these uncertainties and contracting difficulties.

43. The mission also considers that Chinese policy makers should recognize more clearly the main attraction for foreign investment in China: the domestic market of 1 billion people. As noted earlier, efficient import substitution is as good for the economy as exports, and in addition, there could be benefits to the economy from the demonstration effect and competition that this would bring to the domestic market. Potential contributions which joint ventures can make towards the diversity and sophistication of locally-based capability, through their ability to mobilize advanced technology and management, should not be left unutilized. However, it would be dangerous to encourage investments aimed at the domestic market which would enjoy high levels of protection. Therefore, the mission would recommend a gradual opening up of the domestic market to foreign investment in line with the implementation of trade policy reform outlined earlier, particularly in activities where foreign investment could make the greatest contribution in bringing in new production or management techniques.

44. Other issues are raised by compensation trade, leasing and similar contractual arrangements for private direct investment. These are granted concessions in the form of tax waivers which are similar to those granted to equity joint ventures. However, they are qualitatively very different, in that they do not confer, in particular, any form of management skills. There are five key issues with respect to these arrangements: (1) they are not true private direct investments, but are really a form of importing machinery and equipment with noncash payments; (2) as such, they represent a form of financing, and therefore this is debt, with a future stream of obligatory repayments; (3) because of the form of repayment, a part of future export earnings is pledged, and this should be taken into account in balance of payments planning; (4) given the form of the arrangements, it may well prove that this is a rather expensive type of borrowing, as the lenders may be increasing machinery prices or reducing export prices to cover their increased administrative costs and higher risks; and (5) the tax concessions granted to such arrangements create serious distortions, and may well not be justified in view of the facts already described. From these points, two courses of action can be recommended. Given the debt implications, MOFERT should ensure that all such arrangements are fully reported to SAEC, so that they can be incorporated into the debt monitoring system and foreign

exchange planning. Secondly, the Government would be advised to review its current policy stance towards such arrangements, and seriously reconsider whether the benefits they confer merit the major concessions that are currently granted.

Debt Issues

45. External debt has risen rapidly in the last two years to fund the large trade deficits. The mission concurs with the government's intention to slow down debt accumulation, and to bring debt management under control, not least because of the unfavorable composition of recent debt, of which about one-half is short term and at variable interest rates. In particular, we welcome the State Council's April 1986 decision to make the State Administration for Exchange Control (SAEC) the sole agency responsible for debt monitoring, and the efforts of SAEC to improve debt information and ensure the consistency of the volume and composition of debt with overall macroeconomic objectives. In this context, arrangements such as compensation trade, leasing and other contractual forms of foreign investment which result in pledges on export earnings should be taken into account in assessing the ability to service external debt.

46. In addition to the Bank of China, there are eight institutions permitted to borrow abroad, subject to SAEC approval. Some of those we met considered that borrowing rights should be further decentralized, and that they should be permitted to borrow abroad without SAEC approval. We would urge caution in this matter, and recommend continued approval authority for SAEC. Centralized control over foreign borrowing is necessary in all cases where such borrowing is explicitly guaranteed by the government and represents sovereign borrowing. But even if such guarantees are not explicitly given, foreign lenders very often construe such debt as implicitly guaranteed by the government, and therefore de-facto sovereign. In the Chinese circumstances, it is especially important that the responsibility of government on debt incurred by institutions such as CITIC and the other provincial investment and trust companies, as well as commercial debt guaranteed by the Bank of China, be clarified as soon as possible. If these debts are recognized as sovereign borrowing it is obviously disadvantageous to China for enterprises or financial institutions with lower credit standing to enter international financial markets and borrow at higher interest rates than available for sovereign borrowing. The effective costs of countertrade transactions, leasing or similar operations can be particularly high and the higher cost of such borrowing needs to be weighed against any other benefits that they might provide such as, for example, more efficient resource allocation and greater flexibility. However, if a foreign exchange market were established as recommended above, these advantages would probably be very small. Centralized management of foreign borrowing remains therefore essential, not only to ensure that the total volume of debt does not result in debt servicing problems, but also that the cost of debt is minimized by adopting an appropriate composition and structure.

47. There is also a danger that borrowing by joint ventures or countertrade practices could lead to an unplanned increased in debt, or an inappropriate composition of debt. We would recommend that any such borrowings should require prior registration with SAEC, on an automatic approval basis, but with provision for SAEC to investigate and delay for a specified time-period, any such borrowing over a certain level, say US$5 million.

48. Chinese trade and financial corporations incorporated in Hong Kong can borrow abroad and onlend to Chinese enterprises without prior approval, despite the fact that it appears that the government of China is ultimately responsible for such debt. These corporations should be treated as foreign corporations, and their borrowing should not be guaranteed implicitly or explicitly by the government. If the government wishes to continue to offer these implicit guarantees, such debt should be included in SAEC's debt program. If the first option is chosen, borrowing from these corporations by Chinese enterprises should be subject to SAEC approval, for the present practice, which appears to be on the rise, also runs the risk of increasing China's external debt in an unplanned way.

49. These three recommendations all entail a greater role for SAEC. They will be beneficial to the extent that SAEC becomes an efficient institution. Therefore, the overriding priority is to continue the efforts already begun to make SAEC an efficient and respected debt management agency.

Annex III

China
External Trade and Capital Study
Proposed Outline

Summary and Recommendations

Main Report (60-80 pages)

1. Recent Trends in Foreign Trade and Economic Relations
2. The Role of Foreign Trade, Technology and Capital
3. Trade Policy and Macro-Economic Management
4. Export Prospects for Manufactured and Primary Commodities

Annexes (150-180 pages)

1. China's Foreign Economic Relations and Trade System and Institutions
2. Trade Incentives, Policies and Institutions
3. External Economic Policies and Technology Transfer
4. The Role of Foreign Direct Investment
5. Agricultural Trade Policies in a Distorted World Market
6. External Borrowing and Debt Management

INTERNATIONAL MONETARY FUND

my file

Mr. Brau

For your information

c/c Ms Kelly

China

Kunio Saito

KS c
Fued

Office Memorandum

TO: The Deputy Managing Director

November 3, 1986

FROM: P.R. Narvekar PRN

SUBJECT: Your Visit to China

As requested, attached is the latest World Bank economic report on China, together with the executive summary of the Bank's study on finance and investment. 1/ Also attached are some notes on key institutions and officials in China prepared as background material for participants in the colloquium.

There are two matters that may be raised during your stay in Beijing to which I felt I should draw your attention. First, Chinese officials may inquire whether the level of conditionality under their first credit tranche program (now scheduled for Board consideration on November 12) is excessive, given the guidelines under the Fund's tranche policies. (This will be the first Fund arrangement in the first credit tranche since China's previous program in 1981.) On our part, we have responded to this question by attempting to set it in the context of the need to reduce China's large external deficit. Consistent with their financial conservatism, the authorities fully agree with this objective and the need for domestic and external financial restraint, together with exchange rate, interest rate and price adjustments--all of which are major elements of the program. In finalizing the program, we stressed to the authorities the importance of persevering with financial restraint, continuing improvements in the system of macroeconomic management, and implementing further price and enterprise reforms.

The second matter which may be raised by Chinese officials involves the recent measures for promotion of foreign direct investment, which were announced in response to complaints by foreign investors concerning, inter alia, high labor costs and difficulty of access to foreign exchange. The new measures include reductions in the previously high level of payments made to the state for the hire of local labor, some additional tax preferences, and permission for joint venture and foreign-owned enterprises to mutually adjust their foreign exchange surpluses and deficiencies. While this arrangement for foreign exchange transactions would introduce additional flexibility and a greater market orientation, it may give rise to a multiple currency practice subject to approval under Article VIII. In this connection, we are presently endeavoring to collect additional information, but it appears that the authorities are still at a very early stage in drafting detailed regulations. The authorities may also raise with you the more general question of the possible use of multiple exchange rates in China; we

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1/ The finance and investment summary, which is only in yellow-cover draft and has not yet been discussed with the authorities, has been provided by our Bank counterparts on a confidential basis.

have responded to this question by pointing out the serious administrative and resource allocation problems to which such systems generally give rise.

Attachments

cc: Mr. Mohammed (without IBRD economic report)

CHC--gsc61103ch 11/3/86

China--Key Institutions and Officials--Background Information for the Colloquium

The People's Bank of China (PBC), one of the cosponsors of the Colloquium, is now a full-time central bank, as its urban commercial banking function was transferred to a newly established specialized bank in 1984. It also handles the matters related to the Fund and AsDB--the Ministry of Finance handles IBRD matters.

Governor (Mme.) Chen Muhua spent much of her earlier career in various agencies in charge of foreign economic relations. She was the Minister of Foreign Economic Relations and Trade until March 1985 when she was appointed PBC Governor to strengthen the Bank's leadership (unlike her predecessor, she is a state councillor). She is well-briefed on key policy issues and an impressive speaker. She is expected to attend the Annual Meetings next year as the Governor to the Fund.

The First Deputy Governor Liu Hongru virtually runs the PBC. He studied in Russia, is also a part-time lecturer at universities, and has many publications on monetary issues. Mr. Shang Ming used to be a Deputy Governor and, then, Advisor. He has now formally retired but still plays an active role, especially in international meetings. Other PBC officials involved in the Colloquium include Mr. Che Peiqin (Director of the International Department and Alternate Governor to the Fund) and Mme. Yang Jingping (Acting Chief, IMF Division).

A number of other institutions will also be involved in the Colloquium; the roles of these institutions are changing considerably with economic reforms. The State Commission for Restructuring the Economic System (the other cosponsor of the Colloquium) is a relatively new institutions (established in 1980), and is in charge of formulating policies for long-term reform. The State Planning Commission used to be the most powerful institution handling the formulation of the State Plan. Its power has diminished with reforms, but, nevertheless, it still commands considerable influence in the interdepartmental discussions of all aspects of economic policies. The role of the Ministry of Finance has also changed with reforms from one of a direct controller of all public sector finance to that of an agency in charge of fiscal policy and central government accounts--greater autonomy has been given to local governments and public enterprises, and the importance of fiscal policy as a macroeconomic instrument has increased. The Ministry of Foreign Economic Relations and Trade now focuses on external trade policy, as most of its operational functions have been transferred to foreign trade corporations. The specialized banks consist of the Industrial and Commercial Bank (urban commercial banking), the Agricultural Bank (rural commercial banking), the Bank of China (foreign exchange), and the People's Construction Bank (long-term investment finance).

The State Council (Cabinet) consists of Premier Zhao Zhiyang, Vice Premiers Wang Li, Yao Yilin, Li Peng, and Tian Jiyun, and some 20 other members (including Minister of Finance Wang Bingqian and PBC Governor Chen Muhua) who are elected by the Party. It meets regularly and frequently (at least once a week) to consider policy matters brought up by responsible ministries, usually after interdepartmental meetings. The Party's Secretariat (9 members) is headed by General Secretary Hu Yaobang and works closely with the State Council. Key policy issues are referred to senior leaders--Mr. Deng Xiaoping, Mr. Li Xiannian (President), Mr. Chen Yun (a well-known economist and an architect of the planning system in the 1950s), as well as Messrs. Zhao and Hu. These officials meet frequently on an informal basis and form the five-member "Politburo" (more formally, the standing committee of the Political Bureau of the Party). Reportedly, Messrs. Li and Chen (as well as Army Marshal Ye Jianying who was also a Politburo member but died recently) expressed occasional reservations to reform moves put forward by Messrs. Deng, Hu, and Zhao. Mr. Deng Xiaoping's only formal positions are the Chairmanships of the Party's Advisory Committee and the Military Commission.

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中國人民銀行

THE PEOPLE'S BANK OF CHINA

HEAD OFFICE

Address: San Li He,
Beijing, China
Cable Address: RENMINBANK

November 1, 1986

Dear Mr. de Larosiere:

I hereby confirm that the signature of Mr. Liu Hongru, Deputy Governor of the PBC, on the Letter of Intent dated October 3, 1986, has been under my authorization.

Sincerely yours

Chen Muhua
Governor
People's Bank of China

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

ORIG: ASD
CC: MD
DMD
MR. DAI
ETR
FAD
LEG
RES
TRE
SEC
MR. R. BROWN

Office Memorandum

TO: Mr. Saito — October 22, 1986

FROM: Peter J. Quirk

SUBJECT: China--Foreign Exchange Swaps by Foreign Direct Investment Enterprises

The following is in response to your request for clarification of some aspects of the reported scheme for swapping foreign exchange between foreign direct investment enterprises in order to facilitate more efficient use of exchange for import requirements.

On the basis of available information it is not entirely clear whether the swaps will be permitted between the enterprise themselves, or with the intermediation of the banks. There is also the question as to whether the exchange rate at which the swaps take place is negotiable between the enterprises, or is set at the prevailing official rate or another rate by the authorities. It is reported in the press that the rates will be negotiated.

I have discussed the jurisdictional implications with Mr. Francotte. The view of the Legal Department is that, if the exchange rate struck for these transactions differs from the official exchange rate, then governmental action would be involved. This would result from actions necessary to preclude transactors other than the foreign direct enterprises from the arbitrage opportunities that the different exchange rate would create. For this reason, the swaps could give rise to a multiple currency practice, if the 2 percent threshold is exceeded.

Broadly speaking, the scheme appears, from available information, to introduce an element of market-related flexibility, although with the added complexity associated with dual exchange rate mechanisms.

cc: Mr. Finch
Mr. Brau
Mr. Francotte
Ms. Kelly (o/r)

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MR. SAITO OF ASIAN DEPT.
INTERFUND

AFTER CHECKING WITH NATIONAL BUREAU OF STATISTICS WE NOW PROVIDE YOU THE REVISED DATA ON TRADE (LINE 70-ZF AND 71-ZF) FOR THE PERIOD NOV.1985 THROUGH APRIL 1986 AS FOLLOWS:
(IN BILLION OF YUAN)

PERIOD	EXPORT	IMPORT
NOV.1985	7.82	12.21
DEC.1985	11.99	20.03
JAN.1986	5.90	7.34
FEB.1986	6.03	10.16
MAR.1986	6.82	10.89
APR.1986	7.73	12.47

PLEASE NOTE THAT DATA FOR NOV. AND DEC. OF 1985 ARE SUBJECT TO FURTHER REVISION.

BEST REGARDS

YANG JINGPING
DEPUTY CHIEF
IMF DIVISION
INTERNATIONAL DEPT.
PEOPLE'S BANK OF CHINA
OCT.24,1986
86-925

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Connect Time : 183 seconds

INCOMING CABLE/TELEX

Office Memorandum

my file

TO: Mr. Huang

October 23, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--New Foreign Exchange Arrangements

Attached please find, for your information, two recent press articles regarding new foreign exchange arrangements for joint ventures and foreign enterprises in China. Since this subject is of great interest to the Fund and could be raised during the forthcoming Board discussion on China, we would appreciate it very much if you could consult your authorities and provide any additional relevant information. In the meantime, we have asked Ms. Kelly, who is in Beijing during October 23-24, to try to contact SAEC officials.

Attachments

cc: Messrs. Brau/Quirk

India May Get Military Aid From the U.S.

But Help Would Depend On Keeping Technology Away From the Soviets

By TIM CARRINGTON
Staff Reporter of THE WALL STREET JOURNAL

NEW DELHI, India—Defense Secretary Caspar Weinberger indicated the U.S. is willing to help India modernize its military, but officials added that such aid would depend upon safeguards meant to keep U.S. technological secrets from the Soviets.

U.S.-Indian collaboration appears most likely in the possible sale of a so-called supercomputer to India and the possible production of an Indian light-combat aircraft. After meeting Saturday with Indian Prime Minister Rajiv Gandhi, Mr. Weinberger held out the promise that the two countries might set up coproduction plants here.

The Indian government tomorrow is expected to give the Pentagon delegation, which is on a four-day visit to India, a response to suggestions by the U.S. about how it might assist India in building a fighter plane. A potential stumbling block, officials said, will almost certainly involve proposed security arrangements to keep U.S. fighter-plane technology from the Soviet Union, India's main source of military hardware.

Lost Technology

Secretary Weinberger is scheduled to tour Indian technological facilities in Bangalore today. Officials say the Indians hope to impress the Pentagon chief with their tight security there. "We have an excellent track record" in protecting sensitive technology, an Indian government official said. He noted that, over the years, India has closely guarded Soviet military secrets.

The Pentagon will remain skeptical, however. "We have the basic position that we have lost, in the United States, a lot of technology to the Soviets," Mr. Weinberger said. "We have been quite careless."

Because of this concern, Mr. Weinberger has assigned Assistant Defense Secretary Richard Perle, the Reagan administration's staunchest anti-Soviet official, to lead a compaign to block sensitive technology sales except when countries can satisfy U.S. demands for tight security.

'A Few Barnacles'

Working out these details with India is creating "a few barnacles" in negotiating the terms of military collaboration, a U.S. official said.

Another problem is that by law, the U.S. government reserves the right to cancel a planned arms sale as international

Peking Announces Regulations Meant To Mollify Foreign Investors in China

By VIGOR FUNG
Staff Reporter of THE WALL STREET JOURNAL

HONG KONG—The Peking government unveiled regulations meant to address growing complaints by foreign investors in China.

The new rules, which took effect immediately, are meant to deal with red tape, growing operating costs for foreign investors, a shortage of foreign-exchange income and government interference.

News of the regulations came after an announcement Thursday that the State Council has set up a working group to supervise foreign investment in China. At a time when China is short of funds to develop its economy, officials worry that foreign investors will shun the country. Foreign investment in China fell 20% in the first half from a year earlier, to $1.24 billion, the first decline since Peking opened to foreign investment in 1978.

"Previously, Chinese officials thought that when they opened the door, money would flood in," an Asian diplomat said. "It isn't true. They don't know how capitalists work. Without a good environment, no one would invest in China." Now, he said, China is beginning to realize that foreign investors won't come if they can't make money.

Exports, Technology Cited

The new regulations apply mainly to Sino-foreign joint ventures and to enterprises in China that are wholly owned by foreign companies and that either are export-oriented or possess advanced technology.

The regulations aim to cut labor costs, lower taxes and reduce land-use fees for enterprises with foreign investment. The rules guarantee that these enterprises will have priority in getting services, such as electricity, and in getting loans from Chinese banks. Also, ventures are assured greater management autonomy.

Under the rules, export-oriented and technologically advanced Sino-foreign enterprises will be exempted from making various payments to the government, except for items such as labor insurance. This should cut labor costs. Charges for water, electricity and other amenities will be the same as for state concerns. Currently, Sino-foreign joint ventures pay higher prices for such services.

Income-Tax Provisions

The regulations stipulate that when the foreign investors in these enterprises remit profit abroad, the amount remitted will be exempted from income tax. Most Sino-foreign joint ventures currently pay a 33% income-tax rate, but they are exempted from paying income tax for two years, and the tax is reduced by half for the subsequent three years.

Also, all enterprises set up in China with foreign investment will be allowed to trade foreign exchange for Chinese currency among themselves, instead of having to go through banks. If foreign investors in all such enterprises reinvest their profits in China, the tax paid on profit will be refunded, but such reinvestment has to last at least five years. And all Sino-foreign enterprises will be exempted from paying the consolidated industrial and commercial tax, a kind of sales tax, levied on goods they export, except for crude oil and a few other items.

Also, their autonomy will be guaranteed. They will have the authority to set production plans, hire or dismiss employees, set wages, and manage their enterprises "with international advanced scientific methods," which could mean capitalist methods.

Bundesbank Will Determine Whether Dollar Rallies or Declines, Traders Say

By CHARLES W. STEVENS
Staff Reporter of THE WALL STREET JOURNAL

After trading within a tight range most of last week, is the U.S. dollar ready to rally, or will it resume its decline?

"That's something only the Bundesbank can decide," said James S. Vick, vice president and chief corporate foreign-exchange trader at Manufacturers Hanover Trust Co., referring to the West German central bank.

It was the Bundesbank that halted a dollar sell-off last Tuesday as it led several other European central banks in making large dollar purchases. The U.S. currency was little changed Wednesday and Thursday, but speculators sold dollars Friday after Claus Koehler, a Bundesbank directorate member, said that Tuesday's intervention wasn't intended to reverse the dollar's course but only to slow its decline. His remarks were made in a speech in [illegible] tem, a joint float of eight continental currencies.

Temporary Rebound Possible

Although market sentiment toward the dollar is generally negative, the currency could rebound temporarily this week, some traders said.

According to technical analysts, who predict exchange-rate movements based on past trading patterns, the dollar is near a bottom "chart point" where the currency appears as a good short-term buy. Also, a string of government reports on the U.S. economy this week may be interpreted positively, traders said.

"Between the technical and the economic indicators, people may find excuses to buy back dollars," said Francoise Soares-Kemp, vice president and chief corporate trader at Credit Lyonnais, New York.

In late New York trading Friday, the

c c: Mr. [illegible] K8

looks a bargain.

Despite this refusal to be straitjacketed, financial services seem set to remain the focal centre. Mr Gunn is bringing four new, and relatively young, directors with him onto B&C's aging board, all of whom have worked with him and share financial backgrounds. Their first task will be to review the more than 60 associate and subsidiary companies listed in B&C's latest annual report.

Meanwhile, Mr Gunn could be excused a wry smile at Exco's plight. By sitting tight on its cash pile of £350m, Exco has attracted hostile predators, among them Mr Tan Sri Khoo Teck Puat, a Malaysian businessman who has a 29% stake, and Canada's Belzberg family, which has a 10% holding. Standard Chartered Bank, in which Mr Tan holds a stake, is an oft-rumoured suitor. An Exco attempt to merge with Morgan Grenfell fell through earlier this year because of a Bank of England ruling that a banking group can hold no more than 10% of a money broker. Now Exco looks ripe for dismemberment.

Inter-dealer brokers

Gilty adolescents

Amid all the changes associated with London's Big Bang on October 27th, only one wholly new species of dealer is being born: the six firms of inter-dealer brokers (IDBs) in the new gilts market. These infants are having to grow up fast. During the first rehearsal of the new market on September 27th, turnover was so much higher than expected that, if it is repeated at the second rehearsal on October 18th, IDBs will have to raise more capital. This is because the Bank of England bans them from trading more than 200 times their capital base. One—Williams, Cooke, Lott & Kissack—is already taking precautions. On October 15th, it secured an increase in the capital available to it from its parent, Exco, a financial services group, from £4.2m ($6m) to £12.7m.

From October 27th, IDBs will act as intermediary brokers increasing liquidity between the 27 primary dealers in gilts. They will buy gilts from one market-maker and sell them on to another, taking a turn of 1/128th of a percentage point, which they add to the price the buyer pays for the bond. America, which has had these beasts in its Treasury bond market for years, sees no need to set capital ratios for them.

Initially, each IDB had capital of around £3m-4m, making a total of between £18m and £24m for the lot. Under the 200 times rule, that would mean that all six could between them handle turnover of about £4.5 billion a day, if it was evenly distributed between the firms. Average daily turnover in the pre-Big Bang gilts market is only £1 billion-1.5 billion. Most IDBs expect about 50% of the new market's turnover to go through them.

Rough estimates put the volume of business going through IDBs during the rehearsal on September 27th at £6 billion in only two hours. The dealing was so heavy that some IDBs' computer systems failed. And it was not evenly distributed between them. Still, the first dummy run was only a blurred guide to the future. The Bank pummelled the market with a barrage of "events" (eg, money supply announcements and so on) unlikely to coincide on a normal dealing day. The gilts futures markets, where market-makers could normally hedge their positions instead of dealing, were not open.

The Bank says it will check each IDB daily once proper trading starts. If an IDB does run into capital-adequacy problems, most should be able to get help from their parent companies without much difficulty.

Capital will not be the only problem, however. Most in the City of London reckon there is room for only three or four IDBs in the London market. It is not shortage of business that matters, but shortage of space. Inter-dealer brokers' prices are quoted on screens, and it is too much to expect busy traders to stare at six screens. As some IDBs prove they are more efficient than others, business is likely to flock their way. The others could die quickly, becoming Big Bang's first victims.

Chinese financial reforms

On your Marx . . .

China is dabbling with financial markets and competition between banks, in reforms ranging from "socialist" joint-stock companies to trading in shares, bonds and foreign exchange. Our correspondent visited Shanghai to try to make sense of this babble of experiments. One thing was plain: Chinese shares are not quite like anybody else's

In late August, China's most authoritative newspaper, the *People's Daily*, astonished readers used to 37 years of central planning by saying that stock-issuing companies are "precisely" the form of common ownership that Karl Marx envisaged. In September, it added that eventually all medium and large enterprises in China—even railways, utilities, banks and telecommunications—should issue shares and answer to a board of directors. The paper suggested the government should own no more than 51% of a company's total share issue.

Such statements are part of a debate being encouraged by Mr Deng Xiaoping and other Chinese leaders on how best to see that more domestic cash and foreign-exchange flow to efficient managers than at present. The main experiments are to allow businesses to borrow by selling bonds to the public and to raise capital by issuing shares. Out of these experiments are emerging fledgling exchanges trading shares and bonds. The banks are also being prodded to be innovative. The government has permitted them to trade money through an interbank market and foreign-exchange swapping, and has pushed them to compete with each other for deposits and loan business.

The enthusiasm of middle-ranking bankers and urban entrepreneurs for the experiments is unmistakable. Only five cities—Shenyang, Chongqing, Wuhan, Canton and Changzhou—were chosen formally earlier this year for experiments in fund raising and money trading. But bankers in Shanghai, China's financial hub before the Communist revolution, and other cities are muscling in and experimenting on their own.

The re-opening of the **Shanghai stock exchange**, closed since 1949, is the most internationally visible, if partly symbolic, example of the new liberalisation. Hundreds of people jammed a small banking counter (not the site of the pre-1949 exchange) on September 26th when trading began in the first two listed Chinese "socialist joint-stock" companies. A tiny board on the wall listed the two companies' shares.

This reform is not as clear as it seems, for in China bonds and shares are hard to tell apart. Businesses in a few cities have been able to issue bonds for about two years, and what China calls shares for about a year, though securities have not been traded publicly. In Shanghai, more than 1,400 companies have offered stocks or bonds; most are sold through company employee schemes or to co-owners and customers of small factories.

Most issues so far, whether called shares or bonds, are more like what westerners call bonds. They are issued for a fixed term and earn a fixed interest rate—plus for shares a dividend, too. Except for Shanghai's two pilot listings, trading is limited to a fixed price and conducted through a branch of a state bank. Interest paid on some issues equals the 7.2% offered on bank deposits. Dividends are subject to ceilings that vary from city to city.

For example, the larger of Shanghai's two listed companies, the Shanghai Yanzhong Business Company, had sold "shares" for a year before its listing. With a product range extending from underwear to photocopiers, it has 18,000 shareholders, with shares worth a total of 5m yuan ($1.4m). During the first three weeks of trading, Shanghai Yanzhong's share price rose from 50 yuan to 54.70 yuan. Issues often feature a lottery as part of the sales pitch. Shanghai Yanzhong's boss, Mr Zhou Xinrong, has set aside 40,000 yuan just for lottery prizes with his shares.

Mr Zhou is both chairman and general manager, responsible to a board of 32 directors. He proudly shows visitors a videotape of national news coverage of the company's first day of trading, and of its first shareholders' meeting. The question of how much say in management to give shareholders is still being debated. But apparently some "shareholders" are already more equal that others. Only 300 of the Shanghai Yanzhong's 18,000 so-called shareholders were invited to elect the board of directors. Mr Zhou says the 300 were those who had large holdings, or were technical advisers to the company, or (even in China's classless society), were "social notables".

Mr Wang Yuchun, manager of the Shanghai office of China's Industrial and Commercial Bank, the new exchange's sponsor, jokes that the exchange is only a *mengya*, or beansprout market. A question about underwriting drew a shrug. There are no brokers, nor an easy way to match buyers and sellers.

Anybody wanting to sell his shares can go to the exchange's banking counter, which quotes the price and acts as a jobber. Many buyers and sellers just find each other. It is too early to say whether this rough-and-ready secondary market really works. Though formal listing requirements are minimal, four of six applicant companies "are not suitable".

The total return on Shanghai Yanzhong's shares will probably be 15% in the coming year. Mr Wang explains the interest rate on shares by saying that China's erratic structure of prices and subsidies, itself undergoing reform, means investors cannot judge the performance of a company on its profits alone. Therefore, until China's economic reforms are more advanced, investors in shares as well as in bonds will be guaranteed at least the equivalent of bank interest.

The city of Shenyang, which in August opened China's first **bond market** since 1949, has so far issued some 200m yuan worth of bonds. Chongqing is preparing to open a stock exchange soon. In Canton, at least 600 companies have raised a total of 120m yuan through various issues, and an exchange is planned, too.

Shanghai has moved ahead in recognising the need for two big changes in banking: lateral links between bank branches rather than, as now, passing all orders through head office; and ways to ease shortages of foreign currency.

In mid-September, the city launched a **short-term, interbank market for money**. This is to let bank branches trade cash, matching surpluses at one with shortages at others. According to the New China News Agency, the five official pilot cities had by then already begun smaller experimental markets, involving banks in some 20 cities, with 14 billion-yuan-worth of trading so far this year. On Shanghai's first day of trading, 137m yuan changed hands. Since then, trading has averaged about 100m yuan a week, involving about 20 bank branches in the Shanghai area, and the system is open by request to banks anywhere else.

The Industrial and Commercial Bank's Shanghai headquarters has authorised its branch managers to develop cross-district relations. And Shanghai is the home of China's first private bank. It is the Shanghai Aijian Banking, Trust and Investment Company, a finance company set up to support one industrial firm but now permitted to trade in interbank and deposit markets.

The authorities are encouraging customers to shop around for the best service from banks, even though bank deposit rates are fixed and uniform. This is a boon to the four foreign banks allowed full branches in Shanghai for the past year, whose business is beginning to take off, albeit from a small base. Their attraction to Chinese managers is speed of execution. Factory managers are said to have travelled more than a day by train to open business with a foreign bank because of its faster service.

Foreign exchange blockages are worrisome because they deter foreign investment. The Shanghai foreign-exchange bureau, run by the People's Bank, is building a pool of surplus funds to try to develop a basic market **"swapping" foreign exchange**. So far that just means linking companies needing foreign exchange with other ventures, such as hotels, that have surpluses. There is talk of forward contracts as well. Only a few deals have been done, but, significantly in a country where the domestic currency is not convertible, the exchange rates for these "swaps" are negotiable.

The assistant director of the bureau, Mr Zhu Xiaohua, says that for the moment swaps are available only in Shanghai, although Shenzhen, the special economic zone on the border with Hongkong, has experimented with an exchange centre for some time. On October 13th, Canton authorities announced plans to open a foreign-exchange trading centre for the use of foreign joint ventures later this month.

Meanwhile, the Shanghai bureau has prepared a submission to the State Council in Peking outlining a national foreign exchange swap programme. It is typical of the gung-ho mood in the city that Mr Zhu says that should the State Council prove snooty, Shanghai will continue developing the idea anyway.

 Shares Shanghaied

ETR Files

Office Memorandum

TO: Mr. Saito

October 22, 1986

FROM: Peter J. Quirk

SUBJECT: China--Foreign Exchange Swaps by Foreign Direct Investment Enterprises

The following is in response to your request for clarification of some aspects of the reported scheme for swapping foreign exchange between foreign direct investment enterprises in order to facilitate more efficient use of exchange for import requirements.

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Broadly speaking, the scheme appears, from available information, to introduce an element of market-related flexibility, although with the added complexity associated with dual exchange rate mechanisms.

cc: Mr. Finch
Mr. Brau
Mr. Francotte
Ms. Kelly (o/r)

China file

Office Memorandum

TO: Mr. Saito

October 3, 1986

FROM: Eduard Brau

SUBJECT: China: Staff Report

This is a well written report on which I have one comment of substance, one on an omission, and smaller presentational points.

I am a little unhappy with the section on external financing on pages 28-30 because (i) no text table is provided giving, in easily readable form, an overview of the improvement in the debt structure that will be achieved as a result of the adjustment steps; (ii) no reference is made to the policy on gross reserves, nor to the fact that continued relatively high borrowing from commercial sources in 1987 is partly for the purpose of increasing gross reserves (a reference to this point should be made in the staff appraisal as well); and (iii) no reference is made to the fact, as I understood the September mission to have found, that a functioning debt control and approval procedure is in place, although clearly in need of considerable improvement. The present description is silent on this key point and, instead, talks on page 30 about "projected" flows instead of flows controlled at that level.

As to an oversight, I would urge inclusion in the staff appraisal of a sentence that indicates the staff's appreciation for the Chinese invitation for a small staff team to visit China in early 1987 in order to inform itself on the 1987 budget and the price reform, on which a report would be made for Executive Directors' information.

The presentational points include the following:

1. The title of Section V of the paper seems too grandiose.

2. Pages 14/15: Mention the past growth of export and import volume as a background to the medium-term projections. Contrary to the footnote on page 14, Table 10 does not list the assumptions regarding the external environment.

3. Page 20: Clarify the statement that before the recent reforms the main source of fiscal revenue was profit remittances.

4. Page 22: Include some of the details on the envisaged improvements in the tax system in 1987 that are discussed in paragraph 8 of the policy memorandum.

5. Page 30: Replace paragraph 4 (iii) with: "Cumulative limits from October 1, 1986, and through end-1987, on the contracting or guaranteeing of nonconcessional external debt with a maturity of over

1 year and up to 15 years, with a sublimit for debt with less than 5 years' maturity."

6. Page 36: The minor multiple currency practice is not recommended for approval because it apparently is not temporary and could easily be replaced by an alternative measure. The absence of balance of payments need is immaterial.

7. Appendix Table 3: Heading covers 1982-87 but data cover only 1982-86.

8. Appendix Table 6: Include as memorandum items the overall fiscal position according to the national definition (both in levels and as percent of GDP).

cc: Ms. Kelly

INTERNATIONAL MONETARY FUND

October 3, 1986

Mr. Brau:

China--Draft Staff Report for Consultation and SBA Request

Attached are comments on the draft staff report for China which was reviewed by Mr. Neuhaus.

cc: Ms. Dillon
Mr. Johnson
Ms. Kelly

Christian Brachet Cb.

October 3, 1986

China--Comments on Draft Staff Report for Consultation and SBA Request

I. Overview

The program seems to be broadly appropriate for a first credit tranche purchase, even though the authorities' intentions in the fiscal and trade areas are somewhat vague, as discussed below. Beyond these issues, our comments are mainly of a presentational nature.

1. Fiscal policy

The use of the national definition of the budget in the authorities' policy memorandum and of the GFS definition in the staff report is somewhat confusing. 1/ In our assessment of the policy memorandum a few days ago, and in the absence of tables, the authorities' objective of "achieving at least the targeted budgetary balance for 1986 . . . (or even) to realize a small surplus" (paragraph 7) seemed quite reasonable. The staff report, following the GFS definition, puts the matter into a different perspective, i.e., the financial program was framed on the assumption of a small deficit of Y 3.5 billion (0.4 percent of GDP) but the authorities have merely committed themselves to limiting the deficit to Y 7 billion (page 21). This ambiguity carries over into 1987, for which year the authorities' undertakings in the policy memorandum are equally vague. The staff report notes that the authorities are contemplating "a further reduction in the fiscal deficit" but it is not clear whether their 1986 base would be the budgeted deficit of Y 7 billion or the program's target of Y 3.5 billion; we note on Appendix Table 6 an indicative deficit of Y 3.1 billion for 1987 but it is not clear how firmly the authorities intend to aim for such a lower figure. Incidentally, the indicative quantitative benchmarks under the program do not include any subceilings on banking system (or PBC) credit to the Government; as the Treasury's net creditor position with the banking system is expected to improve during the program period, a floor on that creditor position might have been in order.

2. Trade and exchange system policies

On trade policies, the reforms in the recent past and the near future seem to focus on reducing administrative controls over foreign trade activities (i.e., letting enterprises transact directly with foreign customers and, to an extent, with foreign suppliers), and to broaden the scope of transactions that use the official exchange rate (rather than an accounting internal settlement rate). These are certainly welcome steps, but they still beg the question of the

1/ See page 21, footnote 1 of the staff report for the differences between the national and GFS definitions of the deficit.

predominant use of quantitative restrictions (instead of tariffs) on the import side. The report (and the policy memorandum) are silent on any scope for a shift towards a tariff-(rather than QR) based commercial policy, and it would at least be useful to indicate whether the coming World Bank study of China's external trade and capital (page 32) is planning to address this issue.

As regards the bilateral payments agreements, the authorities' intention to abolish the remaining arrangements has no operational content, because it is not explicitly linked to the program period. The Fund's satisfaction with the authorities' intention to eliminate these arrangements (pages 36 and 38) simply restates similar language used in the previous consultation, when an equally vague promise was made by the authorities.

3. Presentation

Pages 14-15: Mention the past growth of export and import volume (e.g., during 1980-85) as a background to the medium-term projections.

Page 20: Clarify the statement that before the recent reforms the main source of fiscal revenue was profit remittances.

Page 22: Include some of the details on the envisaged improvements in the tax system in 1987 that are discussed in paragraph 8 of the policy memorandum.

Appendix Table 3: Heading covers 1982-87 but data cover only 1982-86.

Appendix Table 6: Include as memorandum items the overall fiscal position according to the national definition (both in levels and as percent of GDP).

Office Memorandum

TO: The Deputy Managing Director
(Via Director of Administration)

September 29, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--World Bank Mission on the Study of External Trade Policy

The World Bank is sending a mission to conduct a study on China's external trade policy during October 6-25, 1986. We believe that the work in this area will be of crucial importance to us and that our participation would be of benefit not only to the Bank mission but also to our own work. Accordingly, it is proposed that Ms. Margaret Kelly (ETR) participate in the mission during the second part of its stay in China, October 12-25, 1986.

Mr. Huang has informally agreed to Ms. Kelly's participation in the Bank mission.

Mr. Beveridge concurs on behalf of ETR.

cc: ETR

1986 SEP 29 PM 3:09

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OCT 3 1986
EXCHANGE & TRADE RELATIONS

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SEP 29 1986
2:00
DY. DIR. ADM.

MISSION # 87040800
PROGRAM # 710

INTERNATIONAL MONETARY FUND

September 29, 1986

Mr. Brown:

I hate to ask this in these days, but would you kindly get this cleared as soon as possible so that I can give the good word to the Chinese.

PRN

Attachment

It should be better indicated that we can initiate consultations if we feel action is needed

Sept 29 '86

P. R. Narvekar

Office Memorandum

CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

September 29, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--Exchange Rate Policy and Use of Fund Resources

Since your meeting with the Chinese delegation on September 24, the staff has had lengthy discussions with Chinese officials for the purpose of obtaining from them assurances on exchange rate policy which would be an adequate component of the overall policies to be supported by a first credit tranche arrangement. The Chinese remained adamant throughout that they could not give a specific assurance as to the timing and extent of the next exchange rate change. However, they have given assurances on the flexibility with which they would pursue exchange rate policies in the coming months that I would regard as being satisfactory. These are incorporated in the attached (i) revised version of the relevant paragraph of the letter of intent, and (ii) memorandum to files signed by me but carefully reviewed by Deputy Governor Liu.

With Mr. Brau's concurrence, I now recommend the Chinese program for your approval. We could work toward an Executive Board meeting on November 7.

For your approval.

Attachments

cc: Mr. Brau
Mr. Brown

Paragraph on exchange rate policy from the draft Memorandum on the Economic Policies of China.

External policies

15. In the years to come, China will need to achieve export growth at a substantially faster rate than the growth in imports to reduce the external payments deficit. Since the reforms, the greater financial accountability of foreign trade corporations and the larger share of trade carried out through other channels have made the exchange rate an important macroeconomic instrument affecting export performance. To enhance our capacity to earn foreign exchange through export, effective July 5, 1986, the value of the renminbi was changed to Y 3.7 per U.S. dollar, representing a devaluation of 13.5 percent in U.S. dollar terms. With this adjustment, the depreciation of the renminbi against all our major trading partners during the last 18 months amounts to about 40 percent in real effective terms; against our competitors in Asia, the depreciation is estimated to have been about half that amount. We intend to maintain a flexible exchange rate policy in order to increase export volumes and strengthen the balance of payments. We will make further exchange rate adjustments as warranted by the implications of price reforms to be introduced in early 1987, as well as export performance, developments in the net foreign assets of the banking system and movements in the exchange rates and prices of our major trading partners and competitors.

CABLE ADDRESS
INTERFUND

CONFIDENTIAL

September 29, 1986

MEMORANDUM FOR FILES

Subject: Meeting with Chinese Delegation

On September 25, 1986, Messrs. Narvekar, Neiss, and Saito met with PBC Deputy Governor Mr. Liu Hongru, Mr. Zhang Zhixiang, and Ms. Yang Jingping. The meeting discussed China's exchange rate policy against the background of the indication given by the Managing Director in his September 24 meeting with the delegation that, before China's request for a stand-by arrangement could be presented to the Executive Board, there would need to be a clear understanding that the exchange rate for the renminbi would be adjusted during the coming months to the level mentioned by Mr. Narvekar; earlier in the meeting, Mr. Narvekar presented the staff's view that a further exchange rate adjustment to at least Y 4 per US$1 was required to ensure successful achievement of the authorities' export and balance of payments objectives, and that any such adjustment would have to be closely coordinated with price reforms.

Deputy Governor Liu agreed in principle with the need for further adjustment and indicated ~~that exchange rate policy would continue to be implemented flexibly.~~ He also pointed to the important links between the exchange rate and price reform, and stressed the need for careful coordination of these policies. Against this background, he noted the difficulty and time required to establish internal consensus on further exchange rate action in the period immediately ahead. In these circumstances, it was difficult to be specific about the timing and magnitude of further adjustment. However, the authorities would review the implications of price reforms to be introduced in early 1987 with a view to implementing shortly thereafter any further exchange rate adjustment that may be necessary to ensure proper coordination of policies and achievement of their export and balance of payments objectives. In this context, the authorities would discuss exchange rate and related policies with the Fund staff as appropriate.

P. R. Narvekar

P. R. Narvekar

cc: Deputy Governor Liu

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

With the Compliments of

Jiang Hai

Alternate Executive Director

Office Memorandum

cc: Mr. Bean O/r
Mr. Osunsade
Mr. Quirk

TO : Mr. Van Houtven

DATE: July 7, 1986

FROM : Jiang Hai Jiang H.

SUBJECT : China - Exchange Rate of Renminbi Against U.S. Dollar

I have received the following communication from my authorities:

"The exchange rate of RMB against U.S. dollars was adjusted July 5. The new rate is 370.36 Yuan RMB to 100 U.S. dollars, depreciation of 15.8 percent."

Will you please inform the Board.

China

5-150

RCV: @1IM/1.05832 LINE: 1

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ORIG: MR. HUANG

CC: ADM

ETR

MR . HUANG FANZHANG
E.D. FOR CHINA
INTERFUND

cc: Mr. Beaumont
Mr. Bean
Mr. Hino

PLEASE COPY TO ETR AND AD.

WE'VE HAD FRUITFUL DISCUSSIONS WITH MR. HINO AND MR. FETHERSTON ON THE MANAGEMENT OF EXTERNAL DEBT AND EXCHANGE RATE POLICY IN CHINA FROM MAY 27 TO MAY 30. THE IMF STAFF AND THE OFFICIALS CONCERNED OF PBC FRANKLY EXCHANGED THEIR VIEWS ON THESE ISSUES. WE WERE DEEPLY IMPRESSED BY THE STAFF'S EXPERIENCE AND IN-DEPTH PERCEPTION ON THE ISSUES. WE TRUST THAT OUR COOPERATION IN THESE FIELDS WILL CONTINUE.

BEST REGARDS.

INTERNATIONAL DEPARTMENT
PEOPLE'S BANK OF CHINA
JUNE 2, 1986
86-419

RECEIVED
JUN 2 1986
EXCHANGE &
TRADE RELATIONS

INCOMING CABLE/TELEX

Office Memorandum

cc: Mr. Brown
Mr. Hino

TO	:	The Managing Director The Deputy Managing Director
FROM	:	J. B. Zulu
SUBJECT	:	Monetary Instruments and the Framework for Monetary Policy Formulation in the People's Republic of China

DATE: June 2, 1986

Attached please find the summary section of the report of the CBD mission which visited the People's Republic of China during March 10-27, 1986.

Attachment

cc: Mr. Finch
Mr. Hood
Mr. Whittome
Mr. Mohammed
Mr. Ouattara
Mr. Shaalan
Mr. Tanzi
Mr. Tun Thin
Mr. Wiesner
Mr. Guetta
Mr. Sanson
Mr. Brown

EconDiv/86/2

INTERNATIONAL MONETARY FUND

Central Banking Department

MONETARY INSTRUMENTS AND THE FRAMEWORK FOR MONETARY POLICY FORMULATION IN THE PEOPLE'S REPUBLIC OF CHINA

Prepared by

Linda M. Koenig, Tomás J. T. Baliño, and Martin Fetherston

May 1986

I. Introduction and Summary

1. Background

The process of economic and social reform initiated in 1979 has entailed major changes for China's financial system, changes which already are substantial and which are bound to continue for many years to come. One of the most important changes has been the decision to transform the People's Bank of China (PBC) into an autonomous central bank, responsible for the conduct of monetary policy. This transformation in turn entailed the need to review the pre-existing framework for planning financial flows in the economy, and to create instruments whereby the PBC could carry out its task.

Prior to the reforms initiated in 1979, China's banking institutions had, at various times since the establishment of the People's Republic, been fused into a monobank, or divided into specialized banks, each of which was responsible for extending credit to a particular sector of the economy. In either case, the banking system was assigned the role of extending credit to enterprises to fulfill output targets. 1/ As of the start of 1979, all the specialized banks except the Bank of China (BOC), responsible for foreign exchange operations, were a part of the PBC. In line with the objective of moving to an institutional system which would foster efficiency and rely primarily on indirect instruments of macroeconomic control, the banking system was substantially restructured during 1979-83. The Agricultural Bank of China (ABC) was revived as a separate institution in charge of banking operations in

1/ For further details see Luc de Wulf and David Goldsbrough, "The Evolving Role of Monetary Policy in China," IMF Departmental Memoranda, DM/86/2, January 3, 1986.

the rural areas; the BOC was granted greater operational flexibility; and the People's Construction Bank of China (PCBC), previously a conduit for the channeling of budgetary funds to state-owned enterprises, was empowered to receive deposits and extend credit from its own resources.

The culmination of this restructuring process was the vesting of the remaining commercial banking functions of the PBC in a new institution, the Industrial and Commercial Bank of China (ICBC). As from January 1984, the ICBC became responsible for commercial banking functions in the urban areas, and the PBC became responsible for the full range of central banking functions, including inter alia those of formulating monetary policy, controlling the financial markets and supervising all financial institutions. 1/

In the two and a half years since its transformation into China's central bank, the PBC has made substantial progress in refining its financial programming system and developing the instruments required for the exercise of monetary policy. The second semester of 1984 was a watershed in this respect. The much more rapid than projected rate of economic growth and the deep structural changes which had taken place in the economy combined to place heavy pressures for credit expansion on the PBC. This expansion in turn contributed to pressure on prices and on the balance of payments. In response, in early 1985 the authorities moved to reaffirm the PBC's responsibility for monetary policy and to strengthen its authority over the financial system. The PBC

1/ The State Council's Decision: The People's Bank of China to Concentrate on its Functions as the Central Bank, December 1983.

itself tightened credit--in the first instance through direct means--and began to review its system of credit control and its monetary policy instruments.

Substantial progress also was made in the areas of accounting and statistical reporting. In particular, the separation of the accounts of the PBC from those of specialized banks, and the elimination of the common settlement account were major steps in these areas. Although further refinements will be necessary, the present statistical base provides a good starting point for more sophisticated programming techniques, which will be discussed later in this report.

The objective of this study is to evaluate the adequacy of China's monetary policy instruments and of the procedures the PBC uses to program its operations and those of the financial system as a whole. A basic premise is the autonomy of the central bank and its unique responsibility for the formulation and execution of monetary policy. While in any country, key decisions regarding economic and social objectives must be taken in the political arena--and goals regarding key macroeconomic variables such as the rate of inflation, the balance of payments and the rate of real economic growth must be arrived at through interaction between statesmen and technicians--the formulation of monetary policy and its targets is a technical matter falling within the competence of the central bank. The central bank also must design and operate the instruments by which monetary policy is carried out.

A second premise of this report is that, in the interest of economic efficiency, monetary policy should target macroeconomic objectives, work to the extent possible through market mechanisms and avoid allocating resources directly by means of administrative controls. This use of so-called "macroeconomic levers" does not mean total abandonment of the idea of directing financial resources to high-priority activities through selective credit mechanisms. It does mean, however, that in the longer run resource allocation would be effected mainly through the price mechanism and that selective credit would be well defined, limited in scope and with its costs specifically identified.

2. Summary of analysis and recommendations

The present framework for monetary policy formulation and several of the PBC's key monetary instruments have to a large extent been inherited from past decades when credit was fully programmed to support output goals, enterprises did not control their own funds, and the growth of currency was viewed as the principal determinant of macroeconomic balance. Since the transformation of the PBC into a central bank, much has been done to adapt the existing programming framework to the new conditions created by the economic reform and to carry out monetary policy through indirect, rather than direct, controls. In this process, pre-existing instruments of policy have been modified and a new one, the legal reserve requirement, has been created. The following paragraphs summarize the mission's analysis of the programming framework and monetary instruments as they operate at present and its recommendations concerning improvements which would adapt both the framework and instruments to current economic circumstances and to the authorities' policy goals. The mission acknowledges the fact that probably not all the recommendations could be adopted immediately. Therefore, insofar as possible, examples of time sequences that are technically appropriate are provided in different parts of this report.

a. <u>The framework for monetary policy</u>

A well-functioning framework for monetary policy is one that provides continuous support for the formulation and implementation of monetary policy. To perform this role, this framework should: (1) facilitate the establishment of policies which are consistent with the authorities' macroeconomic objectives for output, prices, and the balance of payments; (2) provide information which permits, if appropriate, a flexible and timely response by the authorities if policies move off track or if circumstances change unexpectedly; and (3) give clear operational guidelines to the authorities in their deployment of the various monetary policy instruments. The present Chinese policy-making framework has many of the above-mentioned elements, but there is need for improvement in several areas.

The present financial program--the Credit Plan--is developed "from the bottom to the top" and then executed "from the top to the bottom." This approach introduces an expansionary bias into the program and, more important still, means that the program is not firmly grounded in the authorities' macroeconomic targets. Also, under the present system, the growth in currency in circulation is the residual between bank credit expansion and deposit growth. No direct relation is made between currency growth and that of the other components of broad money. This approach probably was adequate at a time when households and enterprises were not free to substitute deposits for cash and when enterprise deposits could only be used for transactions under the Plan; neither of these conditions obtain any longer.

It is suggested that the programming process begin with a projection of broad money growth that is consistent with the authorities' price and output goals (and with a reasonable assumption concerning velocity). The disposition of banking system loanable funds (i.e., broad money) between net domestic assets and international reserves would be decided upon in a second stage, to incorporate into the program the authorities' balance of payments target. The expansion in the banking system's net domestic lending would be determined as the difference between broad money growth and the targeted change in net international reserves.

From this projection of banking system operations the PBC would proceed to derive a projection of its own operations, which would become the operational basis for day-to-day decisions regarding monetary policy.

A major issue which the authorities of any central bank must face is the selection of the appropriate intermediate and operational targets for monetary policy. Intermediate targets are those whose movement is closely linked to macroeconomic policy goals; operational targets are those which are directly under the control of the authorities and which, if met, will lead to the achievement of the intermediate targets. The two most common aggregates that serve as intermediate targets are money (for a closed economy or an open economy with a flexible exchange rate) and domestic credit (for an open economy with a fixed exchange rate). In the Chinese case, there are strong arguments for targeting both of them, as the economy is in an intermediate position between being closed and open.

A further issue in the selection of intermediate targets is the definition of money. Historically, Chinese monetary policy focused on a narrow aggregate--currency--although in recent years greater attention has been paid to various categories of deposits as sources of purchasing power. In the present circumstances of rapid financial innovation and structural change, broad money clearly is to be preferred to cash or narrow money as there are likely to be substantial shifts between broad money components. The choice of broad money also has the advantage that this aggregate encompasses the total resources of the banking system and thus corresponds well to an all-inclusive financial programming exercise.

The operational target or targets of policy should be aggregates contained in the balance sheet of the central bank itself, as these are under the direct control of the central bank and also can be monitored on a continuing basis with minimal time lag. Some variant of net central bank credit would seem to be the most appropriate operational target and--given the high level of excess reserves which the specialized banks hold on deposit with the PBC--a "net net" definition of credit--that is, net domestic credit <u>minus</u> bank reserve deposits, would seem to be the best operational target in the present circumstances.

The operational target or targets could be monitored at a biweekly or monthly meeting at which senior staff of the PBC would review monetary developments and address the need for any possible modification in policy stance and/or adjustment in the instruments of policy. As the basis for this evaluation, the financial program--both for the banking system and the PBC itself--should be subdivided into monthly subprograms against which developments can be assessed. These subprograms should be adjusted for seasonal variations in the aggregates. The inclusion of seasonality in the monthly subprograms will allow the authorities to make provision for seasonal variations and thereby remove one of the major factors which has caused the financial program to be exceeded in the past. This does not however mean that past seasonal patterns should be followed mechanically in drawing up the monthly subprograms.

The financial program on the basis of which policy is formulated should include all credit operations, regardless of their maturities. It also should cover foreign currency-denominated operations of the banks which, like local currency-denominated operations, affect aggregate demand. Finally, all financial institutions should be covered in the financial programming exercise. This however does not mean that inclusion in the program constitutes an entitlement to receive credit from the PBC.

b. Instruments of monetary policy

The transformation of the Chinese financial system entails important consequences for the instruments of monetary policy. Before the PBC's conversion into a central bank, the People's Republic of China relied primarily on direct instruments of control. The PBC now has begun shifting to indirect methods of monetary control, which are those relied on by most industrial countries and by an increasing number of developing countries as well. At present writing, the PBC has four major instruments to achieve its monetary and credit targets: PBC credit, reserve requirements, controls on interest rates and credit ceilings. Some improvements in the technical characteristics of these instruments are suggested, as well as in their coordination.

(1) PBC credit to specialized banks

In any country, the foremost consideration guiding central bank credit to banks is that the central bank retain tight control over its total credit operations at any point in time. Furthermore, this control should be exercised at the same level of authority as that which defines the monetary targets and executes credit policy; otherwise, the achievement of the monetary targets will be jeopardized. Decisions regarding central bank credit should take into account all types of credit given by the monetary authority, and they should be made in the context of the overall financial program.

PBC credit to specialized banks unquestionably is China's most important instrument for monetary and credit policy and is likely to remain so for the foreseeable future. The PBC at present has two credit facilities for banks, credit under the National Credit Plan and temporary credit. These PBC credit facilities pose several problems. The major ones are lack of accurate control by the PBC head office over the amount of outstanding credit at a given point in time and the attractiveness of PBC credit as a source for funds for specialized banks due to its relatively low interest rate and the fact that this credit does not have to be repaid.

These problems compromise the usefulness of PBC credit as a monetary instrument. To resolve them, the first recommendation is that all PBC credit, regardless of its maturity, be included in the financial program. This will allow the PBC to decide how much credit to grant during each programming period, in line with the intermediate targets for broad money and net domestic credit. PBC credit, like other elements of the financial program, should be broken down into subperiods and seasonally adjusted. The decision as to whether to grant credit up to the maximum allowed by the financial program during any particular period would be taken on a monthly or biweekly basis after a review of monetary conditions.

Control over the aggregate amount of PBC credit should be firmly in the hands of the PBC head office, since it is the head office which is responsible for the attainment of the monetary and credit targets. This does not preclude some operational decentralization, which may be required given China's size and communications difficulties.

All new credit should bear a maturity. This has two purposes. One is to eliminate the expansionary bias discussed above, by giving PBC the possibility of reallocating and absorbing credit rather than just adding to the outstanding stock. The other is to reduce the attractiveness of PBC credit versus deposit mobilization for the specialized banks. Finally, overdue PBC credits should be penalized severely in order to encourage prompt repayment.

It is recommended that the different types of PBC credit be more clearly differentiated from one another. Specifically, the present two-tier system of PBC credit would be replaced by a three-tier system which would consist of the following components:

(a) Directed credit facility. Directed credit would be similar in some respects to the present Plan credit. The PBC would assign credit to each bank according to economic conditions and Plan priorities. The annual amount of directed credit would be broken down into seasonally adjusted monthly amounts, and would be reviewed periodically in the context of the financial program. Over time, it is anticipated that the directed credit facility would become a selective credit facility, reserved for those sectors and activities to which the authorities wish to guarantee special and limited credit support outside the market.

(b) Nondirected credit facility. Nondirected credit would serve as a way of gradually introducing market determination in the allocation of PBC credit. The PBC head office would determine each month how much nondirected credit was to be offered on the market on the basis of its monthly financial program; bank head offices then would be invited to bid for this credit by indicating the amounts demanded by the bank and the interest rates they would be prepared to pay. Funds would be granted to the highest bidders. Initially, the nondirected credit facility would operate on an experimental basis with a limit of 10 percent, for instance, on the proportion of new PBC credit to be granted through this facility. Over time, as banking becomes more competitive, the relative importance of this facility could increase and that of the directed credit facility decline. The nondirected credit facility also can be used to promote the use of commercial bills by incorporating within it a rediscount facility at a more favorable rate.

(c) Temporary credit facility. The temporary credit facility would be transformed into a true lender-of-last-resort facility that would assist banks facing a temporary liquidity shortage.

This facility would have a short maturity (e.g., 30 days with a maximum of one rollover); specialized bank branches could borrow up to a certain limit of their deposits under the temporary credit facility, and could avail themselves of this facility only a limited number of times over a two-year period. The interest rate on temporary credit should be above the highest market interest rate, and it would be increased if the credit was rolled over.

(2) Reserve requirements

Reserve requirements, as indicated above have the potential of becoming a major instrument of monetary policy in China, as they are in many other countries. This instrument functions by affecting the demand for reserve money and, hence, the banks' ability to extend credit to the economy.

A major problem for monetary management in China is the present overhang of excess reserves, which, to a large extent, is a legacy from the old system. Specialized bank deposits at the PBC are currently more than double the amount needed to fulfill the legal reserve requirements. Were banks to reduce these excess reserves to the level required to fulfill the requirements, plus a margin for needed working balances, the expansion in credit would be substantial. Moreover, this overhang makes small variations in the requirement largely ineffective, because banks can cope with them by adjusting their excess reserves without changing the amount of their loans.

Either a voluntary or a mandatory approach could be considered to solve the problem of excess reserves. Given the size of bank excess reserves and the danger they pose to monetary control, a compulsory approach probably is required. This could be accomplished in different ways. However, in the present circumstances the best way would be to issue PBC bonds. Such bonds, carrying a rate of interest perhaps marginally above that paid on reserve deposits, could be placed with the specialized banks to "mop up" the excess reserves. Alternatively, banks could be required to use a part of their excess reserves to repay PBC loans.

A few improvements are suggested in the present system of reserve requirements as they apply to future changes in deposits. The principal of these would be to move to an average contemporaneous reserve system with a uniform reporting period for all branches. Under such a system, reserve requirements would be set as a percentage of the average daily deposits over a period, and would be met by average daily reserve balances over the same period. Ultimately, the PBC might wish to analyze the possibility of setting reserve requirements at the bank, rather than the branch level, provided control and monitoring procedures can be made adequate for this purpose.

(3) Interest rates

Two major issues need to be discussed when analyzing interest rates: their level and their structure. China essentially has two sets of interest rates, those on bank operations with the public and those on the operations of PBC with the banks. Rates within each set should bear an appropriate relationship to one another; in addition the relationship of rates across the system must be considered.

(a) Bank interest rates. The economic reform has reduced the role of mandatory planning and allowed enterprises to retain a part of their profits, making interest rates potentially more important as economic regulators. At the macro level, interest rates should serve to equilibrate aggregate investment and savings, and the supply and the demand for money. At the micro level, they should serve to allocate investment to the projects having the highest rate of return, and to mobilize savings from individuals and enterprises.

Interest rates can only play a more substantial role if they are more flexible. In this regard, the aim should be to move gradually to a system of market-determined rates. However, movement will have to proceed pari passu with progress in economic reform. In the meantime, PBC will have to continue regulating most interest rates on bank operations with the public. While interest rates remain regulated, it is important that they be adjusted frequently before major imbalances occur—the adjustments affecting new operations, but not the outstanding stock of loans. The following paragraphs contain a few basic guidelines for policy as regards bank interest rates with the public.

It is suggested that interest rates on deposits serve as the basis for the interest rate structure. Savings and time deposits of individuals and enterprises should receive a positive real remuneration, which means that they must receive a rate of interest above the expected rate of inflation over the maturity of the deposit. In addition, the maturity structure of interest rates should include a liquidity premium, that is, longer maturities should carry a higher interest rate, all else being equal.

To set bank lending rates, the PBC should determine a permissible spread over deposit rates. This spread should be set at a level sufficient to cover banks' costs (including the financial cost of fulfilling the reserve requirement) and allow well run banks to make a profit, while causing poorly run ones to incur a loss.

In line with the above guidelines there is an urgent need to (1) review interest rates on deposits to ensure that they take due account of current inflation and inflationary expectations, and (2) unify interest rates on deposits of enterprises, and individuals, unless there are clear cost differentials in operating the two. This review could well require some adjustment to interest rates on loans.

(b) Interest rates on PBC operations. The interest rates on PBC credit to banks and on specialized banks' deposits with the PBC have an important impact on bank behavior, and therefore on monetary and credit aggregates. A major concern for the PBC should be that its credit to banks not serve as an attractive substitute for attracting deposits or for interbank borrowing. This requires that the interest rate on PBC credit exceed the rate paid on time and saving deposits, since the latter have higher operational costs and are subject to reserve requirements. This condition does not obtain at present, making it a matter of priority to increase PBC lending rates to an adequate level.

It is recommended that the interest rate on PBC credit under the Plan--or, in the future, directed credit--be set at a level above the highest market rate for deposits of comparable maturities. In order to establish the precise margin above the deposit rate, PBC should take into account the other costs applicable to deposits and not to credit from the PBC.

If a nondirected credit facility is created, its rate would be market determined in auctions, as described earlier in this report. In order to encourage the growth of a commercial paper market, the PBC could charge a somewhat lower rate on the portion of nondirected credit given as a rediscount on commercial paper.

The rate on temporary credit should be raised substantially in order to prevent the use of this credit for the purpose of expanding bank loans.

This rate should be above the highest rate that banks charge for loans or offer for deposits.

The interest rate paid on bank deposits with the PBC currently is very close to the PBC lending rates, giving banks an incentive to draw down their credit allocations under the Plan before the funds are actually needed. This rate should be set at a level significantly below the lowest PBC lending rate. Finally, the rate on reserve shortfalls should penalize such shortfalls very heavily; this is necessary to make the reserve requirement system—and the other instruments—work properly, as otherwise reserve shortfalls could be used by banks to expand lending.

(4) Credit ceilings

Credit ceilings—ceilings on the total credit extended by each bank—are quite effective in the short run, but are prejudicial to the development of the financial system in the longer run; hence, they have been abandoned by the majority of countries. Since credit ceilings limit lending by each individual bank, rather than aggregate lending only, they discourage competition among banks to mobilize savings. They thus retard the growth of the financial system, and over time can lead to the development of an "informal" or "parallel" system outside the control of the authorities. Therefore, it is recommended that credit ceilings be phased out as an instrument of control in the shortest possible time, although they might be maintained in a transitional period while the PBC's other instruments are being improved.

(5) New instruments

Although the preceding discussion has been couched in terms of reforms suggested to the existing monetary instruments, it should be recognized that some of the technical modifications suggested are so fundamental as to create virtually a new arsenal of instruments. For example, PBC credit would now be granted on the basis of a comprehensive financial program subject to continuous review. Plan, or directed credit would be seasonalized and would carry a maturity—as well as an interest rate substantially above the current one. A new nondirected credit facility would be created and the allocation of this credit would be determined by market forces; this facility would include a rediscount window. Finally, temporary credit would become a lender-of-last-resort facility, as originally intended.

In the same way, the reserve requirements would be made effective by sterilizing the outstanding stock of excess reserves. In addition, the flexibility and at the same time the effectiveness of reserve requirements would be increased by moving them to an average contemporaneous basis.

Finally, anomalies in the interest rate structure would be removed to pave the way for a more rapid growth of the financial system and reduce the specialized banks' excessive dependence on borrowing from the PBC. The basic link between the rate structure and macroeconomic variables would be fortified.

Over time, as experience is gained with the nondirected credit facility and, within it, the rediscount facility, the authorities may wish to consider the creation of an open market instrument based on a PBC bill. However, there are many conditions for the introduction of an open market instrument which do not exist in China at the present time, and whose creation is bound to require several years. For one thing, in order for open market operations to operate successfully, banks must operate as enterprises; a large proportion of loans should be subject to free interest rates; and the banks must have gained experience in trading financial instruments (in this respect, the creation of a rediscount facility will be most useful). Until these conditions exist, most of the benefits of open market operations can be obtained through the effective use of the nondirected credit facility and the reserve requirement system.

(6) Coordinated management of monetary instruments

The importance of managing the arsenal of monetary instruments in a coordinated fashion is a point which cannot be overemphasized. One instrument, if improperly used, can render others ineffective. For instance, raising the reserve requirements with the purpose of contracting credit and money will be ineffective if, at the same time, banks have access to inexpensive credit from the PBC.

This does not mean that on every occasion all instruments must operate in the same direction. Rather, it means that the PBC must make sure that on every occasion all its instruments taken together will have the desired impact. Under certain circumstances, adequate instrument combination and adaptation of existing instruments can make PBC policy more flexible and at the same time more effective than the creation of new instruments. When considering the creation of a new instrument, the authorities must take care that its operations mesh well with those of the existing instruments and that it will not undermine, or unduly complicate, their workings. This means that the creation of any new instrument must be approached with caution and--if decided upon--subject to careful technical design.

Office Memorandum

April 29, 1986

MEMORANDUM FOR FILES

CONFIDENTIAL

Subject: China and the GATT

On April 25, 1986, I met with Mr. A. Lindén, head of the GATT's legal department, to give him the comments conveyed to me by Mr. Hino on the GATT Secretariat paper on China. Mr. Lindén expressed strong appreciation for our efforts to help the GATT in this area.

The substance of our comments was that the GATT Secretariat paper seemed to rely rather heavily on the authorities' description of the workings of the restrictive system, the system of price formation, and decision-making in enterprises, while not taking sufficient account of the degree of flexibility actually present in the economic system. Although the description was sufficiently qualified throughout, it was overly nuanced in the direction of characterizing the Chinese system as rigid. I explained that our somewhat different impressions were based on our contacts with the authorities, our monitoring of balance of payments and trade developments, and our collaboration with the IBRD staff, which maintained some contacts with managers of Chinese enterprises.

Mr. Lindén welcomed the comments and undertook to take them into account in the revision to be prepared in due course. The GATT paper is intended for eventual circulation to contracting parties as a description of the Secretariat's understanding of the Chinese system. Issuance will follow the authorities' presentation of a formal memorandum on the Chinese trade regime that the GATT Secretariat is also helping to prepare. It now appears unlikely that China will submit its memorandum before the summer recess. This delay may make it difficult for China to attend the Punta del Este Ministerial meeting in mid-September that will be open to GATT members and countries that have formally requested accession (e.g., Mexico).

Mr. Lindén requested specific drafting comments on the description of the restrictive system in the GATT Secretariat paper--particularly on the exchange rate system. I undertook to provide the comments, if possible, in 2-3 weeks.

Given the apparent sensitivities that exist within the GATT Secretariat on the division of responsibilities for China, we agreed that it would be best for all future comments and contacts on China to be channeled in the first instance through Mr. Lindén.

S.J. Anjaria

cc: Mr. Finch
Mr. Sanson
Mr. Brau
Mr. Hino

Cm. Brau
cc: Mr. Hino
Ms. Kelly
Blue folder

Office Memorandum

TO: The Managing Director

FROM: Tun Thin and E. Brau

April 3, 1986

SUBJECT: Meeting with Deputy Governor Liu Hongru of the People's Bank of China, April 4, 1986, 10:15 am

In his meeting with you, Deputy Governor Liu is likely to focus mainly on China's interest in the use of Fund resources--in particular, a stand-by arrangement in an amount equivalent to the first credit tranche and a drawing under the compensatory financing facility. The former would amount to about SDR 600 million. As for the latter, preliminary calculations show that a shortfall of between SDR 2 billion and SDR 2.4 billion is likely to arise for 1986, in comparison with the maximum access of just under SDR 2 billion.

You may wish to indicate that the Article IV consultation mission, expected to begin work in Beijing on June 23, would also review policies with the thought of assessing their suitability as a basis for the use of Fund resources. The Deputy Governor will surely press you for an indication of the policy framework, especially prior actions, that we are likely to seek. The authorities have been pressing the staff for such an indication over the past several months. We have avoided being specific thus far but may have to be more forthcoming even in Governor Liu's current visit.

The message that would be useful for you to give to Governor Liu at this stage is that in our view the situation in China is rather worrisome. Domestic money and credit have indeed decelerated sharply and economic activity has slowed from its earlier hectic pace. Nevertheless, demand pressure remains strong and inflation and balance of payments problems continue. Import growth has slowed but exports--none too strong in the recent past, in part, because of the loss in competitiveness--are now adversely affected by the fall in oil prices. Under the present policies, the current account deficit in 1986 is estimated to be about US$10-12 billion, about the same as in 1985. International reserves have been drawn down sharply and large amounts of external debt incurred. The former amounted to $13 billion at the turn of the year, $4.75 billion lower than a year earlier; it is not clear how much of this is available for ready use. Debt data are not complete but it does appear that the total amount is now large and that its composition has developed unfavorably, with a rather prominent share being short-term and commercial bank debt. Available information indicates that outstanding debt probably rose by $7 billion in 1985 to $20 billion, half of the latter amount being short term, but yet unreported debt is believed to be substantial. With these developments, the authorities consider 1986 a year of consolidation of reforms already in place and plan no further steps in this respect (a note on recent economic developments is attached).

The large and unfavorable accumulation of debt was partly--but only partly--a matter of external debt management and monitoring. More fundamentally, the underlying macroeconomic situation was such that large external payments deficits were emerging, for which financing was apparently readily available but at unfavorable and potentially volatile terms. Notwithstanding a number of visits the staff has made in recent months in connection with technical assistance and advisory work, we have only a limited knowledge of the institutional arrangements that have permitted these adverse developments to occur, as well as of the improvements that are currently being made. Clearly, we shall have to improve our understanding and be satisfied that a sufficiently firm grip over this situation has been secured--with a view to ensuring that the current account deficit will be reduced to a manageable size--before we could recommend to the Board use of the Fund's resources. This may well imply that the discussion on a first credit tranche program cannot be concluded during the June mission. In that case, another mission could visit China later in the year to evaluate the progress in policy implementation (including improvements in monitoring mechanisms) and finalize the program. We may have to hint at this possibility to the Deputy Governor.

A program aimed at reducing China's external deficit will require domestic financial restraint as a key element. In particular, a credit plan will have to be agreed with the forthcoming mission and put firmly in place. Although, of course, a first credit tranche program would not include performance criteria, strict implementation of the agreed credit plan would be essential for a successful pursuit of adjustment goals. A specific area in which the staff will indicate that prior action will be needed is interest rate policy. Increases in the Peoples' Bank lending rate and some lending rates of specialized banks would be useful signals of official resolve in tackling the problem.

Another area in which prior action would make for a credible program is exchange rate policy. The renminbi was depreciated from Y 2.8 per U.S. dollar to Y 3.2 per U.S. dollar over the period January-October 1985, but has since remained at that level. In real effective terms, the renminbi depreciated by some 15 percent during the twelve months period ending January 1986. Staff work in this area has not yet progressed sufficiently for us to indicate the rate to which a move would be appropriate at this stage but it does appear that a sizable further depreciation would be helpful. A small staff team will be visiting Beijing in May to discuss principles and key indicators of exchange rate management with the authorities.

Finally, concrete steps are urgently needed to ensure coordination of external borrowing and the monitoring of developments in debt and debt service. The recommendations of a team that recently visited Beijing to advise in this area should be implemented forthwith.

You may wish to say to the Deputy Governor that while a certain degree of slowing down of the reform process is understandable in the current circumstances, the pace should pick up again soon. In particular, measures to correct the present imbalances should make the maximum possible use of indirect, price instruments and a retrogression into the use of direct, administrative controls should be avoided.

With regard to the timing of the use of the Fund's resources, you may wish to indicate to Deputy Governor Liu that you would like to keep an open mind at this stage. Even if all the conditionality criteria were to be met, it would seem wise, from the point of view of eventual repurchase obligations, to spread the use of a potentially large amount over a period of at least several months. If all goes well, a proposal for the first credit tranche could be put to the Board say, soon after the Annual Meeting--although, as mentioned earlier, this may turn out to be too optimistic a timetable. A small CF drawing may be available, if a case can be established for a shortfall year ending March or June 1986; a sizable export excess has been estimated for 1985 and it is not clear when the shortfall estimated for 1986 will begin to emerge. Another CF drawing may be considered later, if the shortfall currently projected for 1986 materializes and if adjustment measures are implemented as envisaged in the first credit tranche program. Judgment on this whole question of phasing the use of the Fund's resources could best be deferred until after the staff has formed a view on the balance of payments prospects and the strength of the adjustment measures being taken.

Over the last several months the Fund has provided technical assistance to China through a number of staff missions, including missions on the balance of payments statistics (STAT/ASD), external debt management (ETR), and financial programming (CBD/ASD). Should the Deputy Governor request additional assistance, you may wish to indicate your basic support.

Attachments

cc: The Deputy Managing Director
Mr. Kaibni
Ms. Koenig
Mr. Brown

ATTACHMENT

China: Economic Developments in 1985 and Prospects for 1986

1. Economic developments in 1985

Real GDP grew by 12 percent in 1985 (compared with 14 percent in 1984), with an apparent slowdown in the second half. Retail prices increased by nearly 9 percent (5 percent in 1984), following the adoption of price reform measures in the spring.

Financial policies were tightened considerably during 1985. The growth of net domestic assets slowed to 16 percent in 1985 (from 44 percent in 1984) and the growth of broad money declined to 18 percent (from 41 percent), as the People's Bank of China improved control over its lending to the specialized banks. The state budget deficit was reduced to 0.5 percent of GDP (from 1.6 percent in 1984), partly reflecting a buoyant revenue performance.

China recorded an external current account deficit of about US$11 billion or equivalent to 4 percent of GDP in 1985 (compared with a surplus of US$2.5 billion or about 1 percent of GDP in 1984). This marked weakening mainly reflected the effects of strong domestic demand on imports, which increased by over 50 percent; exports meanwhile rose by only 5 percent. By end-year, however, there were signs that the earlier tightening of demand management policies was beginning to curb the rate of import expansion.

The current account deficit in 1985 was financed by a combination of borrowing and drawdown of reserves. China's medium- and long-term external debt, according to official data, is estimated to have increased by about US$3.5 billion during 1985 to US$10.8 billion (3.7 percent of GDP) at end-year; however, data from creditor sources indicate that China's total external debt (including short-term) rose by US$7 billion during 1985 to about US$19 billion at end-year. Reserves declined by US$4.6 billion during 1985 and amounted to US$13.2 billion (4.5 months of imports) at end-year; of this amount, US$9.3 billion were the foreign exchange asset of the Bank of China, only part of which is readily available to the monetary authorities.

China adopted a managed floating exchange arrangement at the beginning of 1985. The exchange rate of the renminbi depreciated from Y 2.8 per U.S. dollar to Y 3.2 during January-October, 1985 and has since remained close to Y 3.2 per U.S. dollar. In real effective terms, the renminbi depreciated by about 10 percent during January-October 1985 and another 5 percent between October and January 1986, the most recent month for which data are available.

2. Reforms and prospects for 1986

The recently announced Seventh Five-Year Plan (1986-90) emphasizes continuation of economic reforms which are to feature greater responsibility for state enterprises, the development of market mechanisms, and improvements in macroeconomic management. This year is viewed mainly as a period of consolidation of reforms already in place before further steps are taken in 1987 and 1988.

Based on these policies and WEO assumptions on China's external trade, the staff's preliminary projections for 1986 are: real GDP growth at 7-8 percent; inflation at about 5 percent; and the external current account deficit at US$10-12 billion (or about 4 percent of GDP). Exports are projected to decline by about 3 percent, largely because of the recent sharp decline in the price of oil (which accounted for about one-fourth of total exports in 1985); imports are also projected to decline, reflecting the effects of demand restraint measures.

ICUA/CHC bd5ch85 (3/31/86)

CHINA

Basic Data

	1983	1984	1985 Est.	1986 Proj. 1/
	(Year ending December)			
Growth				
Real GDP (change in percent)	9.8	13.9	12.0	7.5
Inflation				
GDP deflator (change in percent)	1.1	4.7	9.0	5.0
CPI (average percent change)	2.0	2.7	8.8	5.0
Terms of trade (percent change)	8.1	-0.3	-1.0	-11.0
Central government budget 2/				
Revenue (growth in percent)	8.3	17.2	26.3	2.4
Expenditure (growth in percent)	9.6	16.7	21.2	4.6
Current account (percent of GDP)	6.1	6.6	6.0	6.0
Overall surplus or deficit (percent of GDP)	-1.8	-1.6	-0.4	-1.0
Borrowing from the banking system (percent of GDP)	0.8	0.7	-0.4	--
Foreign borrowing (net) (percent of GDP)	0.2	0.3	0.2	0.4
Money and credit (end of year, percent change)				
Net domestic assets	17.3	43.6	16.2	19
Currency in circulation	20.7	49.4	24.7	17
Total liquidity	19.2	41.2	18.4	17
Balance of payments				
Exports (bn. dollars)	22.7	23.9	24.1	23.4
Of which: Oil	(4.3)	(5.4)	(6.5)	(3.8)
Imports (f.o.b., bn. dollars)	-18.7	-23.9	-35.8	-35.4
Of which: Oil	(-0.1)	(-0.1)	(-0.1)	(-0.1)
Current account (bn. dollars)	4.5	2.5	-10.7	-10.3
Current account (percent of GDP)	1.6	0.9	-4.0	-4.1
Of which: Interest payments	-0.1	-0.1	-0.2	-0.3
Overall balance (bn. dollars)	4.8	1.8	-6.3	...
(Percent of GDP)	1.7	0.6	-2.3	...
Reserves (end of year)				
Gross official reserves, including gold (bn. dollars)	16.0	17.8	13.2	...
(In months of imports)	8.0	5.8	4.5	...
External debt (end-of-year stock)				
Medium- and long-term (bn. $)	6.4	7.2	10.8	...
(Percent of GDP)	2.3	2.6	3.7	...
Debt service (bn. dollars) 3/	1.5 4/	1.1	1.3	...
(Percent of exports plus service credits)	(6.0) 4/	(3.9)	(4.5)	(...)

Exchange rate
Exchange rate regime: Managed float
Present rate Y 3.2 = US$1 (March 31, 1986)

Quota: SDR 2,391 million

1/ Staff projections except for budget.
2/ Fiscal year ending December.
3/ Includes early repayments in 1983.
4/ Includes repurchase of Fund credits.

Mr. Finch

Office Memorandum

TO: Mr. Saito

FROM: Eduard Brau

April 2, 1986

SUBJECT: China: Brief for Managing Director

We clearly will need to be responsive in a positive way to the Chinese request for use of Fund resources in the first credit tranche. My reading of the economic situation in China, expressed in broad brush terms, is that, in the process of economic reform, the authorities have lost control over balance of payments developments, including debt management, and, for a period, over demand management. At the same time and unavoidably, the staff has serious gaps in its knowledge of the functioning of the Chinese economy and also in its knowledge of the actual effectiveness of economic policy instruments currently at the disposal of the Central Government. In addition, the Central Government is only in the process of acquiring the instruments of indirect economic control in such areas as monetary and exchange rate policy.

In these circumstances, and at the present time, I am doubtful that the staff, in cooperation with the authorities, can fashion a financial program that would give a reasonable degree of assurance of being successfully implemented. Such reasonably successful implementation, in turn, seems to me absolutely essential, not least in view of China's heavy reliance, recently and in the near-term future, on foreign commercial credit, where damage to confidence would be substantial if program implementation deviated widely. The conclusion I draw from the above is that we should not rush into a first credit tranch operation, and I would suggest modifying the draft brief accordingly.

The Managing Director should mention that a considerable amount of work will need to be done in a number of areas, such as debt management policy, exchange rate policy, credit policy, etc., while not being drawn into mentioning prior actions, as I would contend that the staff cannot specify them with any degree of confidence at this time. We should envisage a process of formulating a program extending from the consultation visit in June/July toward the end of 1986, with a first credit tranche program covering calendar (and fiscal) year 1987. Under this approach, the consultation mission would begin elaborating the financial program delineating policies as far as possible in the credit, exchange rate, and external debt management areas, while exploring structural policy needs. The staff would also try to get an operational understanding of the authorities' economic monitoring mechanisms. A mission would follow in October/November to finalize discussions on the basis also of having observed implementation of the tentative agreements reached during the June/July mission.

As regards the CFF, we need to be very cautious at this stage. There obviously can be no commitment at the present time as the case has not been investigated, and I would strongly urge that the Managing Director not raise the issue with the authorities but respond in a noncommital way, if it is raised by the authorities. In any case, I do not think we would consider access in excess of 50 percent of quota under the CFF.

As a final point, and if the approach sketched above should appeal, it seems to me there exists a strong case for responding positively to a request by the authorities that a staff member help them on the spot in matters relating to the finalization of a program in the second half of 1986.

cc: Mr. Finch
Mr. Narvekar
Mr. Hino
Ms. Kelly

Mr. Finch

Office Memorandum

cc: Mr. Bran

TO : The Managing Director
The Deputy Managing Director

DATE: April 1, 1986

FROM : Linda M. Koenig

SUBJECT : Advisory Mission to the People's Republic of China--March 10-28, 1986

Background

A mission to advise the People's Bank of China on its financial programming methods and instruments of monetary policy visited the People's Republic of China on the dates indicated above. The mission dealt primarily with Mr. Liu Hongru, Senior Vice Governor of the People's Bank of China, and his staff. In addition, we met with the officials of the major specialized banks, the State Planning Commission and the State Commission on Economic Restructuring. At Vice Governor Liu Hongru's request, during a five-day period the mission traveled to Hangzhou and Nanjing to hold discussions with the authorities of the PBC and specialized banks for Zhejiang and Jiangsu Provinces.

This mission was the outgrowth of contacts between officials of the People's Bank of China and the Central Banking Department which began in early 1985. In May 1985, Mr. Richard Miller and I visited Beijing and Shanghai, where we delivered lectures on a range of central banking issues and held discussions with Mr. Liu Hongru and other PBC authorities. Shortly after our return to Washington, the People's Bank of China requested the initiation of a long-range program of CBD technical assistance, and we agreed that monetary policy formulation and instruments were the highest priority areas.

In January 1986 a PBC working group headed by Mr. Zhang Tun, Director of the Research Department, visited CBD to initiate discussions. Mr. Zhang Tun brought with him the first crude balance sheet for the PBC, on the basis of which we jointly designed a methodology for financial programming in China against which the present monetary policy and instruments could be assessed. On the basis of this methodology we made some crude projections for 1986. We then reviewed the process of monetary formulation in China and discussed each of the existing monetary instruments. This work in Washington allowed us to assess the extent to which PBC was prepared to discuss institutional and policy making problems, build up a working relationship with our PBC counterparts and agree on the terms of reference for the mission to Beijing.

Discussions in Beijing

Our advisory assistance to the People's Bank of China focused primarily on the framework within which monetary policy is formulated and on the workings of the specific instruments of monetary policy.

The following lines summarize our discussions on these points.

a. Monetary Policy Formulation

The basic framework for monetary policy formulation in China remains the National Credit Plan, a holdover from the days before the PBC was transformed into a central bank, and a reflection of the primacy which central planning still has in the Chinese system. We discussed the credit planning system at length with our Chinese counterparts and concluded that it had a number of deficiencies as a framework for macroeconomic management. First, the National Credit Plan is arrived at "from the bottom up", that is, from the plans formulated by the local levels of the specialized banks. While these local plans are to some extent based on discussion with PBC local branches, this method of adding up credit plans introduces an important upward bias in the draft National Credit Plan and places the PBC head office on the defensive as it negotiates the final Plan with the head offices of specialized banks and with the State Planning Commission. The system has other defects as well. The National Credit Plan is not broken down into monthly or quarterly subsections; thus it allows specialized banks to use their entire allocations of People's Bank credit early in the year, and then to pressure for more funds. Moreover, the Plan projects the growth of currency in circulation as a residual, and currency is the sole monetary target. Finally, so called temporary credits by the People's Bank to the specialized banks are not covered in the Plan. This has become a major problem as, under the tighter credit conditions of 1985, specialized banks substituted temporary credits for credit under the Plan and these credits in fact rarely were repaid.

We discussed different solutions to these problems and suggested some basic principles for financial programming: 1) that the monetary targets be based on macroeconomic objectives rather than coming out as a residual and that broad money be used as the basic target; 2) that the PBC be given authority over determination of the monetary and credit targets once the goals for output, prices and the balance of payments have been agreed with the political authorities; 3) that PBC operations provide the operational targets for monetary policy, with projections for the entire banking system as a background; 4) that the PBC credit plan or financial program include all PBC operations; 5) that this PBC program be seasonalized and broken down into monthly subprojections to be reviewed every month and serve as the basis for decisions regarding monetary policy and instruments. The discussion on these matters also led into the issue of the independence of the Central Bank and that of relations between the PBC and the State Planning Commission, and between the PBC and its own branches. Vice Governor Liu Hongru and his colleagues grasped all these issues and indicated that, although some of them--especially those with more political implications--could be solved only in the longer run, there were many improvements in the programming process that could be introduced immediately.

In the course of our discussions, we jointly refined our financial programming model for China and updated it, and we were able to make a seasonalized quarterly projection. PBC staff showed much interest on using this methodology in their future work; in particular they planned to do further work on financial programming during the forthcoming Article IV consultation mission to China.

b. Monetary Instruments

In the area of monetary instruments, we reviewed in depth (1) PBC credit facilities, (2) the system of reserve requirements and (3) the system of ceilings on total credit of each specialized bank. We also reviewed the timeliness of the introduction of additional instruments. PBC credit presently consists of two types, namely credit included in the National Credit Plan, which is entirely allocated to specific banks and activities, and temporary credit. We discussed changing the nature of "planned" credit over time to a system of "directed" selective credit for specific activities and recommended introducing a "non-directed" facility which would grant credit to banks at a free interest rate. Gradually, the size of this non-directed facility could be increased and that of directed credit correspondingly reduced. With the introduction of such a facility, and the incorporation of seasonality into the PBC credit program, it would be easier to reduce the scope of temporary credit and make it truly temporary. Specific characteristics of these various credit facilities, such as maturity and interest rate (fixed vs. free) also were discussed. Regarding bank reserves, we suggested various technical improvements in the reserve requirement system. We also discussed alternative ways of sterilizing the present large overhang of excess reserves--a consequence of excessive PBC credit expansion in the past.

Because of time constraints, our discussions on interest rate policy were relatively brief and centered on basic principles of policy to be applied on the way to market-determined rates, namely, (1) how to relate the level of interest rates to inflation and other macroeconomic variables; (2) how to determine the internal structure of interest rates on credit and deposits of specialized banks; (3) what should be the relationship of this interest rate structure to that set for PBC's own operations; and finally, (4) how to allow for some experimentation with free interest rates at the present time. Finally, at the authorities' request we discussed the need for new monetary policy instruments. We made the strong point that it was much more important to correct the deficiencies of the present instruments, particularly as regards PBC credit facilities and the system of reserve requirements, than to introduce new instruments. However, in view of Vice Governor Liu Hongru's strong desire to innovate in this area, and also his interest in developing the financial markets, we did discuss the outlines of the above described non-directed credit facility and, within it, a rediscount mechanism for a commercial paper. We also explored the introduction of a PBC bill as a way of sterilizing a part of specialized banks' excess reserves. On the other hand, we discouraged the PBC from introducing open market operations until significant progress has been made in developing the market economy, the banking system and the financial markets.

This mission to China was extremely rewarding and we anticipate that the authorities will request follow up work after they have read the mission's report, which we hope to finalize by end-May.

cc: Mr. Zulu
Mr. Finch
Mr. Habermeier
Mr. Hood
Mr. Whittome
Mr. Mohammed
Mr. Gianvitti
Mr. Ouattara
Mr. Shaalan
Mr. Tanzi
Mr. Teyssier
Mr. Tun Thin
Mr. Van Houtven
Mr. Wiesner
Mr. Dannemann
Mr. Guetta
Mr. Sanson
Mr. Narvekar
Mr. Brown
Mr. Saito
Mr. Fetherston

INTERNATIONAL MONETARY FUND

March 27, 1986

TO : Mr. Beveridge

FROM: Hiroyuki Hino

Re: IFC Seminar in China

I spoke with Messrs. Saito and Goldsbrough on the above subject. I understand that ASD has to decide whether or not Mr. Goldsbrough will participate, and if he is not to participate whether anyone else should attend, and if so whether ASD would ask ETR to provide the person. Therefore, there is no action needed by ETR at this time. I asked Mr. Saito to request that Mr. Narvekar communicate with you if he wished an ETR person to attend. The seminar is to take place in early May.

Having listened to the Board discussion yesterday, I think that it would be useful for us to develop some expertise on foreign direct investment. This seminar might provide the opportunity for us to get started on this subject.

cc: Mr. Brau
Mr. Quirk

Mr. Finch

Office Memorandum

cc Mr. Brau

to China file

TO: Mr. Rhomberg

March 19, 1986

FROM: P.R. Narvekar PRN

SUBJECT: CFF Drawings by Oil Exporting Countries

Thank you for your memorandum of March 14. As you note, China, Indonesia and Malaysia are all expected to experience shortfalls for 1986 and we would expect that all of them will want to and will probably be able to draw under the facility; the probability we attach would be a little over 50 percent in each case. The amounts could be the equivalent of 50 percent of quota in the case of Indonesia (in the first quarter of 1987) and Malaysia (in the third quarter of 1986); in the case of China, it may be that there will be two drawings--25 percent of quota, each--one in August-September 1986 and one toward the end of the year.

cc: Mr. Finch
Mr. Habermeier
Mr. Gianviti

Mr. Brau

Office Memorandum

MAR 14 1986

TO: Mr. Tun Thin — March 14, 1986

FROM: R.R. Rhomberg RRR

SUBJECT: Projections of CFF Drawings by Oil Exporting Countries

In view of the sharp decline in oil prices, we have been asked by the Managing Director to have a fresh look at the projections of possible CFF drawings by the oil exporting countries.

In order to facilitate the task of providing forecasts of CFF drawings by the oil exporting countries, we have calculated shortfalls with respect to calendar years 1985 and 1986 for individual countries covered by your department. The calculations are based on data compiled by the Commodities Division on the basis of forecasts provided last week by the staff of your department. The attached sheets show respectively: (a) country shortfalls for 1985 and 1986 under two assumptions regarding projected oil prices for 1986-1988 ($20/bbl and $15/bbl for 1986-87, and both prices raised by 4.5 percent for 1988); (b) the annual value of total exports for the period 1983-85 and projections for 1986-88; and (c) country sheets providing a breakdown of exports by oil and non-oil trade, and the price and volume assumptions underlying the projections for oil exports.

An examination of the shortfall calculations reveals (i) that none of the oil exporting countries covered by your department experienced shortfalls with respect to 1985 under either price assumption, and (ii) all the oil exporting countries are expected to experience shortfalls for 1986 substantially above the maximum available access under the CFF even with the $20 assumption. The implications of this finding for possible use of the CFF are that sooner or later all the oil countries covered by your department will experience shortfalls that could qualify them for use of the CFF. As you know, however, in order to qualify a requesting member must, in addition to having experienced a shortfall, meet all the other requirements of the CFF, namely need, beyond control, and cooperation.

The task before us is twofold; (i) to identify those countries that are likely to meet all the criteria for use of the facility, and (ii) to assign a probability for those countries identified in (i) that you expect to submit requests in the period through 1987. In identifying countries in (i) a judgment must be made whether the member would meet the criteria for a drawing in the lower CFF tranche (up to 50 percent of quota) or in the upper tranche (up to 83 percent). A rough indication (e.g., by quarter) of the timing of possible requests will be helpful.

I would be grateful if this information could be provided to the Commodities Division by close of business Wednesday March 19.

Attachment

cc: Mr. Hood (o/r)
Mr. Whittome
Mr. Finch
Mr. Habermeier
Mr. Gianviti

MARCH 13, 1986

U.S. $20 SCENARIØ

ASIAN DEPARTMENT : EXPØRT EARNINGS ØF FUEL EXPØRTING CØUNTRIES

CØUNTRY NAMES	FUEL EXPØRT EARNINGS AS PERCENT ØF TØTAL EARNINGS AVERAGE 1983-85	EXPØRT EARNINGS 1983	1984	1985	1986 1/	1987 1/	1988 1/
		IN MILLIØNS ØF SDRS 2/					
CHINA, PEØPLE S REP.	23.7	19370.4	23321.7	23779.2	21758.6	23654.7	26616.5
		(1)	(20)	(2)	(-8)	(9)	(13)
INDØNESIA	71.7	18150.4	20090.9	18499.2	15516.7	15816.2	17105.6
		(6)	(11)	(-8)	(-16)	(2)	(8)
MALAYSIA	22.7	12836.2	16006.7	15150.6	13274.1	14217.4	15481.3
		(18)	(25)	(-5)	(-12)	(7)	(9)

1/ SHØRTFALLS IN 1985 AND 1986 ARE CALCULATED ØN THE BASIS ØF EXPØRT PRØJECTIØNS MADE FØR 1986,1987 AND 1988 BY AREA DEPARTMENTS. FØR 1986 AND 1987, AVERAGE CRUDE ØIL PRICE IS ASSUMED TØ BE US $20/BBL (REPRESENTING A REDUCTIØN ØF 25 PERCENT FRØM THE 1985 LEVEL ØF US $26.65/BBL). FØR 1988, THE PRICE ØF US $20.9/BBL IS USED TØ REFLECT A 4.5 PERCENT RATE ØF INFLATIØN.

2/ PERCENTAGE CHANGE IN PARENTHESES.

?

MARCH 13, 1986

U.S. $20 SCENARIØ

ASIAN DEPARTMENT -- SHØRTFALL CALCULATIØNS FØR 1985 AND 1986

	MAXIMUM CFF ACCESS 1/ (1)	ØUTSTANDING CFF PURCHASES AS ØF 2/28/86 (2)	MAXIMUM AVAILABLE ACCESS (3)=(1)-(2)	AMØUNT ØF SHØRTFALL FØR 1985 2/ (4)	AMØUNT ØF SHØRTFALL FØR 1986 2/ (5)	ANNUAL AVERAGE RATE ØF GRØWTH IN 1987-1988 FØR 1986 SF EQUIVALENT TØ: 50%QUØTA (6)	ANNUAL AVERAGE RATE ØF GRØWTH IN 1987-1988 FØR 1986 SF EQUIVALENT TØ: MAXIMUM ACCESS 3/ (7)	1986 SHØRTFALL AS % ØF MAXIMUM ACCESS 3/ (8)
	IN MILLIØNS ØF SDRS					IN PERCENTAGE		
CHINA, PEØPLE S REP.	1984.4	0	1984.4	-1467.7	2017.0	4	10	102
INDØNESIA	838.1	42.0	796.1	-969.0	1806.9	-9	-6	227
MALAYSIA	457.0	9.2	447.8	-901.1	1519.5	-7	-5	339

1/ MAXIMUM CFF ACCESS EQUALS 83% ØF QUØTA.

2/ SHØRTFALLS IN 1985 AND 1986 ARE CALCULATED ØN THE BASIS ØF EXPØRT PRØJECTIØNS MADE FØR 1986, 1987 AND 1988 IN CØNJUNCTIØN WITH AREA DEPARTMENTS. FØR 1986 AND 1987, AVERAGE CRUDE ØIL PRICE IS ASSUMED TØ BE US $20/BBL (REPRESENTING A REDUCTIØN ØF 25 PERCENT FRØM THE 1985 LEVEL ØF US $26.65/BBL). FØR 1988, THE PRICE ØF US $20.9/BBL IS USED TØ REFLECT A 4.5 PERCENT RATE ØF INFLATIØN.

3/ MAXIMUM AVAILABLE ACCESS SHØWN IN CØLUMN (3), I.E. AFTER DEDUCTING ØUTSTANDING PURCHASES.

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3/13/86

U.S. $20 SCENARIØ
CHINA, PEØPLE S REP. : EXPØRTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPØRTS							
AVERAGE PRICE ($/BBL)	29.95	28.17	27.14	26.05	19.54	19.54	20.42
VØLUME (MILL. BBLS.)	154.90	153.40	200.80	249.50	250.00	261.50	273.60
VALUE ($ MILL.)	4640.00	4321.00	5450.00	6500.00	4885.00	5110.00	5587.00
NØN-ØIL EXPØRTS ($ MILL.)	16485.00	16386.00	18455.00	17644.00	19624.00	21597.00	24464.00
TØTAL EXPØRTS ($ MILL.)	21125.00	20707.00	23905.00	24144.00	24509.00	26707.00	30051.00

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3/13/86

U.S. $20 SCENARIO
INDONESIA : EXPORTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPORTS							
AVERAGE PRICE ($/BBL)	33.03	29.39	27.84	26.27	21.46	20.14	20.84
VØLUME (MILL. BBLS.)	451.40	489.80	532.30	493.10	503.10	526.60	541.30
VALUE ($ MILL.)	14911.70	14394.60	14820.40	12951.50	10796.80	10607.60	11279.40
NØN-ØIL EXPØRTS ($ MILL.)	3989.80	5008.30	5773.00	5831.50	6681.30	7249.50	8033.50
TØTAL EXPØRTS ($ MILL.)	18901.50	19402.90	20593.40	18783.00	17478.10	17857.10	19312.90

?

3/13/86

U.S. $20 SCENARIØ
MALAYSIA : EXPØRTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPØRTS							
AVERAGE PRICE ($/BBL)	37.02	31.37	29.45	27.00	20.25	20.25	21.26
VØLUME (MILL. BBLS.)	89.00	108.10	126.60	118.40	126.00	126.00	126.00
VALUE ($ MILL.)	3294.50	3391.00	3728.00	3197.00	2552.00	2552.00	2679.00
NØN-ØIL EXPØRTS ($ MILL.)	8671.50	10331.00	12679.00	12186.00	12400.00	13500.00	14800.00
TØTAL EXPØRTS ($ MILL.)	11966.00	13722.00	16407.00	15383.00	14952.00	16052.00	17479.00

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MARCH 13, 1986

U.S. $15 SCENARIØ

ASIAN DEPARTMENT : EXPØRT EARNINGS ØF FUEL EXPØRTING CØUNTRIES

CØUNTRY NAMES	FUEL EXPØRT EARNINGS AS PERCENT ØF TØTAL EARNINGS AVERAGE 1983-85	EXPØRT EARNINGS 1983	1984	1985	1986 1/	1987 1/	1988 1/
		IN MILLIØNS ØF SDRS 2/					
CHINA, PEØPLE S REP.	23.7	19370.4	23321.7	23779.2	20674.4	22523.2	25379.4
		(1)	(20)	(2)	(-13)	(9)	(13)
INDØNESIA	71.7	18150.4	20090.9	18499.2	13120.4	13467.4	14608.1
		(6)	(11)	(-8)	(-29)	(3)	(8)
MALAYSIA	22.7	12836.2	16006.7	15150.6	12707.7	13652.3	14888.1
		(18)	(25)	(-5)	(-16)	(7)	(9)

1/ SHØRTFALLS IN 1985 AND 1986 ARE CALCULATED ØN THE BASIS ØF EXPØRT PRØJECTIØNS MADE FØR 1986,1987 AND 1988 BY AREA DEPARTMENTS. FØR 1986 AND 1987, AVERAGE CRUDE ØIL PRICE IS ASSUMED TØ BE US $15/BBL (REPRESENTING A REDUCTIØN ØF 44 PERCENT FRØM THE 1985 LEVEL ØF US $26.65/BBL). FØR 1988, THE PRICE ØF US $15.7/BBL IS USED TØ REFLECT A 4.5 PERCENT RATE ØF INFLATIØN.

2/ PERCENTAGE CHANGE IN PARENTHESES.

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MARCH 13, 1986

U.S. $15 SCENARIØ

ASIAN DEPARTMENT -- SHØRTFALL CALCULATIØNS FØR 1985 AND 1986

	MAXIMUM CFF ACCESS 1/ (1)	ØUTSTANDING CFF PURCHASES AS ØF 2/28/86 (2)	MAXIMUM AVAILABLE ACCESS (3)=(1)-(2)	AMØUNT ØF SHØRTFALL FØR 1985 2/ (4)	AMØUNT ØF SHØRTFALL FØR 1986 2/ (5)	ANNUAL AVERAGE RATE ØF GRØWTH IN 1987-1988 FØR 1986 SF EQUIVALENT TØ: 50%QUØTA (6)	ANNUAL AVERAGE RATE ØF GRØWTH IN 1987-1988 FØR 1986 SF EQUIVALENT TØ: MAXIMUM ACCESS 3/ (7)	1986 SHØRTFALL AS % ØF MAXIMUM ACCESS 3/ (8)
	IN MILLIØNS ØF SDRS					IN PERCENTAGE		
CHINA, PEØPLE S REP.	1984.4	0	1984.4	-1910.1	2409.0	1	7	121
INDØNESIA	838.1	42.0	796.1	-2083.7	2597.5	-18	-15	326
MALAYSIA	457.0	9.2	447.8	-1139.0	1725.7	-10	-7	385

1/ MAXIMUM CFF ACCESS EQUALS 83% ØF QUØTA.

2/ SHØRTFALLS IN 1985 AND 1986 ARE CALCULATED ØN THE BASIS ØF EXPØRT PRØJECTIØNS MADE FØR 1986, 1987 AND 1988 IN CØNJUNCTIØN WITH AREA DEPARTMENTS. FØR 1986 AND 1987, AVERAGE CRUDE ØIL PRICE IS ASSUMED TØ BE US $15/BBL (REPRESENTING A REDUCTIØN ØF 44 PERCENT FRØM THE 1985 LEVEL ØF US $26.65/BBL). FØR 1988, THE PRICE ØF US $15.7/BBL IS USED TØ REFLECT A 4.5 PERCENT RATE ØF INFLATIØN.

3/ MAXIMUM AVAILABLE ACCESS SHØWN IN CØLUMN (3), I.E. AFTER DEDUCTING ØUTSTANDING PURCHASES.

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3/13/86

U.S. $15 SCENARIØ
CHINA, PEØPLE S REP. : EXPØRTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPØRTS							
AVERAGE PRICE ($/BBL)	29.95	28.17	27.14	26.05	14.66	14.66	15.32
VØLUME (MILL. BBLS.)	154.90	153.40	200.80	249.50	250.00	261.50	273.60
VALUE ($ MILL.)	4640.00	4321.00	5450.00	6500.00	3663.75	3832.50	4190.25
NØN-ØIL EXPØRTS ($ MILL.)	16485.00	16386.00	18455.00	17644.00	19624.00	21597.00	24464.00
TØTAL EXPØRTS ($ MILL.)	21125.00	20707.00	23905.00	24144.00	23287.75	25429.50	28654.25

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3/13/86

U.S. $15 SCENARIØ
INDØNESIA : EXPØRTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPØRTS							
AVERAGE PRICE ($/BBL)	33.03	29.39	27.84	26.27	16.10	15.11	15.63
VØLUME (MILL. BBLS.)	451.40	489.80	532.30	493.10	503.10	526.60	541.30
VALUE ($ MILL.)	14911.70	14394.60	14820.40	12951.50	8097.60	7955.70	8459.55
NØN-ØIL EXPØRTS ($ MILL.)	3989.80	5008.30	5773.00	5831.50	6681.30	7249.50	8033.50
TØTAL EXPØRTS ($ MILL.)	18901.50	19402.90	20593.40	18783.00	14778.90	15205.20	16493.05

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3/13/86

U.S. $15 SCENARIØ
MALAYSIA : EXPØRTS, 1982-1988

	1982	1983	1984	1985	1986	1987	1988
ØIL EXPØRTS							
AVERAGE PRICE ($/BBL)	37.02	31.37	29.45	27.00	15.19	15.19	15.95
VØLUME (MILL. BBLS.)	89.00	108.10	126.60	118.40	126.00	126.00	126.00
VALUE ($ MILL.)	3294.50	3391.00	3728.00	3197.00	1914.00	1914.00	2009.25
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?

3/17 MD o/r

Mr. Erb

Office Memorandum

cc: Mr. Beveridge
Mr. Brau
Mr. Hino

→ MD (o/r)
Mr. Narvekar
OK
March 15, 1986

TO: The Managing Director
The Deputy Managing Director

March 13, 1986

cc: PRN
ETR Div

FROM: P.R. Narvekar PRN

SUBJECT: Mr. Hino's Visit to China

The attached report by Mr. Hino on his recent visit to China discloses a rather worrisome situation. China's external debt is rising rapidly and its composition has developed unfavorably. Planning and monitoring external debt is not yet vested in a single agency. More fundamentally, it is not clear that any one agency has been taking an overall view of all aspects of the external payments and the underlying domestic situation and forging policies to influence them. It is clear that these weaknesses should be tackled before a first credit tranche program is entered into--as the Chinese authorities wish--with reasonable hope of success.

Discussions for Article IV consultation and a first credit tranche program are now scheduled to begin in the last week of June. In the meanwhile, Chinese officials will be visiting Washington for the Interim Committee meeting and we believe it would be useful if you expressed to them our concerns. We shall, of course, submit a specific briefing to you in due course.

Yes

The Chinese authorities have also asked that Mr. Hino return to Beijing in May to discuss principles and key indicators of exchange rate management. Recent staff contacts with the authorities have clearly been very useful to both sides and we would recommend for your approval that Mr. Hino, accompanied by a staff member of the Asian Department, visit China in May as requested. While exchange rate policy will certainly be a crucial element in the Article IV consultation and first credit tranche discussions, it would clearly be useful to keep discussion of basic principles out of a formal and negotiating atmosphere and got out of the way first. Mr. Beveridge agrees with this proposal.

OK

For your approval

Attachment

cc: ETR
ADM
Mr. Brown

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

March 13, 1986

FROM: P.R. Narvekar PRN

SUBJECT: Mr. Hino's Visit to China

The attached report by Mr. Hino on his recent visit to China discloses a rather worrisome situation. China's external debt is rising rapidly and its composition has developed unfavorably. Planning and monitoring external debt is not yet vested in a single agency. More fundamentally, it is not clear that any one agency has been taking an overall view of all aspects of the external payments and the underlying domestic situation and forging policies to influence them. It is clear that these weaknesses should be tackled before a first credit tranche program is entered into--as the Chinese authorities wish--with reasonable hope of success.

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For your approval

Attachment

cc: ETR
ADM
Mr. Brown

Office Memorandum

CC: PRN
ETR

March 12, 1986

TO: The Managing Director
The Deputy Managing Director

FROM: Hiroyuki Hino HH

SUBJECT: China--Staff Visit on External Debt Management

Mr. Boutros-Ghali visited Beijing to help establish a computer-based external debt database during February 17-March 4, 1986, and I joined him for the last five days to discuss short-term debt management. The discussion was held with operational staffs of the State Planning Commission (SPC), the Ministry of Foreign Economic Relations and Trade (MOFERT), the Ministry of Finance (MOF), and the People's Bank of China (PBC), and was concluded in a meeting with Mr. Shang Ming, Council Member, PBC.

In 1985, China incurred an external current account deficit of $11 billion, its international reserves declined by $5 billion, and its debt to commercial banks rose by $4.2 billion during January-September. According to OECD data, China's outstanding debt was $12.4 billion at end-1984 and may have risen by a further $7 billion by the end of 1985. (The data exclude loans extended to local entities and joint ventures without official guarantee, which are believed to be substantial.) More importantly, the structure of outstanding debt is distinctly unfavorable with a low share of bilateral and multilateral credits (about 15 percent) and a very high share of short-term debt (about 50 percent). Foreign exchange reserves held by the State declined to $2.6 billion by the end of 1985 and only part of the remaining international reserves ($9.3 billion held by the Bank of China) is available to the State.

We suggested that any recourse to short-term financial credit to finance a balance of payments deficit be avoided in 1986, and bilateral and multilateral loans and medium- and long-term suppliers' credits be increased. Although a substantial financing could be obtained from lengthening the average maturity of import financing through, for example, a minimum maturity requirement for certain imports, China may not have the administrative apparatus required for its effective implementation. In addition, the introduction of such minimum maturity requirements at this juncture might have adverse repercussions among foreign creditors. In any event if the current account deficit in 1986--now projected at $10-12 billion--is not reduced, a substantial increase in commercial bank debt with inappropriate maturities will become inevitable.

Thus, we emphasized that it was particularly important to monitor and coordinate closely China's external borrowing. However, at present various agencies somewhat independently plan and regulate borrowing of entities under their supervision. My report of the last visit (November 1985) was submitted to the State Council, on the basis of which the Council decided to establish a central unit to monitor external debt in one of the agencies, but left the choice of the agency unresolved. As a result, various agencies declined to put forward data on external loans to be entered into the database that Mr. Boutros-Ghali prepared for the PBC. After extensive discussions, a consensus emerged at the operational staff level that the SPC expand its external borrowing program to include borrowing of all agencies; that the MOFERT, the MOF, and the PBC implement the borrowing program; and that data on external loans that various agencies now collect be collated by a central unit to be established in PBC. The officials expect a decision by the State Council on this issue by April.

Mr. Shang Ming said that the Chinese officials are in complete agreement with our suggestions. Our concern still remains, however, because China apparently does not at present have an institutional arrangement to address balance of payments management in a well-orchestrated and comprehensive manner. Indeed, when the officials put together with our assistance various components of the balance of payments in 1986 that their agencies had independently projected, they were struck by the magnitude of the balance of payments deficit and its implications on financing requirements. The SPC is empowered with broad authority to manage foreign exchange, but has no apparatus to ensure its effective implementation.

The officials informed me that the role of exchange rate policy is being actively debated among policy makers, and asked me to return to Beijing preferably in early May to lay out principles and key indicators for exchange rate management. I noted the importance of an active involvement of the SPC and MOFERT in an interagency study and stated that I would seek your guidance on their request for our assistance.

cc: Mr. Tun Thin/Mr. Narvekar
Mr. Finch
Mr. Brau
Mr. Brown

R. Boan
cc: ASD

RECEIVED
IMF CABLE ROOM
1986 MAR -7 AM 7: 21

cc: Mr Beveridge
Mr Hino
Mr Boutros-Ghali

INCOMING TELEX

RCV: @1IM/3.19837 LINE: 3 703461

RCA MAR 07 0051
248331 IMF UR

22612 PBCHO CN

MR. HUANG FANZHANG
ED FOR CHINA
INTERFUND

WE HAD VERY FRUITFUL DISCUSSIONS WITH MR. HINO AND MR. BOUTROS-GHALI ON CHINA'S SHORT TERM DEBT MANAGEMENT AND ON INSTRUMENTS FOR COMPUTER-BASED PROJECTION OF CHINA'S EXTERNAL DEBT. IF IS HOPED THAT OUR PRODUCTIVE COOPERATION WILL CONTINUE IN THIS FIELD. IT WAS ALSO SUGGESTED DURING OUR DISCUSSION THAT A JOINT STUDY ON THE ROLE OF EXCHANGE RATE POLICY IN CHINA BE CONDUCTED BY THE FUND STAFF AND CHINESE OFFICIALS IN THE NEAR FUTURE.

KINDLY INFORM ETR AND ASIAN DEPARTMENTS OF THE ABOVE.

REGARDS

INTERNATIONAL DEPT.
PBC
MAR. 7, 1986
86-124

22612 PBCHO CN
248331 IMF UR
KKKKK
TIME: 00:59 03/07/86 ???
CONNECT TIME : 149 SECONDS

Office Memorandum

cc: ~~Mr. Gianturco~~
cc: Mr. Brown

TO: The Managing Director February 10, 1986

FROM: P. R. Narvekar PRN

SUBJECT: China--Presentation of Data on the Internal Settlement Rate in IFS

As you will recall, the Chinese authorities had always insisted that their internal settlement rate--now abolished--was not an exchange rate and Fund documents and the relevant Executive Board decisions were carefully drafted to take account of this sensitivity. You will have noted, however, that beginning with the January 1986 issue, the IFS presents this rate as a "secondary exchange rate" and publishes historical data on it (together with data on "secondary rates" for eight other countries). We thought you should know that the Chinese authorities not only agreed to this presentation which had been cleared with them beforehand but also themselves provided the relevant data.

For your information.

cc: The Deputy Managing Director
Mr. Finch
Mr. McLenaghan
Mr. Brown

Office Memorandum

January 6, 1986

MEMORANDUM FOR FILES

Subject: China--Meeting with GATT Officials, November 14, 1985

I met with Mr. David Hartrage, Chef du Cabinet, and Mr. Ake Linden, Legal Adviser, to discuss general issues related to China's accession to the GATT. They said that the GATT expects to receive in early 1986 a request by China for readmission to the GATT (China maintains that it is one of the founding members of the GATT). China is required to submit a memorandum on its foreign trade system when it presents its request for readmission. The memorandum will describe: what agencies are authorized to engage in foreign trade; who (the State or importing entities) decide what and how much to import; who issues import licenses and how much; how domestic prices of traded goods are determined; and what the structure of import duties is. China has indicated informally that it wishes to be considered a developing country, rather than a State foreign trading, for the purpose of GATT membership.

After the receipt of request for readmission, the GATT will enter into negotiations on concessions by China required for the readmission. Such concessions will take a form of reduction in import duties, a liberalization of quantitative restrictions, or a commitment to increase the value of total imports by a fixed percentage per year. Although China may prefer the first, some member governments are skeptical as to the effectiveness of tariffs in affecting import volumes. In the case of Hungary, concessions in the form of tariff cuts were accepted. This was because the country is small and the GATT wanted to encourage Hungary to move further toward a market economy. It would not be as easy for China, and several member countries already raised questions on this matter.

Some countries prefer to require a liberalization of quantitative restrictions as the concession from China. It is an awesome issue to determine how much of these restrictions could be maintained by China for the reason that it is a centrally planned economy. If the IMF certified that the country was having balance of payments problems, the extent of liberalization required of China would be less than otherwise.

In the case of Poland and Romania, the concession was in the form of a commitment to increase the value of imports by a specified percentage. This form of commitment has not been working well, and a number of officials find it inappropriate. However, better alternatives are yet to be found.

I described briefly the present system of import restrictions as well as the reform of the trade system underway, and discussed the balance of payments situation very briefly. I promised to send them a few articles from JETRO publications and to inquire into the possibility of making this year's RED available.

Hiroyuki Hino
Advisor
Exchange and Trade Relations Department

cc: Mr. Narvekar
Mr. Brau
Mr. Saito
Mr. Anjaria
Mr. Boonekamp

Office Memorandum

To : Mr. Hino

February 6, 1986

From : S. J. Anjaria SJA

Subject: GATT Report on China

Attached please find a confidential paper prepared by the GATT Secretariat entitled "Price Formation and Foreign Trade Regulations in China." Mr. Linden, GATT legal advisor to the Director-General, has requested Fund staff comments on a personal and confidential basis. No deadline has been given, but I suppose at the latest our comments should be ready for me to take to Geneva early in April.

Two copies are attached for your convenience.

cc: Mr. Finch (o/r)
Mr. Brau

Office Memorandum

cc: Mr. Bean

TO: The Deputy Managing Director
(Via Director of Administration)

January 31, 1986

FROM: Tun Thin

SUBJECT: China--Mission on External Debt Management

The Chinese authorities have requested (through Mr. Huang) that a staff team be sent to China to follow up on the work initiated by Mr. Hino (ETR) on external debt management in November 1985. At this time, they wish to focus on the processing of debt information and the management of short-term debt. We believe that the work in these areas will be of crucial importance to the upgrading of China's external debt management and its debt statistics, which would benefit not only China but also the international financial community in general. Accordingly, it is proposed that Mr. Boutros-Ghali (ETR) visit Beijing during February 17-March 1, 1986 to provide assistance on processing of external debt data; Mr. Hino will join him a week later and stay through March 1 for advisory work on the management of short-term external debt.

Mr. Beveridge concurs on behalf of ETR.

cc: ADM
ETR

Mr. Brau

Office Memorandum

December 19, 1985

MEMORANDUM FOR FILES

Subject: China-AsDB Membership

During our recent visit to Beijing, Mr. Che Peiqin (Director, International Department, People's Bank of China) told us that a basic agreement has been reached for China to join the Asian Development Bank (AsDB). Taiwan will remain as a member under the name of "Taipei, China". This matter will be brought to the AsDB's Executive Board in late March 1986 and then to the Annual Meeting of its Governors in April 1986. Mr. Che Peiqin visited Manila twice in the last few months to finalize the basic agreement.

K. Saito

cc: Mr. Narvekar
Mr. Brau

ETR

Office Memorandum

CONFIDENTIAL

cc: Mr. Brau
Mr. Ihro

TO: The Acting Managing Director

December 18, 1985

FROM: Kunio Saito

SUBJECT: Visit to China

In late November, the Chinese authorities expressed interest through Mr. Hino 1/ in the possibility of a first credit tranche program. To conduct a preliminary exchange of views on such a program, I visited Beijing during December 9-11, after the consultation discussions in Western Samoa; I was accompanied by Mr. Fetherston (ASD). During our stay we met with Deputy Governor Liu Hongru of the People's Bank, Mr. Shang Ming, Member of the Council of the People's Bank, and other officials of the People's Bank, the Ministry of Finance, the Ministry of Foreign Economic Relations and Trade, the State Planning Commission, and the State Administration of Exchange Control.

We outlined to the authorities the particular characteristics of a first credit tranche program and mentioned the possibility of combining an appropriate program with a CFF drawing, for which preliminary staff calculations indicate the likelihood of an export shortfall. We emphasized the need for the Fund to be reasonably assured that any Fund-supported program would attain the desired adjustment goals; the absence of performance criteria and reviews under a first credit tranche program would require that the principal adjustment measures should be in place before the Board considers the program. The authorities briefed us on the current economic situation and policies, which indicate that a balance of payments need indeed exists but the adjustment policies for 1986 are still being finalized (see below). In these circumstances we indicated that possible negotiations could be held only after the policies for 1986 are reasonably firmed up, perhaps in February 1986. At the end of our stay, Deputy Governor Liu told us that, following consultation between concerned government departments, the Fund will be informed through Mr. Huang whether the authorities will proceed with a formal request.

Economic situation

Domestic economic activity now appears to be expanding less rapidly in response to the restrictive measures taken earlier this year. The year-on-year rate of industrial output growth was below 9 percent in November, compared with over 20 percent in the first half; the authorities feel that they have also succeeded in controlling the hectic pace of investment expansion, which had exceeded 40 percent in the first half, and price increases have moderated. They now have greater confidence than before that their original plan target for

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1/ Mr. Hino was in Beijing to provide technical assistance on external debt management.

credit expansion--18 percent--can be met; this would represent a considerable achievement against the background of very rapid expansion in late 1984/early 1985. Budgetary policy has been successfully tightened, with expenditure held in check despite pressure for relaxation prompted by a buoyant revenue performance. As a result, the overall deficit should be less than 1 percent of GDP this year, and the authorities now expect to have no net recourse to bank borrowing for budgetary financing.

External developments have been less favorable. Although there are signs of a modest pickup in exports from earlier sluggish levels, import growth has remained rapid, as the effects of demand restraint on imports are being felt only gradually. As a result, the current account deficit this year could be as high as $11 billion (4 percent of GDP). The underlying trend in international reserves remains downward, and has been slowed somewhat in recent months only as a result of increased borrowing abroad by the Bank of China. At end-September, international reserves were $13.8 billion (equivalent to 4.5 months of imports), about $4 billion less than at end-December 1984. 1/ The State's foreign currency deposits at the Bank of China--the counterpart to which forms part of total reserves held by the Bank of China--declined still more sharply than the total, and at end-September stood at $3.4 billion, almost $5 billion less than at end-December. These deposits from which foreign exchange is provided for most import payments are expected to decline further in the coming months. The authorities noted that the State does not normally purchase foreign exchange from the Bank of China to replenish its deposits; the State could borrow additional foreign exchange from the Bank of China (as it did in 1980) for this purpose, but in this event the Bank of China would need to increase its borrowing abroad.

Policies for 1986

A sizeable current account deficit is again in prospect for 1986, reflecting a continuing trade imbalance. To prevent a further decline in reserves to an uncomfortably low level, the authorities are therefore presently reviewing their options for securing additional balance of payments financing.

For the next two years the authorities intend to give priority to stabilization and consolidation of existing reforms over major new reforms. Details of their adjustment policies for 1986 are still being worked out, and at this stage for the most part only broad outlines are available. The authorities intend to continue pursuing restrained

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1/ On a comparable basis, i.e., including holdings of foreign securities throughout this period. The authorities' published data for foreign exchange reserves include holdings of foreign securities only from July 1985; as a result, published data show a 16 percent increase in reserves during July-September 1985, whereas, on a comparable basis, reserves declined by 6 percent during that quarter.

financial policies, and are contemplating a number of measures to strengthen the effectiveness of monetary policy, including possible increases in the interest rate on People's Bank lending to the specialized banks and in reserve requirements, and incorporation of rural credit cooperatives into the credit plan. Fiscal policy will also remain tight, with the 1986 budget expected to eschew recourse to bank financing. Administrative measures to restrain investment and wages are likely to remain in place. In the external sector, exports are being given priority over domestic needs and restrictions have been placed on imports of luxury items such as automobiles.

The exchange rate for the renminbi against the U.S. dollar depreciated progressively from Y 2.97 to Y 3.20 during October, but has since remained unchanged. The authorities indicated that the halt in the depreciation of the renminbi was a temporary measure to deter Chinese enterprises from exploiting leads and lags in their foreign exchange transactions. Exchange rate policy for 1986 is currently under study on the basis of relative movements in other countries' prices and nominal exchange rates; however, Deputy Governor Liu noted that the renminbi had been overvalued in recent years and that he personally expected further depreciation in 1986 under the new managed floating arrangement to be adopted in January.

cc: Managing Director (o/r)
CBD
ETR ✓
EXR
LEG
RES
SEC
TRE
Mr. Brown

Mr. Finch

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

December 11, 1985

FROM: for Hiroyuki Hino

SUBJECT: China--Discussion on External Debt Management

I visited Beijing during November 19-26 to discuss basic principles of external debt management and its implementation. Intensive discussions were held in the first five days with officials of Peoples' Bank of China directly responsible for debt management, and the concluding meeting was chaired by Mr. Ji Chong Wei, Chairman of the Economic Research Center of the State Council and a key adviser for the State Council on external policies. Senior officials of concerned Ministries and Mr. Huang, Executive Director, also attended the final meeting. I met separately with Mr. Shang Ming, Member of the Council of the Peoples' Bank of China. The officials said that the discussions were timely as they are in the process of formulating the Seventh Five-Year Development Plan (1986-90) and were useful for this purpose. They expressed interest in continuing the dialogue, focusing next on management of short-term debt.

The main objective of the discussions was to introduce a methodology for setting limits on external borrowing, by maturity and by type of creditor, in the medium-term framework. We developed a framework for medium-term balance of payments analysis in which various balance of payments strategies could be simulated and their implications on external debt analyzed. To illustrate the application of their framework, alternative balance of payments projections for China were examined and the desirability of external borrowing was assessed. Although we discussed at length determinants of each of the major variables of the balance of payments and factors affecting the vulnerability of the external position, more reliable projections are required for several key items to make the framework fully operational.

The officials said that the Seventh Plan will place great emphasis on export growth (target volume growth of about 8 percent per year); to this end, production will be increased, competitiveness enhanced, marketing improved, quality upgraded, and markets in Latin America and North America penetrated. Imports are to fall somewhat in 1986 reflecting the slowdown in economic growth, but normal growth will resume thereafter. The projection which incorporates these assumptions implies a current account deficit of 2.0-2.5 percent of GDP during 1986-90, compared with about 4 percent in 1985, and an increase in the debt service ratio from 4 percent in 1985 to 13 percent in 1990. The officials said, however, that the Seventh Plan will aim at a current account deficit and external borrowing substantially smaller than those presented in the projection. I emphasized the importance of adopting policies to achieve the desired level of the current account deficit.

Data on outstanding debt are incomplete with respect to borrowings by local entities, import-related credits, and foreign liabilities of financial institutions. Borrowing decisions are not centralized, and a proposal is under consideration to grant external borrowing authority to a large number of local entities. The Chinese officials expressed the desire to establish a system for comprehensive monitoring and careful screening of all foreign borrowing activities, the area where the World Bank has provided assistance. I said that such a system is a prerequisite for the effective implementation of debt management.

Partial information indicates that foreign liabilities of Bank of China increased by more than $2 billion (about 60 percent) in the first nine months of 1985. In spite of the apparently large foreign borrowing, international reserves (including holding of foreign securities) declined by $4 billion in this period, and the officials expect the pressure on reserves to continue over the near term. They expressed serious concern about the lack of an effective mechanism to control short-term debt. I shared this concern and pointed to the potential danger of resorting to short-term financial credits to finance the large balance of payments deficits.

cc: Mr. Tun Thin (o/r)/Mr. Narvekar
Mr. Finch
Mr. Brau
Mr. Brown

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ORIG: MR. ZHANG
CC: ASD
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NOV 29 1985
EXCHANGE & TRADE RELATIONS

MR. ZHANG ZICUN
ED OF CHINA
INTERFUND

PLEASE COPY TO ETR AND ASIAN DEPARTMENT

WE HAVE HAD GOOD DISCUSSIONS ON THE MANAGEMENT OF EXTERNAL DEBT AND MEDIUM TERM PROJECTION OF CHINA'S BALANCE OF PAYMENTD FOR THE PERIOD OF 1986 TO 1990 DESPITE OF LACKING OF SOME OF THE NECESSARY DATA. THE CHINESE AUTHORITIES FEEL IT VERY USEFUL 'TO HAVE CSUCH DISCUSSIONS WITH THE FUND STAFF AND APPRECIATE MR. HINO'S EFFORTS IN THIS REGARD DURING THE LAST WEEK, AND WISH TO TAKE THIS OPPORTUNITY TO EXPRESS OUR APPRECIATION TO THE FUND AND MR. HINO FOR THEIR ASSISTANCE.

MR. HINO LEFT BEIJING ON NOV. 27, 1985.

BEST REGARDS.

PEOPLE'S BANK OF CHINA
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EXCHANGE & TRADE RELATIONS

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Mr. Beveridge
cc Mr HINO.

Office Memorandum

November 27, 1985

TO: The Deputy Managing Director
(Via Administration Department)

FROM: Tun Thin

SUBJECT: Official Travel to China

As noted in our confidential memorandum to Management dated November 22, we propose that Mr. Saito have discussions with officials in Beijing during December 9-11, 1985 on his way back from a consultation mission to Western Samoa. He will be joined by Mr. Fetherston who is presently in China on a Bureau of Statistics mission, which is due to end December 5. Mr. Saito will proceed to Beijing via Tokyo where he will meet with Mr. Narvekar and Mr. Hino for a day or two. This arrangement obviates the need for Mr. Hino to stay behind in China. He is now on annual leave in Japan.

We seek your approval for Mr. Saito's visit to Beijing as well as for the stop in Tokyo by Mr. Hino on his return to Washington.

cc: ADM
Mr. Beveridge

Office Memorandum

cc: Mr. Hino
Blue Folder

1985 OCT 30 AM 10: 52

OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

October 30, 1985

FROM: P. R. Narvekar PRN

SUBJECT: China--Supplement to Staff Report

Attached for your approval is a supplement to the staff report for the 1985 Article IV consultation with China. The paper has received comments and clearance from Mr. Brau.

The supplement reviews developments in recent months, which feature a slowdown in the rapid output growth and monetary expansion, but a continuing external deficit. A summary of the recently issued party proposal for the next Five-Year Plan is provided. A supplementary staff appraisal focuses on the short-term domestic situation and the external deficit; however, the thrust of the appraisal in the main report remains valid.

Executive Board discussion is scheduled for Friday, November 8; we would wish to have the supplement available to Executive Directors by Monday, November 4.

Attachment

cc: Mr. Brau
Mr. Brown

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

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BEIJING, CHINA

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Mr. Levin

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THANK YOU FOR YOUR TELEX OF OCTOBER 21, 1985. FOLLOWING DISCUSSIONS WITH MR. JIANG HAI, ALTERNATE EXECUTIVE DIRECTOR FOR CHINA, WE SHOULD LIKE TO CONFIRM THAT THE MISSION IN BALANCE OF PAYMENTS STATISTICS WILL COMMENCE ON NOVEMBER 25, 1985 AND WILL BE IN BEIJING UNTIL NOVEMBER 30. THE MISSION WILL COMPRISE MR. ARIE C. BOUTER, ASSISTANT DIRECTOR OF THE BALANCE OF PAYMENTS DIVISION IN THE BUREAU OF STATISTICS, AND MR. MARTIN J. FEATHERSTON, ECONOMIST IN THE ASIAN DEPARTMENT. IN ADDITION, MR. HINO, ADVISOR IN THE EXCHANGE AND TRADE RELATIONS DEPARTMENT, WHO WILL BE IN BEIJING AT THAT TIME WOULD JOIN THE MISSION'S DISCUSSIONS FOR A FEW DAYS. FLIGHT PARTICULARS FOR MESSRS. BOUTER AND FEATHERSTON WILL BE COMMUNICATED AS SOON AS THEY ARE FINALIZED. THE QUESTIONNAIRE REFERRED TO IN YOUR TELEX IS UNDER PREPARATION AND WILL BE FORWARDED SHORTLY.

WITH REGARD TO THE PROPOSED SEMINAR ON GOVERNMENT FINANCE STATISTICS, WE AGREE TO ITS POSTPONEMENT TO

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Mr. Brau
cc: Mr. Hino
B/folder

Office Memorandum

CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

October 24, 1985

FROM: P.R. Narvekar PRN

SUBJECT: Visit to China

After Seoul, I visited Beijing for a few days and held meetings with officials of various ministries and the People's Bank. The main points that emerged from these meetings and the meetings I had in Seoul with Vice Minister of Finance Li Peng and People's Bank Deputy Governor Liu Hongru are set out below. The Article IV consultation is to be concluded by the Executive Board on November 8 and a supplement to the staff report, incorporating these and other recent information, will be issued in due course.

1. There is some evidence of slowing down but the Chinese economy roars along. The annual rate of growth of industrial production was 20 percent during January-September. For the year 1985 as a whole, a rate of growth of about 18 percent is expected and national income is expected to grow by over 12 percent, both rates being recognized by the authorities to be excessive. They stress, however, that they are seeking a soft landing for the economy rather than impart to it a sharp brake, and that the recent measures to restrain domestic demand are beginning to take effect. I indicated that the situation would continue to need close monitoring, and welcomed their willingness to consider additional measures in the monetary area.

2. Monetary expansion, while continuing apace, has slowed down. The authorities concede that credit expansion is likely to exceed the initial 18 percent target--which the staff had considered reasonable--but could not say by how much. The excess is unlikely to be small. The authorities are considering increases in reserve requirements and in the rate of interest charged on lending to the specialized banks.

3. The budget, however, continues to be comfortable, the authorities being reasonably confident of achieving a balance this year after several years of deficit. The balance is on the official method of reckoning, and would mean a small deficit (less than one percent of GDP) on ours.

4. The authorities expect the price increase for 1985 to be of the order of 10 percent. No major price reform measures have been taken since the consultation discussions and none appear likely to be until the overall demand situation settles down.

5. The foreign trade situation has proven a little more impervious to the corrective measures than we had anticipated. We had

estimated a trade deficit of $2 billion for the second half of 1985 but one twice as large was recorded in the third quarter and there is little basis for envisaging a sufficiently sharp improvement in the last quarter. Exports were somewhat smaller in the third quarter than expected and the authorities said imports contracted earlier continued to be delivered.

6. The authorities attributed the continuing decline in foreign exchange reserves to this same factor of the backlog of earlier contracts. In July--the latest month for which data are available--reserves dropped by $2 billion to $10 billion; the cumulative loss since the beginning of the year was $5 1/2 billion and that from the peak of July 1984, $8 billion. The authorities estimated a further loss of only about $1 billion by the end of the year. This would imply an overall deficit of $6 1/2 billion in 1985, nearly twice as large as the deficit projected by the July mission.

7. Finally, on the subject of the exchange rate arrangement, the Chinese authorities have just informed the staff that effective next January, they would replace the basket peg of the yuan by a "managed float". They said that a more flexible exchange rate arrangement was desirable in view of the substantial adjustment of the yuan in the recent past and the price and wage reform in process.

cc: Mr. Brau
Mr. Brown
Mr. Collins

cc: Mr. Quirk

Office Memorandum

RECEIVED
OCT 22 1985
EXCHANGE & TRADE RELATIONS

TO : Mr. Narvekar

DATE: October 22, 1985

FROM : Zhang Zicun T C Chang

SUBJECT : Exchange Rate Arrangement for the Chinese Yuan

In response to your memorandum to Mr. Che Peiqin dated July 29 while you were in Beijing, the Government wishes me to pass on to you the following information which I received today.

> "In view that the Chinese yuan has been adjusted substantially since 1984 and also on account of the present price and wage reform in process, more flexible exchange rate arrangement is desirable. Therefore, China has decided that the original peg of yuan to a basket of currencies will be replaced by the "managed floating" beginning from January 1, 1986 and may be reclassified as such by the Fund."

I trust you will take the appropriate action.

cc: Mr. Finch

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CC: ETRD

TO MR. SAITO
ASIAN DEPT.
INTERFUND

DATA ON FINANCIAL OPERATIONS OF THE PEOPLE'S CONSTRUCTION BANK OF CHINA AT THE END OF JUNE ARE AS FOLLOWS: (IN BILLIONS OF YUAN)

DEPOSITS WITH THE PBC	25.5
LOANS	86.9
LOANS IN PLACE OF STATE BUDGET APPROPRIATIONS	22.1
LOANS IN PLACE OF LOCAL GOVERNMENT APPROPRIATIONS	8.6
DEPOSITS	112.4
ENTERPRISE DEPOSITS	44.3
OF WHICH: CAPITAL CONSTRUCTION DEPOSITS	17.4
OTHER DEPOSTIS	37.4

CC. MR. ZHANG ZICUN, ED FOR CHINA

IMF DIVISION
INTERNATIONAL DEPT.
PEOPLE'S BANK OF CHINA
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cc: Mr Hino

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MR. SAITO, ADVISOR, ASIAN DEPT. IMF

COMMENTS ON 'CHINA: AGRICULTURAL SECTOR POLICIES' ARE AS FOLLOWS:

1. IN THE ARTICLE, IT SAYS, 'FARMERS WERE FREE TO PLANT THEIR LANDS, OFTEN LEASED ON A LONG-TERM BASIS.' WE CONSIDER THAT IT IS NOT APPROPRIATE TO USE 'LEASED' TO DESCRIBE THE RELATIONSHIP BETWEEN CONTRACT HOUSEHOLDS AND LAND. BECAUSE THE OWNERSHIP OF LAND BELONGS TO THE COLLECTIVES, THE CONTRACT HOUSE-HOLDS HAVE ONLY THE RIGHT OF PLANTING AND OPERATING ON THE LAND. THEY DO NOT LEASE THE LAND.

2. IN THE ARTICLE, IT SAYS, 'WHILE THE STATE, THROUGH ITS LOCAL AGENTS, RETAINED OWNERSHIP OF THE LAND AND HEAVY M MACHINERY.' IT IS NOT IN ACCORDANCE WITH THE ACTUAL SITUATION IN OUR COUNTRY. IN THE COUNTRYSIDE OF OUR COUNTRY, THE OWNERSHIP OF LAND BELONGS TO THE COLLECTIVES, NOT TO THE STATE. AS REGARDS TO OTHER MEANS OF PRODUCTION, AT PRESENT, IT IS NOT ONLY THE STATE THAT OWNS HEAVY MACHINERY, BUT ALSO RURAL COLLECTIVES. AT THE SAME TIME, THE INDIVIDUAL FARMERS NOW OWN SOME LIGHT MACHINERY SUCH AS TRUCKS, WALKING TRACTORS AND IRRIGATION AND DRAINAGE EQUIPMENT.

3. IN THE ARTICLE, IT SAYS, 'PERHAPS ONLY DISTINGUISHABLE FROM PRIVATE FARMING BY THE FACT THAT THE LAND OWNERSHIP WAS RETAINED BY THE STATE.' IT DOES NOT ACCORD WITH THE ACTURAL SITUATION IN OUR COUNTRY EITHER. FIRST, IN OUR COUNTRY, THE OWNER-OF LAND IN THE COUNTRYSIDE BELONGS TO THE COLLECTIVES, NOT TO THE STATE. SECOND, THERE ARE MANY DISTINCTIONS BETWEEN CONTRACT HOUSEHOLDS AND PRIVATE FARMERS. FOR EXAMPLE, CONTRACT HOUSE-HOLDS PRODUCE CROPS ACCORDING TO THE CONTRACTS WITH THE STATE OR PRODUCTION TEAMS. THEY PAY AGRICULTURAL TAXES TO THE STATE OR PRODUCTION TEAMS ACCORDING TO THE CONTRACTS.
THE REMAINDER AFTER TAX BELONGS TO THEMSELVES. WHILE THE PRIVATE FARMERS PRODUCE AUTONOMOUSLY. BOTH THE STATE AND PRODUCTION TEAMS CAN HARDLY GUIDE THE PRODUCTION OF PRIVATE FARMERS. CERTAINLY, THERE ARE ALSO OTHER DISTINCTIONS BETWEEN CONTRACT HOUSEHOLDS AND PRIVATE FARMERS. WE SHALL NOT LIST ALL OF THEM HERE.

COMMENTS ON 'THE EVOLVING ROLE OF MONETARY POLICY IN CHINA' ARE AS FOLLOWS:

1. IN THE ARTICLE, IT SAYS, 'THE 'COMMODITY INVENTORY SYSTEM' OF CREDIT CREATION IS A VARIANT OF THE 'REAL BILL' PRINCIPLE.' IN THE EARLY 1950S, THE SOVIET EXPERTS SAID THAT THE BANKS COULD ISSUE SHORT-TERM LOANS TO THE ENTERPRISES WHOSE WORKING CAPITAL WERE USED FOR INVENTORYIES. THE LOANS, THEREFORE,

WERE GUARANTEED BY THE GOODS AND MATERIALS IN THE INVENTORY AND IT WOULD BE EASY TO RECALL AT DUE TIME. IT WOULD NEVER CAUSE ANY INFLATIONARY PROBLEMS. REAL BILL DOCTRINE IS THE STAND OF BRITISH BANK SCHOOL IN 19 CENTURY IN BRITAIN. ITS MAIN CONTENT WAS THAT ALL THE LOANS OF COMMERCIAL BANKS SHOULD BE SHORT-TERM AND SELF-LIQUIDATING. SO THE SIZE OF MONEY STOCK DEPENDED ON THE BNEEDS OF ENTERPISES. AT THAT TIME, BRITAIN EXERCISED THE GOLD STANDARD SYSTEM, WHAT COULD CAUSE THE INFLATION? DUE TO THESE TWO REASONS, IT SEEMS IRRELEVANT TO MAKE A COMPARISON BETWEEN THE LOANS GRANTED TO ENTERPRISES BY THE CHINESE BANKS BEFORE 1979 AND THE REAL BILL THEORY.

2. IN THE ARTICLE, IT SAYS, 'HOWEVER, MOST OF THE DOMESTIC TRUST COMPANIES WERE CLOSED IN 1983.' IT DOES NOT ACCORD WITH THE ACTUAL SITUATION IN OUR COUNTRY. BECAUSE THE INDIVIDUAL PROVINCES AND MUNICIPALITIES IN OUR COUNTRY NOW STILL HAVE MORE THAN 20 INVESTMENT AND TRUST COMPANIES.

END.

INTERNATIONAL DEPT.
PEOPLE'S BANK OF CHINA
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Office Memorandum

cc: Mr. Brau

October 10, 1985

MEMORANDUM FOR FILES

Subject: Meeting of the Chinese Delegation with the Managing Director, October 10, 1985

The Chinese delegation was led by Mr. Liu Hongru, Deputy Governor of the People's Bank. Mr. Zhang, Mr. Erb, Mr. Brau, and Mr. Narvekar were present. There was initially some discussion of the major issues deliberated at the Annual Meeting. Inter alia, the Managing Director expressed appreciation of the position taken by China in relation to the Trust Fund and said that China should feel assured that this would not disqualify it from getting other concessional assistance.

There was then a discussion of the Chinese economic situation. Mr. Liu reviewed in particular the credit restraint measures being taken. In their comments, the staff expressed agreement with the broad thrust of recent policies, said that there was still a long way to go in cooling down the overheated economy, and that there was need for exchange rate flexibility. They also outlined plans for technical assistance in the areas of central banking, debt management and economic intelligence.

The meeting lasted 45 minutes.

PRN

P. R. Narvekar

cc: The Deputy Managing Director
ETR
Mr. Brown

Mr. Brau
ETR file

Office Memorandum

To: Mr. Narvekar

September 18, 1985

From: Hiroyuki Hino HH

Subject: China--World Bank's Balance of Payments Scenario

The World Bank staff sent us a draft of the next country program paper that included medium-term balance of payments scenarios. Their base scenario envisages an export volume growth of 8.7 percent per year and an import volume growth of 6.4 percent, and projects a current account deficit of US$5.1 billion in 1990 (Table 1). The Bank staff expects China's Seventh Five-Year Plan to include an external borrowing strategy in line with this scenario. They recognize that the export target is ambitious and incorporate a somewhat lower growth in the high borrowing scenario. The draft states that this latter scenario which puts the current account deficit in 1990 at US$15.1 billion is not advisable because (i) China would not be able to deal with imbalances of this magnitude with the macroeconomic tools at their disposal; (ii) the borrowing would entail substantial "interest-related liquidity risks"; and (iii) borrowing requirements would be so large (US$16 billion by 1990) that China could face supply constraints.

The base scenario is broadly in line with our medium-term projection, except that the Bank staff assumes the volume growth of manufactured exports of 10.6 percent, compared with our 8.5 percent. We thought that ours was already optimistic and would require policy adjustments to achieve it. The draft does not discuss the policies needed to make their base scenarios feasible.

Attachment

cc: Mr. Brau
Mr. Saito

Table 1. China: Medium-Term Balance of Payments Scenario

	Fund staff	Bank staff	
		Base	High Borrowing
	(In billions of U.S. dollars)		
Current account deficit in 1990	8.6	5.1	15.1
	(In percent)		
Export volume growth	7.8	8.7	7.3
Primary	6.8 1/	6.2	6.2
Manufacturers	8.5 2/	10.6	8.0
Import volume growth	5.5	6.4	6.4
Debt service ratio in 1990	7.4	7.1	12.6

1/ Refers to oil; average annual growth rate.
2/ Refers to non-oil.

Table 1. China: Medium-Term Balance of Payments Scenario

	Fund staff	Bank staff Base	Bank staff High Borrowing
	(In billions of U.S. dollars)		
Current account deficit in 1990	8.6	5.1	15.1
	(In percent)		
Export volume growth	7.8	8.7	7.3
Primary	6.8 1/	6.2	6.2
Manufacturers	8.5 2/	10.6	8.0
Import volume growth	5.5	6.4	6.4
Debt service ratio in 1990	7.4	7.1	12.6

1/ Refers to oil; average annual growth rate.
2/ Refers to non-oil.

Mr. Guitián
MG

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OFFICE OF
THE MANAGING DIRECTOR

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 17, 1985

FROM: P. R. Narvekar PRN and Manuel Guitián MG

SUBJECT: China--Draft Staff Report

Attached for your approval is the draft Staff Report for the 1985 Article IV consultation with China. It has been reviewed by Messrs. Mahler (FAD), Silard (LEG), Chandavarkar (TRE), Hood (RES), McLenaghan (STAT), and Ms. Koenig (CBD). It has also benefited from the comments of Mr. Tidrick (IBRD).

Attachment

cc: Mr. Collins

system, to proceed in parallel with the domestic reforms. A reformed system need not always equate domestic and international prices; for instance, the authorities might wish to insulate the domestic prices of agricultural products from temporary fluctuations in world market prices or to provide moderate tariff protection for certain developing industries. However, too heavy a protection of domestic industry would only lead to a continuation of the excessive domestic market orientation that has already been encountered in some recent foreign investment projects.

The staff also believes that a system in which the price mechanism plays a greater role in balance of payments management would require a more flexible exchange rate policy. Since the last consultation, the internal settlement rate has been eliminated; the staff welcomes this development. All transactions are now conducted at the official exchange rate. The real effective rate of the renminbi depreciated by 3 percent between November 1984, when the Executive Board last discussed China's exchange rate policy, and July 1985.

The staff welcomes the termination, since the last consultation, of the bilateral payments agreement with Egypt. The tax on remitted profits of certain joint ventures gives rise to a multiple currency practice subject to approval under Article VIII; in view of the relatively limited scope of this practice there seems to be no balance of payments need for it and, therefore, the staff does not recommend its approval by the Executive Board.

is the decision the same as last year?

Office Memorandum

→ MD P.41 DD 9/21/85

TO: The Managing Director
The Deputy Managing Director ✓

1985 SEP 17 PM 5:25

September 17, 1985

FROM: P. R. Narvekar PRN and Manuel Guitián MG

OFFICE OF THE DEPUTY MANAGING DIRECTOR

SUBJECT: China--Draft Staff Report

Attached for your approval is the draft Staff Report for the 1985 Article IV consultation with China. It has been reviewed by Messrs. Mahler (FAD), Silard (LEG), Chandavarkar (TRE), Hood (RES), McLenaghan (STAT), and Ms. Koenig (CBD). It has also benefited from the comments of Mr. Tidrick (IBRD).

Attachment

cc: Mr. Collins

to other sectors

Executive Directors have often expressed interest in the international implications of national policies. In last year's consultation report, the staff had commented on these from the perspective of China's foreign trade. They noted that, in the longer term, China's increasing integration with the world economy could only benefit both China and the rest of the world. This remains true although both China and its trading partners may encounter short-term difficulties in some sectors as costs ~~in reallocating~~ resources are reallocated so as to accommodate comparative advantages. ~~Ultimately,~~ However, it is the overall result of the Chinese efforts to achieve its triple objectives that will have the most far-reaching implications for the rest of the world.

— China and others should benefit in the short run also

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

Office Memorandum

TO: Mr. Guitián September 12, 1985

FROM: Peter J. Quirk

SUBJECT: People's Republic of China--Draft Staff Report for the 1985 Article IV Consultation

Following are ERD comments on this report:

There is a question that Mr. Hino has raised with me concerning the tightening of the foreign exchange allocation scheme. Prior to the mission we had examined this scheme, and it is clear that it constitutes an exchange restriction. I have been informed by Mr. Hino that, following substantial relaxation in recent years, the budget has been tightened in 1985. This places the tightening within an issue that is currently being examined (following similar questions in the cases of Western Samoa and Zimbabwe) concerning the meaning of "adaptation" under Article XIV. The view that I have expressed to the Legal Department is that a very large change may materially alter the restrictiveness of the system which should not be dealt with as an adaptation which would have the measure retain protection under Article XIV. We have been examining the precedents in this respect, and there are more recent precedents whereby a major tightening (and this requires some judgment as to quantification) has taken the measure from Article XIV to being subject to approval under Article VIII (e.g. Cyprus, Western Samoa, Yemen Arab Republic, and Zambia).

On page 20 it is stated that imports in the second half of the year would be about ten percent lower than in the first half, although these estimates are noted to be "very tentative." Given the increase in imports that has occurred in recent years, there is a question as to whether or not this would constitute the structural "sea change" in the restrictiveness of the exchange system that would take a measure from Article XIV to Article VIII. I understand from Mr. Hino that full information on the extent of this tightening is not presently available to the staff (he is sending you a more detailed note on the matter). However, there is likely to be a special visit to China later in the year, by which time an assessment could be made of the extent of the tightening, and the issue addressed.

A rather basic comment on the paper--more in the nature of a question--is the role of monetary policy and the methods of its implementation. The paper suggests the development of a redeposit scheme for the control of credit, but does not state directly the technique of control in use at present. Presumably, it is a rationing system of some sort. If so, the extent of the inflation at present disguised by price controls may be important in assessing the level of interest rates. Deposit rates are shown as now being just under seven percent on page 16, but the observation on interest rates for loans is given only in change terms so that it is difficult to formulate a view as to the real interest rate. This could be made more explicit. There is an important question as to how to judge the interest rate and also external competitiveness in the presence of price controls. It may be useful if the paper was to discuss this issue and it could be an objective of the further work planned in this area by Central Banking and Asian departments, which is footnoted on page 17.

The paragraph on page 23 dealing with the special economic zones may be a little lower key than required, given the amount of publicity that these have received, and the likely interest of Executive Directors. It may be useful to specifically state the growth of exports from the zone, compared with total exports, along with some assessment by the staff of the likely prospects in the zones. In the paragraph dealing with the issue of exchange rate determination it could also be useful to record any information concerning the exchange rate at which the unauthorized foreign exchange activcities mentioned in the previous paragraph have been undertaken, if this is known with any degree of certainty. Mention of parallel exchange rates is a common feature of staff reports. With respect to the chart on page 24a showing effective exchange rate indices, it may be useful to indicate which exchange rate, the internal settlement or official exchange rate, is contained in these indices.

Page 31, bottom of page: I wonder if the statement by the World Bank regarding the foreign trade system is helpful, in that it tends to overstress the merits of gradualism in liberalizing the trade regime.

Page 35, line 9: the statement that there has been a switch to "other foreign assets" is somewhat cryptic.

Page 37, the penultimate sentence: I would suggest that the sentence beginning "A reformed system..." be redrafted: "The authorities might wish to insulate the domestic prices of agricultural products from obviously temporary fluctuations in world market prices.

Page 38, last partial paragraph: It would be useful to list the exchange restrictions. To this end, there could be added after the first sentence the following: "China now maintains bilateral payments agreements with ... Fund members. These agreements and the exchange restriction arising from the foreign exchange budget are maintained under the transitional provisions of Article XIV."

cc: Mr. Finch
Mr. Hino
Mr. Belanger

cc: MR HINO

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RECEIVED
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EXCHANGE &
TRADE RELATIONS

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ORIG: ASD
CC: ETR

MR. SAITO, ASIAN DEPARTMENT, IMF

REF. YTLX OF AUG. 29, 1985.

1. DATA ON OFFICIAL FOREIGN EXCHANGE RESERVES FOR MAY AND JUNE, 1985 ARE US DOLLARS 11.177 BILLION AND 10.852 BILLION RESPECTIVELY.

2. QUARTERLY DATA ON IMPORT LETTERS OF CREDIT FOR THROUGH JUNE IS US DOLLARS 3.69 BILLION. MONTHLY DATA IS NOT AVAILABLE.

3. THE BANK OF CHINA DOESN'T HAVE DATA ON OUTSTANDING HOLDINGS

OF FOREIGN BONDS AND SECURITIES AND THERE HAS BEEN NO NEW ISSUANCE SO FAR FROM 1985.

4. DATA ON AGGREGATE OPERATING LOSSES OF STATE-OWNED INDUSTRIAL ENTERPRISES IN 1984 AND DATA ON BUDGETED REVENUE IN 1985 WILL BE AVAILABLE IN LATE SEPT. AND SHALL BE TELEXED TO YOU ASAP.

5. END-JUNE MONETARY DATA WILL BE MAILED TO YOU AROUND MID-SEPT.

6. MINUTES OF THE MEETINGS WHICH HAVEN'T BEEN RETURNED TO YOU WILL REACH YOU IN EARLY SEPT.

BEST REGARDS.

IMF DIVISION
INTERNATIONAL DEPT
PEOPLE'S BANK OF CHINA

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248331 IMF UR
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INTERNATIONAL MONETARY FUND

September 3, 1985

Mr. Finch -

For your information.

Zhang Zicun

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1985 AUG 30 PM 9:46

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MR. ZHANG ZICUN, ED FOR CHINA, IMF

DATA ON OFFICIAL FOREIGN EXCHANGE RESERVES FOR MAY AND JUNE 1985 ARE US DOLLARS 11.177 BILLION AND 10.852 BILLION RESPECTIVELY.

IMF DIVISION
INTERNATIONAL DEPT.
PEOPLE'S BANK OF CHINA

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EXC
TRAD... RELATIONS

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Office Memorandum

August 14, 1985

Memorandum for Files

Subject: China--Definition of International Reserves

The overall balance of payments is normally defined as a change in net international reserves of the banking system. In the case of China, the Fund staff has so far derived the overall balance from the change in gross international reserves on the assumption that foreign liabilities of the Bank of China are very small or do not change significantly; the foreign exchange component of gross international reserves consisted of state foreign exchange reserves and borrowed reserves of the Bank of China which excluded, inter alia, holdings of foreign bonds and securities. With a view to examining the appropriateness of this procedure, I met Mrs. Yin Bao Yu, Deputy Chief, Planning and Statistics Division, State Administration of Exchange Control, and officials of the Bank of China on July 26, 1985 to review (a) the present method of compiling gross reserve figures and (b) changes in foreign liabilities of the Bank of China over the last several years.

Compilation of gross reserves

China's international reserves have been reported in the format of Table 1. According to the officials, there are two equivalent ways to derive the figure for total foreign exchange reserves ($14.4 billion at the end of 1984). Under the first method, foreign exchange reserves equal Bank of China's (BOC) cash holdings and deposits with banks abroad (A+B+C in Table 2). This includes State foreign exchange reserves since the State buys its foreign exchange from, and deposits it with, the BOC, which in turn invests such exchange in banks abroad. BOC's liabilities to the State on the latter's foreign exchange account do not appear in the BOC's balance sheet as such liabilities are offset against domestic assets (renminbi) with which the State purchased foreign exchange. The difference between total foreign exchange reserves and state foreign exchange constitutes BOC's own reserves. We should not use the term "BOC's borrowed reserves" since it is misleading.

Under the second method, reserves are derived as foreign exchange resources minus usages. Resources consist of due to foreign banks (J+K in Table 2), foreign currency deposits and some asset items (F+G+H+I), while foreign currency lending (E), buyers' credit (F), and some liability items (M+N+O) comprise usages.

The two methods are in general not equivalent. The equivalence would hold if (i) total foreign assets equaled total foreign liabilities and (ii) resources items in the asset side equaled usage items in the liabilities side. However, these equalities do not generally hold.

The officials neither denied nor confirmed that it was the first method that they actually use in compiling the figures reported to us. They simply reiterated that the two methods were equivalent. Thus, we do not understand clearly how total foreign exchange reserves are defined. I did not discuss other issues such as the residency vs. the currency criterion, consolidation of BOC's foreign branches, and possible inclusion of foreign bonds and securities in foreign reserves.

Foreign liabilities

The IFS reports "National Banks: Other liabilities" which amounted to US$3.6 billion at the end of 1984. This figure includes mainly BOC's borrowings from foreign banks and overseas affiliates; claims on China of banks in the BIS reporting area amounted to US$3.5 billion at the end of 1984, of which about two-thirds represent claims on banks in China. The officials did not provide a complete definition of "National Banks: Other Liabilities."

The Fund staff has not been provided with the data on total foreign liabilities of the BOC. The bank's annual report contains a balance sheet but it does not separate foreign from domestic components; the officials said that this segregation would be difficult because some items are not included in the balance sheet. In addition to borrowing from foreign banks, BOC's foreign liabilities include nonresidents' foreign exchange deposits (US$3.6 billion as of end-1984), bonds and CDs held by nonbank entities (amount unknown), and if the currency criterion is used, residents' foreign exchange deposits (US$6.2 billion as of end-1984). It appears safe to assume that BOC's total foreign liabilities are fairly large.

Hiroyuki Hino
Advisor
Exchange and Trade Relations Department

cc: Mr. Narvekar
Mr. McLenaghan
Mr. Saito
Mr. Fetherston

Table 1. China: International Reserves, 1981-85

(In millions of U.S. dollars, end of year)

	1981	1982	1983	1984	1985 End June
Foreign exchange					
Foreign exchange balance total	3,506	7,728	9,730	9,116	
Minus bilateral payments assets (net)	798	742	829	897	
State foreign exchange	2,708	6,986	8,901	8,219	
Plus Bank of China borrowed reserves	2,065	4,139	5,575	6,201	
Total foreign exchange reserves	4,773	11,125	14,476	14,420	
Gold (People's Bank of China holdings) 1/	516	491	464	435	
Reserve position in the Fund	--	--	176	255	
SDRs	275	214	335	406	
Total reserves	5,564	11,830	15,451	15,516	

Source: ~~Bank of China.~~ STATE ADMINISTRATION OF EXCHANGE CONTROL

1/ Valued at SDR 35 per fine troy ounce.

Table 2. Bank of China--Foreign Assets and Liabilities, 1981-84

(In millions of U.S. dollars)

	1981	1982	1983	1984
Foreign assets 1/				
A. Cash				
B. Due from foreign banks				
C. Due from foreign branches				
D. Foreign bonds and securities				
E. Loans				
Residents				
Nonresidents				
F. Buyers credit				
G. Export bills				
H. Commercial papers				
I. Other				
Foreign liabilities				
J. Due to foreign banks				
K. Due to foreign branches				
L. Foreign exchange deposits				
Residents				
Nonresidents				
M. Buyers' credit				
N. Commercial papers				
O. Other				

1/ Excludes State foreign exchange account.

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

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HIROYUKI HINO
XIYUAN HOTEL
BEIJING, CHINA

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REFERENCE REQUEST FOR INFORMATION REGARDING EXPORT EARNINGS RETENTION SCHEME IN PAKISTAN. PAKISTAN PERMITS INDUSTRIAL UNITS ESTABLISHED UNDER A PAYE SCHEME TO UTILIZE UP TO 50 PERCENT OF THE F.O.B. VALUE OF EXPORTS FOR SERVICING SUPPLIER'S CREDITS ON IMPORTS OF PLANTS AND MACHINERY. UNLIKE COUNTRY IN QUESTION AND SPECIFICALLY SEZ'S, THE UNOFFICIAL MARKET IN PAKISTAN IS USED PRIMARILY FOR WORKERS' REMITTANCES AND IS SAID TO BE VERY SMALL. AS OF JULY 1 THE UNOFFICIAL RATE FOR THE PAKISTAN RUPEE WAS LESS THAN 20 PERCENT DEPRECIATED WITH RESPECT TO THE OFFICIAL RATE. EFFECT OF RETENTION ON INCENTIVES FOR SUBVERTING CONTROL SYSTEM THEREFORE DIFFERENT.

I WOULD NOTE THAT THE ZAIRE PROGRAM IN 1983 PROVIDED FOR AN ELIMINATION OF ALL BUT A FEW EXPORT RETENTION QUOTAS, AND THE INTRODUCTION OF ANY NEW FOREIGN EXCHANGE RETENTION SCHEME WAS MADE SUBJECT TO PRIOR CONSULTATION WITH FUND STAFF. IN GENERAL, RETENTION SCHEMES ARE

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DRAFTED BY NAME (TYPE): Alison Mitchell — EXT.: 8526 — DEPT.: ETR — DATE: 7/22/85

AUTHORIZED BY NAME (TYPE): Peter J. Quirk — AUTHORIZED BY NAME (TYPE):

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SEEN AS INADEQUATE SUBSTITUTES FOR ADJUSTED EXCHANGE RATES THAT WOULD PROVIDE APPROPRIATE INCENTIVES TO EXPORTERS.

BEST REGARDS.

PETER QUIRK

INTERFUND

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cc: Mr. Tun Thin
Mr. Guitián

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Office Memorandum

July 12, 1985

MEMORANDUM FOR FILES

Subject: China--Meeting with Mr. Hope, July 9, 1985

Messrs. Saito, Fetherston and I met Mr. Hope, Chief, External Debt Division, Economic Analysis and Projections Department, IBRD, to be informed of the latest status on collection of external debt data and the outcome of the seminar on external debt management held in Beijing.

Data collection

The Bank has received standing reporting forms from the Ministry of Finance (MOF), but the report included only 18 loans directly under the auspices of MOF. Apparently, the MOF does not receive a report on utilization of foreign loans contracted by other agencies. At present, there is no single agency to which all actual borrowings are reported. (A circular was issued recently, however, instructing that all foreign borrowing be reported to the People's Bank of China.)

Seminar in Beijing

Officials from key financial agencies as well as representatives from provincial governments, open cities, and Special Economic Zones attended the seminar. The sessions were well received.

Drawing on the discussions in the seminar, the MOF made the following recommendations to the State Council: (i) to set up a body in charge of formulating overall external debt policy in a macroeconomic framework which would report directly to the State Council; (ii) to continue with the requirement that all projects and loans be approved by the State Planning Commission; and (iii) to establish a unit within the MOF which would collect data on external debt from all agencies and monitor the developments.

The authorities have decentralized foreign borrowing decisions without having an ability to monitor. This is not desirable. They should determine the overall borrowing policy, e.g. the amount that the country would borrow in a year, at the central level, and each borrowing decision should be made by end-users within the overall policy framework. At present, foreign borrowing is approved to finance a project if it is expected to generate foreign exchange enough to cover debt service payments for the loan. This principle is not appropriate since it could (i) not permit borrowings for infrastructure projects; and (ii) favor borrowings by opening cities in the coastal areas.

Hiroyuki Hino
Advisor
Exchange and Trade Relations Department

cc: Mr. Narvekar
Mission members

Office Memorandum

TO: Mrs. Lachman

June 28, 1985

FROM: Peter J. Quirk

SUBJECT: China--Treatment and Identification of Exchange Restrictions

Mr. Zhang has raised with Mr. Hino, who will be participating in the forthcoming mission, two questions concerning China's exchange system. I have set out below some preliminary responses, and would appreciate your reactions to them.

1. If China were to eliminate the tax from profit remittances would the decision on Article IV consultations still be needed?

My view on this is that such a decision would clearly continue to be required as long as China continued to invoke Article XIV. The need for a decision would continue even if the last feature subject to Article VIII and not maintained under the provisions of Article XIV would be eliminated, i.e. the tax on profit remittances. (The other multiple currency practice arising from the internal settlement rate was eliminated at the outset of 1985.) The decision would, as for other Article XIV members, refer to any actions that the Board deemed appropriate for the restrictions or multiple currency practices maintained under the provisions of Article XIV, e.g. encouragement for liberalization.

2. Would the practice of foreign exchange budgeting constitute a restriction for China?

This is generally speaking, a more difficult question, involving examination of the precise modalities of the restriction to ascertain if it involves a "direct governmental limitation on the availability or use of exchange as such." 1/ As you know, the position of various practices maintained over time under Article XIV is sometimes not clear, and the staff may need to engage in a thorough review of the system with a view to ascertaining which measures are or are not subject to Fund jurisdiction, although maintained presently under provisions of Article XIV--particularly as it is now coming to the point that the decisions may need to focus more on these restrictions. The principles for determining whether or not a foreign exchange budget would constitute a restriction as with other restrictions, would involve the relative proximity of the practice to the exchange system, as compared to the trade system. I believe it has been the practice for foreign exchange budgets that are set annually and subsequently administered through the trade system, without intervening variation in response to foreign exchange availability, to be regarded as trade-related, and therefore

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1/ Legal Aspects of Article VIII and Article XIV, SM/59/73, November 18, 1959, page 33.

not subject to the Fund jurisdiction. However, should the foreign exchange budget be implemented or modified on a short-term basis in the light of ongoing foreign exchange availability--for which the payments instruments would be monitored--then Fund jurisdiction would be involved. The present system in China, on the basis of the description in the draft 1985 AREAER of the "Administration of Control," (attached) involves frequent revision in response to foreign exchange availability, and administration on a comprehensive basis by the financial authorities (State Administration of Exchange Control and the Bank of China). A restriction on payments and transfers for current international payments therefore appears to be involved. It may be that the mission would need to look further into this question, and we would appreciate your indications as to any especially pertinent questions that it should ask. If you wish, we could meet for this purpose.

cc: Mr. Finch
Mr. Brau
Mr. Saito
Mr. Hino

An experimental foreign exchange trading system has been established by the Bank of China in a few areas (such as Beijing, Guangdong, Hefei, Shanghai, and Tianjin), under which national enterprises holding foreign exchange earned through the system of retention quotas are permitted to sell such foreign exchange to other national enterprises that have a quota for spending foreign exchange. The Bank of China acts as a broker and levies a commission of 0.1 percent on both sides of the transaction, but does not operate in this trading system on its own account or provide foreign exchange or take up positions in foreign exchange. Most transactions are in U.S. dollars, but Hong Kong dollars and pounds sterling are also traded.

Forward exchange rates are published for 15 currencies. 3/ China does not apply a system of forward premiums and discounts but instead uses the spot rate plus a forward charge. Forward transactions are only permitted in connection with an underlying trade transaction. When banks sell renminbi forward, a charge is levied; when they buy, no charge is levied except for the Japanese yen and the Swiss franc. Rates are given for one to six months; transactions can be renewed for a further six months, but for not longer than one year. Forward charges reflect interest rates and trends in international markets in the currencies concerned.

Administration of Control

The People's Bank of China exercises central bank function and control over foreign exchange; and the State Administration of Exchange

3/ Austrian schillings, Belgian francs, Canadian dollars, Danish kroner, deutsche mark, French francs, Hong Kong dollars, Italian lire, Japanese yen, Netherlands guilders, Norwegian kroner, pounds sterling, Swedish kronor, Swiss francs, and U.S. dollars.

Control (SAEC), as a government administration under the leadership of the People's Bank of China, is responsible for implementing the exchange regulations and controlling all foreign exchange transactions in accordance with state policy. There are sub-bureaus in the provinces, in main municipalities, autonomous regions, and special economic zones. Other banks and financial institutions, including affiliates of nonresident banks, may handle designated transactions with the approval of the SAEC. The China International Trust and Investment Corporation (CITIC) is authorized to conduct transactions connected with investments of foreign capital in China and any other foreign exchange transactions in the special economic zones. Individuals and institutions may hold foreign exchange but may not deal in it or conduct arbitrage operations. Special exchange control regulations apply to special economic zones, the 14 designated coastal cities, and border regions.

Foreign exchange transactions are generally made in accordance with a foreign exchange plan. Those parts of the foreign exchange plan dealing with foreign trade, foreign loans, and China's external assistance program are prepared by the Ministry of Foreign Economic Relations and Trade (MOFERT); the foreign exchange budgets of other government departments are prepared by the Ministry of Finance. The SAEC draws up the section of the plan covering local and provincial nontrade transactions, receipts from overseas Chinese, and individual receipts. The overall foreign exchange plan is coordinated and balanced by the SAEC; after it has been reviewed and reconciled with other plans by the State Planning Commission, it is submitted to the State Council for approval. Following approval, the plan is sent back to the various localities and ministries for implementation.

The Bank of China is responsible for supervising the implementation of the foreign exchange plan.

In principle, the foreign exchange plan covers all transactions, including those with countries with which China maintains bilateral payments agreements. 4/ The annual plan is divided into quarterly plans, and at the end of each quarter the State Planning Commission reviews the implementation of the plan and determines whether corrections are necessary. That part of the foreign exchange plan dealing with trade is broken down by commodity. Unexpected events, such as changes in foreign trade policies, might necessitate a revision of the plan.

Prescription of Currency

Trade transactions with Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, the Democratic People's Republic of Korea, Mongolia, Poland, Romania, and the U.S.S.R. are expressed in Swiss francs, and with Cuba in pounds sterling at the official exchange rate and settled through bilateral payments arrangements. In normal circumstances, imbalances emerging toward the end of each year are covered by increased deliveries of goods. Noncommercial transactions are settled on a current basis in convertible currencies, except for part of such transactions with the Democratic People's Republic of Korea and Romania, and all the transactions with Cuba, which pass through the clearing account. Payments to and from countries with which China has bilateral payments agreements are made in

4/ China maintains operative bilateral payments agreements with the following Fund members: Afghanistan, Bangladesh, Egypt, Hungary, the Islamic Republic of Iran, Pakistan, Romania, and Sierra Leone. It also maintains bilateral payments agreements with Bulgaria, Cuba, Czechoslovakia, the German Democratic Republic, the Democratic People's Republic of Korea, Mongolia, Poland, and the U.S.S.R.

Ctfy & Marl Alle Mr. Finch

Office Memorandum

cc: Mr. Braun

o/r

CONFIDENTIAL

RECEIVED MAY 23 1985 EXCHANGE & TRADE RELATIONS

TO : The Acting Managing Director

DATE: May 21, 1985

FROM : Linda M. Koenig

SUBJECT : Mission to People's Republic of China-- May 3-16, 1985

Introduction

Mr. Richard Miller and I visited the People's Republic of China during the first two weeks of May to carry out the first formal contact between the People's Bank of China and the Central Banking Department. In Beijing we held extended and frank discussions with People's Bank officials on a wide-range of central banking matters. The PBC team was headed by Vice-Governor Liu Hongru who appears for all intents and purposes to be the de-facto Governor of the Bank. (The new Governor, Chen Muhua, is at the Bank only two or three times a week as she is occupied with other duties as member of both the Politburo and the State Council.) We also delivered a series of lectures on central banking to a group consisting mainly of People's Bank Department Heads and Branch Managers. Each of these lectures, which we repeated in Shanghai, was followed by a free-wheeling discussion session which lasted for several hours. In Beijing, Vice-Governor Liu participated actively in these sessions, as did Department Heads of the PBC.

Background

As you are well aware, the People's Republic of China is presently reaping the fruits--and also experiencing the growing pains--of the program of economic liberalization begun in 1979. In the past year, the decentralization of agricultural production under the "incentive system," whereby farm workers are allowed to keep a part of their production for sale on the free market, has led to an unprecedented increase in agricultural output and exports, and in farm workers' income. The "incentive system" now is being extended to the industrial and service sectors.

Although data on the Chinese economy are very incomplete, there are many indications in official pronouncements, what data are available, and indeed through sheer visual observation, that these production gains have, since the latter part of 1984, been accompanied by a serious overheating of the economy. Based on figures cited in speeches by Premier Zhao and other key officials, both currency and money supply are estimated to have risen by 30 percent during 1984, and at a much higher rate during the fourth quarter. During this last quarter, China's international reserves suffered a substantial decline, indicating that domestic credit expansion was even more rapid than money growth. Official pronouncements allude to some slowdown in monetary expansion in the first months of 1985, but this probably reflected seasonal factors and increased velocity as the drain on net international reserves reportedly continued. The strong expansion in credit reportedly reflected some overshooting of credit to the central government, but mainly was due to strong credit expansion to enterprises and local governments. Premier Zhao's speech suggests that this excess financing went to cover sizable wage increases and other rises in current and capital outlays. The existence of inflationary pressures was confirmed in the second week of May, after the mission had left Beijing for Shanghai, when food prices in the Beijing area were increased by amounts ranging from 10 percent for eggs to 100 percent for beef and 200 percent for fish.

The apparent weakening in monetary control during this period focused attention on weaknesses in credit policy and made our visit especially timely. Until 1984, the central banking function in the People's Republic had not been developed and, indeed, prior to the 1979 reforms, the People's Bank of China functioned as a monobank on the Soviet model. Some of the commercial banking activities of the PBC were spun off in 1979. However, only at the end of 1983 was it invested with traditional central banking functions, including responsibility for monetary policy and supervision of the financial system, the part of the Bank responsible for commercial banking in urban areas having been transformed into a new institution, the Industrial and Commercial Bank (ICB). In the course of 1984, the functions, personnel and accounts of the PBC and the newly-created ICB began to be divided, but this process is far from complete. In our discussions, Vice-Governor Liu frankly indicated that the PBC in 1984 was far too new a central bank to be able to resist the pressures for credit expansion accompanying liberalization in the real economy. Not only were its monetary instruments and financial programming techniques insufficiently developed but, more important still, its authority to set financial policy and its general "clout" within China's complex institutional system were inadequate. References in recent speeches by Premier Zhao and others to the need to fortify the PBC, and the naming of Ms. Chen Muhua, a high ranking party member, as Governor, hold out some hope that this situation will be corrected over time, although the fact that she is not at the Bank on a full time basis is a source of some concern.

Discussions with the authorities

Our discussions with Vice-Governor Liu and his colleagues dealt mainly with the techniques of monetary and credit targeting and the instruments to achieve these targets; with the relationship between the People's Bank of China, the rest of the financial system, and the Government; and with the future development of the financial system and the financial markets.

Regarding monetary targeting and policy, Vice-Governor Liu expressed a great deal of concern about the appropriate monetary targets for the People's Republic, and with ways of improving projection of the monetary aggregates. We discussed at length the issue of credit versus money, and the link between the choice of a credit or money target and a country's exchange rate policy. From this we went on to talk about the appropriate coverage of credit and monetary aggregates in the case of the PRC. Vice-Governor Liu and his colleagues showed enormous concern about the targeting of narrow and broad money and, in particular, with the interpretation and treatment of velocity--a phenomenon about which the Bank has been questioned by Premier Zhao. Although he offered good reasons for the apparent sharp decline in velocity, Vice-Governor Liu clearly feared, even though he did not say so, that the growth in money supply in recent months had been excessive. Without directly expressing a view on the matter, we stressed the importance of looking at supply shortages and at the balance of payments--in addition to the price index--for signals regarding the appropriateness of a country's monetary stance. The notion that the balance of payments deficit of the past few months might be a sign of excessive credit expansion was quickly grasped by Vice-Governor Liu and his colleagues, who did not seem to have thought of it before.

In discussing monetary policy, the authorities requested our views on the PBC's present use of monetary instruments--the reserve requirement and the mechanism of credit to banks--and on the system of interest rates. They expressed a great deal of interest in moving, albeit gradually, to more flexible interest rates, possibly in conjunction with the introduction of new rediscount mechanisms. The reserve requirement still was being experimented with; possible further modification of the 10 percent basic rate or use of a marginal requirement was not ruled out. We were questioned at length about the prospects for developing open market operations or a simpler variant of dealings in treasury or central bank bills. It was clear that the authorities had not grasped the monetary nature of open market operations and we attempted to explain it.

What struck us most about our discussions on monetary policy and instruments was the fact that the People's Bank apparently had not yet modified its system of financial programming to permit appropriate credit and/or monetary targeting. The present system of programming has several important deficiencies, the most serious of which is that the operations of the People's Bank are not broken out from those of the banking system as a whole. The strongest point we made to the authorities was that any improvement in monetary targeting and the use of monetary instruments would be contingent upon a radical modification of financial programming methods. We indicated that the forthcoming Article IV consultation discussions might provide an opportunity to deal further with this issue, and that, if desired, we subsequently could field a mission, in collaboration with the Asian Department, to assist the authorities in designing improved monetary instruments in the context of an improved system of programming.

On more institutional questions--but ones certainly very much related to the process of formulating monetary policy--we were asked repeatedly about the relations between central banks and government and central banks and the rest of the financial system. We described the relations between the monetary authority, the finance ministry and other organs of government in various industrial and developing countries, stressing the importance of good policy dialogue and well founded technical expertise in the central bank. While we spoke of the desira-ability of central bank independence, we were frank in recognizing its limits. Vice-Governor Liu had had the opportunity to talk with Chairman Volcker in Washington and was enormously interested in the role of the Chairman of the Federal Reserve Board of Governors; he clearly considered it an ideal, if one that probably was unattainable under the Chinese system.

With specific application to the PRC, the People's Bank authorities identified the authority and independence of the central bank with the ability to say no to the credit requests of governments, enterprises and banks when these requests were out of line with the financial program. Clearly, an inability to do this had been behind the rapid credit and monetary expansion of the last months of 1984 and early 1985. The authority of the People's Bank over monetary policy has now been affirmed, we were told, at the highest level. While welcoming this development, we again stressed the necessity of improving financial programming techniques if its authority is to be successfully exercised.

The authorities were very much interested in learning about the bank supervision function of a central bank and how it is exercised in various industrial countries through analysis of bank returns and on-site inspections. We described the "camel" system of supervision applied in the United States, expanding on the concepts of capital adequacy, liquidity, etc., and also discussed supervisory practices in a number of European countries. The authorities told us about their plans for licensing foreign banks to operate in China's free economic zones, and we stressed the importance of there being an adequate piece of general banking legislation to allow the People's Bank to deal with the establishment and regulation of both domestic and foreign financial intermediaries.

Finally, our discussions touched briefly on prospects for the future development of China's financial system and financial markets.

Vice-Governor Liu told us that the question of whether to change the structure of the banking system to permit the existing financial institutions to compete with one another--right now each serves a different part of the financial market--and to permit the establishment of new banks and/or non-banks was under discussion. We had the impression that no immediate actions were planned in this area, but that the authorities were trying to think ahead to see what would be a more efficient financial system for the longer run; indeed, substantial structural innovation probably is not advisable until the powers of the PBC have been more firmly established. Regarding development of the financial market, steps already are under way to lay the basis for a "horizontal" flow of funds among enterprises. Many of China's rural and industrial enterprises have become highly liquid and the opportunity to invest in other enterprises would provide an alternative to overspending, while reducing enterprise reliance on government transfers and improving the overall efficiency of investment.

All the above subjects, we indicated to the authorities, could be the subject of further staff work by CBD, in conjunction with the Asian Department, if the authorities so desire. There seems to be quite a bit of interest in this prospect and we were given to understand that the matter might be further discussed during the Annual Meeting.

Like all the Fund staff who have visited the People's Republic of China before us, we were treated with great cordiality and hospitality. We were extremely pleased at the openness of the authorities in discussing their problems with us. We had the impression, and this was supported by some of our Chinese hosts, that this openness was to an important extent a reflection of the attitude and newly enhanced status of Vice-Governor Liu himself. Also, we would like to think that it reflects the progressive opening up of Chinese society and the steadily growing trust the authorities place in the Fund management and staff.

cc: The Managing Director (o/r)
Mr. Zulu (o/r)
Mr. Finch
Mr. Habermeier
Mr. Guetta
Mr. Hood
Mr. Mohammed
Mr. Nicoletopoulos
Mr. Ouattara
Mr. Sanson
Mr. Shaalan
Mr. Tanzi
Mr. Teyssier
Mr. Tun Thin
Mr. Van Houtven
Mr. Whittome
Mr. Wiesner
Mr. Collins

Wb

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MR. VAN HOUTVEN,
INTERFUND

WE HAVE THE HONOUR TO INFORM YOU THAT PRESIDENT LI XIANNIAN OF THE PEOPLE'S REPUBLIC OF CHINA HAS, IN ACCORDANCE WITH A DECISION ADOPTED BY THE TENTH SESSION OF THE STANDING COMMITTEE OF THE SIXTH NATIONAL PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA ON MARCH 21, 1985, APPOINTED OUR FORMER GOVERNOR LU PEIJIAN AUDITOR-GENERAL OF THE AUDITING ADMINISTRATION OF THE PEOPLE'S REPUBLIC OF CHINA, AND STATE COUNCILOR CHEN MUHUA GOVERNOR OF THE PEOPLE'S BANK OF CHINA.

PEOPLE'S BANK OF CHINA
BEIJING, CHINA
MARCH 25, 1985

ORIG: ASD
CC: MD
DMD
MR. ZHANG
~~ETR~~
FAD
SEC
TRE
MR. DANNEMANN
MR. BOUTER
MRS. BAGARES
MR. COLLINS

22612 PBCHO CN
248331 IMF UR
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Time: 03:08 03/26/85 ???
Connect Time : 145 seconds

INCOMING CABLE/TELEX

Mr. Quirk
Mr. Brau
ETR f.l.

Office Memorandum

TO: Mr. Tun Thin February 15, 1985

FROM: K. Saito

SUBJECT: China's Exchange Rate--Recent Developments

This note is an update of recent developments in China's exchange rate, one of which pertains to the classification of China's exchange rate arrangement.

1. During 1984, the RMB (official rate) depreciated from about Y 2.0 = US$1 to Y 2.8; in early 1985, the exchange rates were "unified," as the internal settlement rate (Y 2.8 = US$1) was abolished. During January 2-February 18, the rate remained at Y 2.80 - Y2.81, but on February 12, jumped to Y 2.85; the rate has been at that level since then (see attached chart and table for exchange rate movements through December 1984).

2. These exchange rate developments, especially the sharp depreciation during 1984, have attracted considerable attention from the press (two reports attached). In these reports it is suggested that the Chinese authorities have been allowing market forces to play a greater role in determining the rate and letting the RMB depreciate to a more realistic level.

3. The Fund has been notified that the RMB exchange rate is "linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions"--this position was not changed at the time of the "unification". However, the basket-peg arrangement does not seem to explain fully the sharp depreciation during 1984 (the RMB would have depreciated less, if the arrangement was strictly applied) or the exchange rate stability during January-mid-February 1985 (the RMB would have depreciated).

4. While it is difficult to visualize "market forces" in the Chinese context, the basket-peg explanation raises some questions. In these circumstances, ETR (Mr. Quirk) has recently suggested that China's exchange rate arrangement be reclassified from "Pegged to currency composite" to "More flexible arrangement--managed floating;" this reclassification would also be in line with the policy of encouraging developing countries to adopt more flexible exchange arrangements. I believe we should consider this suggestion and discuss the matter with the authorities when appropriate.

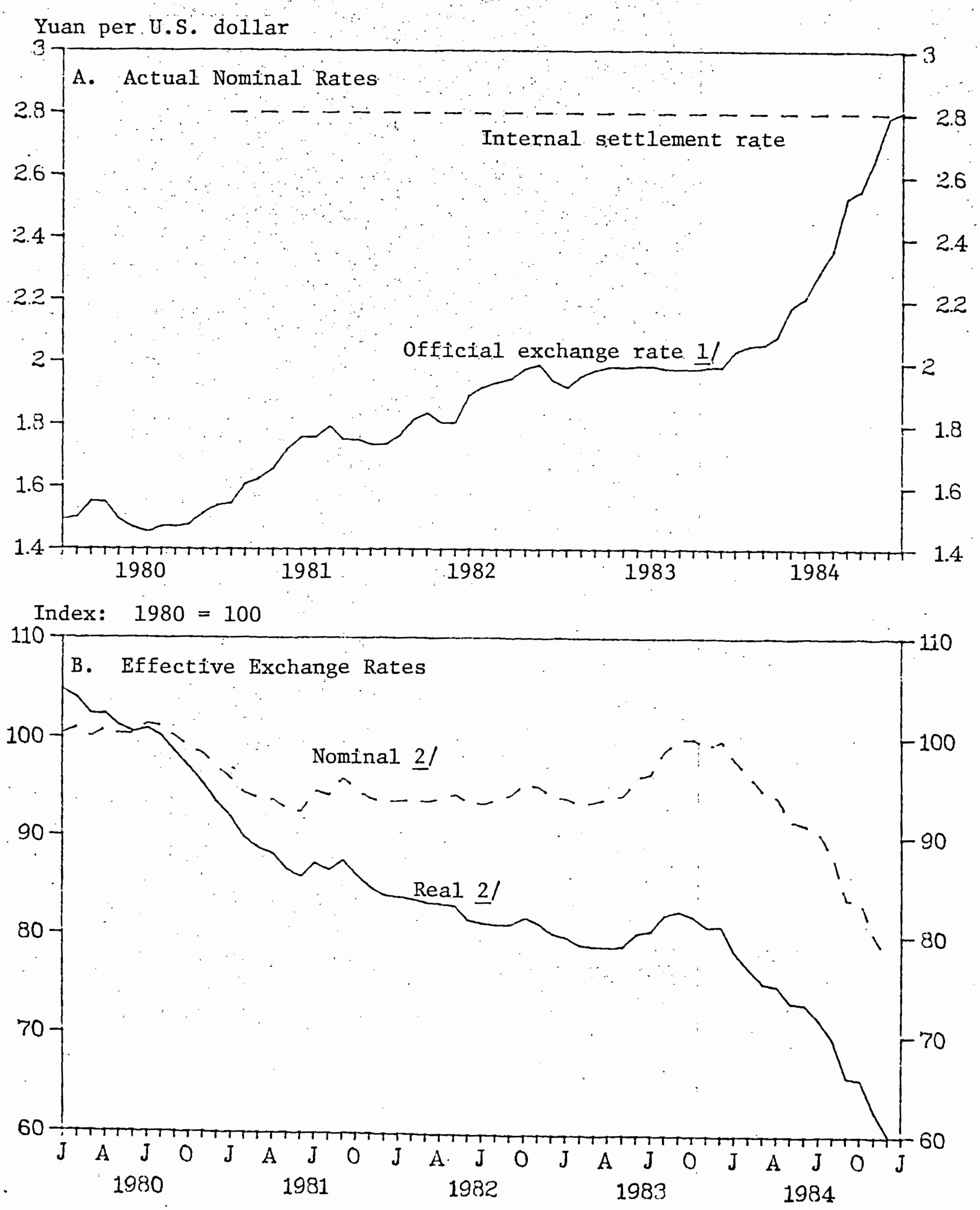
Attachments

cc: Mr. Narvekar
Division F

CHART 4

CHINA

EXCHANGE RATES, 1980–1985



SOURCE: INFORMATION PROVIDED BY THE CHINESE AUTHORITIES; AND STAFF ESTIMATES.
1/ HIGHER FIGURES INDICATE MORE DEPRECIATED RATES.
2/ HIGHER FIGURES INDICATE MORE APPRECIATED RATES.

GROUP OF PRODUCERS OF PRIMARY COMMODITIES

REAL EFFECTIVE EXCHANGE RATES, NOMINAL EFFECTIVE EXCHANGE RATES, RELATIVE PRICES IN LOCAL CURRENCY, EXCHANGE RATES AND CONSUMER PRICES

INDEX : 1980 = 100

CHINA, PEOPLE S REP.

(924)

	REAL EFF	NOM EFF	REL PRICE	EX RATE	CPI(SA)	CPI
1978 Q3	91.769	83.100	110.452	88.044	91.300	91.300
1978 Q4	93.117	85.659	108.740	91.593	91.300	91.300
1979 Q1	97.116	90.685	107.118	95.043	91.500	91.500
1979 Q2	98.011	93.694	104.631	94.588	91.867	91.867
1979 Q3	97.562	95.688	101.981	97.184	92.267	92.267
1979 Q4	103.481	99.508	103.986	98.577	96.733	96.733
1980 Q1	103.625	100.529	103.100	98.867	99.300	99.300
1980 Q2	101.339	100.529	100.824	99.855	99.800	99.800
1980 Q3	99.814	100.838	99.000	102.271	100.433	100.433
1980 Q4	95.222	98.103	97.076	99.007	100.967	100.967
1981 Q1	90.043	94.675	95.121	93.894	101.667	101.667
1981 Q2	86.771	92.979	93.339	87.385	102.233	102.233
1981 Q3	87.071	94.966	91.706	84.684	102.867	102.867
1981 Q4	84.865	94.046	90.253	86.027	103.500	103.500
1982 Q1	83.516	93.620	89.225	82.892	103.933	103.933
1982 Q2	82.497	93.875	87.896	80.880	104.200	104.200
1982 Q3	81.122	93.752	86.546	77.290	104.600	104.600
1982 Q4	81.035	94.882	85.421	75.942	104.867	104.867
1983 Q1	79.196	93.504	84.714	76.711	105.500	105.500
1983 Q2	79.314	94.721	83.752	75.358	106.167	106.167
1983 Q3	81.649	98.444	82.960	75.508	106.867	106.867
1983 Q4	81.182	99.627	81.502	75.683	107.467	107.467
1984 Q1	76.679	96.259	79.671	72.977	107.200	107.200
1984 Q2	73.746	92.290	79.924	69.357	109.000	109.000
1984 Q3	69.019	87.413	78.966	62.588	109.567	109.567
1984 Q4	62.709	80.410	77.988	56.184	110.200	110.200
1982 DEC	80.125	94.151	85.119	77.205	105.000	105.000
1983 JAN	79.770	93.815	85.046	78.029	105.300	105.300
1983 FEB	78.950	93.144	84.777	76.397	105.500	105.500
1983 MAR	78.868	93.552	84.320	75.708	105.700	105.700
1983 APR	78.801	93.886	83.949	75.363	105.900	105.900
1983 MAY	78.910	94.227	83.761	75.438	106.200	106.200
1983 JUN	80.230	96.050	83.546	75.273	106.400	106.400
1983 JUL	80.455	96.549	83.347	75.303	106.600	106.600
1983 AUG	82.077	98.848	83.049	75.648	106.900	106.900
1983 SEP	82.415	99.935	82.484	75.573	107.100	107.100
1983 OCT	81.807	99.948	81.865	76.367	107.300	107.300
1983 NOV	80.783	99.070	81.557	75.303	107.500	107.500
1983 DEC	80.956	99.862	81.084	75.378	107.600	107.600
1984 JAN	78.288	97.794	80.069	73.431	107.000	107.000
1984 FEB	76.609	96.358	79.520	72.802	107.200	107.200
1984 MAR	75.139	94.624	79.423	72.697	107.400	107.400
1984 APR	74.903	94.007	79.694	71.739	108.200	108.200
1984 MAY	73.249	91.679	79.912	68.654	109.000	109.000
1984 JUN	73.084	91.183	80.167	67.680	109.800	109.800
1984 JUL	71.594	90.461	79.158	65.284	109.300	109.300
1984 AUG	69.652	88.129	79.050	63.346	109.600	109.600
1984 SEP	65.811	83.648	78.691	59.136	109.800	109.800
1984 OCT	65.643	83.652	78.487	58.585	110.000	110.000
1984 NOV	62.401	79.936	78.079	56.270	110.200	110.200
1984 DEC	60.082	77.642	77.399	53.698	110.400	110.400
% CH 11/84	-3.7	-2.9	-0.9	-4.6	0.2	
% CH 12/83	-25.8	-22.3	-4.5	-28.8	2.6	

W45
2/13/85

MARKET FORCES IN CHINA are playing a bigger role in determining the renminbi's value.

Foreign economists and diplomats say Peking has been allowing the currency's value to decline in an apparent effort to attract foreign investors, who can buy more renminbi-denominated goods with other currencies. The government hopes a devalued renminbi will help increase exports and trim imports. The Chinese currency's value against the dollar has depreciated to 2.8 from 1.98 at the end of 1983.

Foreign economists say Peking isn't officially fixing the renminbi's exchange rate. Instead, the government has allowed the currency to fluctuate to a more realistic level that largely reflects supply and demand in domestic and international markets. These economists caution, however, that there is still a long way to go before Peking floats the currency.

Giving the renminbi more leeway to fluctuate is part of Peking's move to overhaul a rigid financial system and liberalize the country's economy.

YUAN"S VALUE

BY VIGOR FUNG

HONG KONG -(DJ)--WHILE CHINA TRUMPETS ONE MAJOR DEVELOPMENT AFTER ANOTHER IN ITS PROGRAM OF ECONOMIC LIBERALIZATION, ITS CURRENCY POLICY IS UNDERGOING QUIET BUT IMPORTANT CHANGES.

FOREIGN ECONOMISTS AND DIPLOMATS SAY MARKET FORCES HAVE BEGUN TO PLAY A BIGGER ROLE IN DETERMINING THE EXCHANGE VALUE OF THE YUAN, THE ASIAN WALL STREET JOURNAL REPORTS. PEKING HAS BEEN ALLOWING THE CURRENCY"S VALUE TO DECLINE IN AN APPARENT EFFORT TO ATTRACT FOREIGN INVESTORS, WHO CAN BUY MORE YUAN-DENOMINATED GOODS WITH FOREIGN CURRENCIES.

PEKING ALSO HOPES THE DEVALUED YUAN WILL HELP INCREASE EXPORTS, TRIM IMPORTS AND ELIMINATE FOREIGN CURRENCY TRANSACTIONS IN THE SO-CALLED GRAY MARKET.

THE MOVE IS PART OF PEKING"S MOVE TO REFORM A RIGID FINANCIAL SYSTEM AND LIBERALIZE CHINA"S ECONOMY.

FOREIGN ECONOMISTS SAY PEKING ISN"T OFFICIALLY FIXING THE YUAN"S EXCHANGE RATE. CHINA INSTEAD HAS ALLOWED THE CURRENCY TO FLUCTUATE TO MORE REALISTIC LEVELS, LARGELY REFLECTING SUPPLY AND DEMAND IN THE DOMESTIC AND INTERNATIONAL MARKETS. THE ECONOMISTS SAY THIS TREND HAS BEEN BORNE OUT BY THE ACCELERATED DEVALUATION OF THE YUAN IN THE PAST SEVERAL MONTHS.

MANY FOREIGN ECONOMISTS BELIEVE THAT THE YUAN HAS BEEN OVERVALUED. WHEN CHINESE OFFICIALS BEGAN TAKING MARKET FORCES INTO ACCOUNT, THE EXCHANGE RATE HAD ONLY ONE WAY TO GO: DOWN.

CHINESE ECONOMISTS SEEM TO AGREE. "PREVIOUSLY, THE YUAN WAS UNREASONABLY OVERVALUED," SAYS QIAN JIAJU, A NOTED CHINESE ECONOMIST WHO UNTIL RECENTLY WAS AN ADVISER IN PEKING"S ACADEMY OF SOCIAL SCIENCES. "WE HAVE CONSCIOUSLY DEVALUATED IT" IN LINE WITH ITS MARKET VALUE.

QIAN"S CANDID AND RARE CONCESSION SUGGESTS THAT CHINESE OFFICIALS ARE TRYING TO ENHANCE THE YUAN"S STANDING AMONG THE WORLD"S CURRENCIES.

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.DJ-02-12-85 0619GMT)

-CHINA LETS MARKET FORCES PLAY BIGGER ROLE-YUAN -2-

FOREIGN ECONOMISTS CAUTION THAT THERE"S STILL A LONG WAY TO GO BEFORE PEKING FLOATS THE CURRENCY. BUT CHINA"S LEADERS HAVE SAID THE SHENZHEN ECONOMIC ZONE MAY ISSUE A SPECIAL FREELY CONVERTIBLE YUAN. PEKING"S NEW APPROACH TO THE YUAN"S EXCHANGE VALUE COULD SIGNIFICANTLY AFFECT FOREIGN INVESTMENT IN CHINA. MEASURED AGAINST THE U.S. DOLLAR, THE YUAN HAS DEPRECIATED TO 2.8 FROM 1.98 SINCE THE END OF 1983. IT ALSO HAS FALLEN AGAINST OTHER MAJOR CURRENCIES. "I WOULDN"T BE SURPRISED IF IT GOES DOWN TO 3.5" AGAINST THE DOLLAR THIS YEAR, A WESTERN DIPLOMAT SAYS.

IT WAS PARTLY BECAUSE OF GROWING PRESSURE FROM FOREIGN INVESTORS THAT CHINESE OFFICIALS BEGAN TO LET THE YUAN FLUCTUATE. BEFORE THE YUAN"S SLIDE, JOINT-VENTURE INVESTMENTS INVOLVING FOREIGN CURRENCIES HAD A LOWER VALUE IN TERMS OF THE OVERVALUED CHINESE CURRENCY.

SOME FOREIGN INVESTORS REFUSED TO ENTER JOINT VENTURES WITH THE CHINESE UNLESS FOREIGN-CURRENCY INVESTMENTS WERE TRANSLATED INTO YUAN AT AN EXCHANGE RATE MORE IN LINE WITH THE CURRENCY"S TRUE VALUE. MANY PROVINCIAL CORPORATIONS QUIETLY AGREED TO THAT SORT OF ARRANGEMENT, THOUGH IT IS OFFICIALLY PROHIBITED.

DEVALUATION ALSO MADE SENSE BECAUSE OF THE NATURE OF MANY JOINT-VENTURE AGREEMENTS IN CHINA. FOREIGN BUSINESSMEN USUALLY USE FOREIGN CURRENCIES FOR SUCH VENTURES, AND THEIR CHINESE COUNTERPARTS PUT UP YUAN. THE YUAN"S DECLINE INCREASES THE VALUE OF THE FOREIGN BUSINESSMEN"S INVESTMENT RELATIVE TO THE CHINESE CURRENCY., THAT HAS HELPED TO STIMULATE FOREIGN INVESTMENT IN CHINA.

PEKING SAYS IT SIGNED 700 JOINT-VENTURE CONTRACTS WITH FOREIGN COMPANIES IN 1984. THAT IS MORE THAN THE TOTAL OF JOINT-VENTURE CONTRACTS SIGNED BETWEEN 1979 AND 1983.

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(DJ-02-12-85 0622GMT)

APART FROM CHINESE OFFICIALS" REALIZATION THAT THE YUAN HAS BEEN OVERVALUED, FOREIGN ECONOMISTS ATTRIBUTE THE YUAN"S FALLING EXCHANGE RATE TO MARKET FACTORS SUCH AS INCREASING DEMAND AMONG CHINESE CITIZENS FOR FOREIGN CURRENCIES, PEKING OFFICIALS" CONCERN OVER THE COMPETITIVENESS OF CHINESE GOODS IN OVERSEAS MARKETS, AND THE STRENGTHENING OF THE U.S. DOLLAR.

ECONOMISTS SAY A LEADING FACTOR IN THE DECISION TO DEVALUE HAS BEEN THE GROWING DESIRE FOR FOREIGN CURRENCIES AMONG CHINESE INDUSTRIAL ENTERPRISES.

THIS IS PARTICULARLY NOTICEABLE IN CHINA"S COASTAL AREAS, WHERE CHINESE CORPORATIONS SCRAMBLE FOR FOREIGN CURRENCIES TO PAY FOR IMPORTS. IN THE OPERATION OF THIS GRAY MARKET, SOME COASTAL ENTERPRISES ARE WILLING TO PAY SIX YUAN-MORE THAN DOUBLE THE OFFICIAL RATE-FOR ONE U.S. DOLLAR, ACCORDING TO DIPLOMATS WHO HAVE TRAVELED IN THAT PART OF THE COUNTRY.

IF CHINESE EXPORT AGENCIES CAN SELL THEIR FOREIGN EXCHANGE HOLDINGS IN THE GRAY MARKET AT THE SIX-YUAN RATE, FEW WILL BE INCLINED TO EXCHANGE THOSE HOLDINGS AT THE BANK OF CHINA"S OFFICIAL RATE. PEKING"S FOREIGN-EXCHANGE RESERVES WOULD SUFFER.

CONVERSELY, A DEVALUED YUAN SAVES LARGE AMOUNTS OF FOREIGN EXCHANGE BY MAKING IMPORTS MORE EXPENSIVE. CHINA POSTED A TRADE DEFICIT OF 1.1 BILLION DLRS FOR 1984.

IN ADDITION, A FIXED RATE HAS MADE IT DIFFICULT FOR CHINESE ENTERPRISES TO CALCULATE REAL COSTS AND PROFITS IN COMPARISON WITH THEIR COMPETITORS WORLD-WIDE.

SOME FOREIGN BANKERS SAY THE DEVALUATION OF THE YUAN HAS HELPED ELIMINATE CHINA"S "DUAL EXCHANGE-RATE SYSTEM," AND SOME BANKERS IN CHINA-OWNED BANKS IN HONG KONG SAY THE INTERNAL SETTLEMENT RATE HAS BEEN SCRAPPED RECENTLY BECAUSE THE OFFICIAL RATE ALREADY HAS DECLINED TO THE INTERNAL SETTLEMENT RATE OF 2.8.

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-(DJ-02-12-85 0625GMT)

INTERNATIONAL MONETARY FUND

Mr. Finch Feb. 13, 1985

The attached AP Dow Jones report is one of several that suggest a greater role for market forces in determining China's exchange rate. As with other cases, illegal currency transactions may have played a part, as there have been also a number of reports of widespread and growing activity in the parallel market.

China's exchange rate is presently classified as pegged to a basket-- Mr. Xiang's office is being contacted as to whether "managed flexibility" would be a better description.

cc: Mr. Brau

Peter J. Quirk

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QIAN"S CANDID AND RARE CONCESSION SUGGESTS THAT CHINESE OFFICIALS ARE TRYING TO ENHANCE THE YUAN"S STANDING AMONG THE WORLD"S CURRENCIES.

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(DJ-02-12-85 0619GMT)

-CHINA LETS MARKET FORCES PLAY BIGGER ROLE-YUAN -2-

FOREIGN ECONOMISTS CAUTION THAT THERE"S STILL A LONG WAY TO GO BEFORE PEKING FLOATS THE CURRENCY. BUT CHINA"S LEADERS HAVE SAID THE SHENZHEN ECONOMIC ZONE MAY ISSUE A SPECIAL FREELY CONVERTIBLE YUAN. PEKING"S NEW APPROACH TO THE YUAN"S EXCHANGE VALUE COULD SIGNIFICANTLY AFFECT FOREIGN INVESTMENT IN CHINA. MEASURED AGAINST THE U.S. DOLLAR, THE YUAN HAS DEPRECIATED TO 2.8 FROM 1.98 SINCE THE END OF 1983. IT ALSO HAS FALLEN AGAINST OTHER MAJOR CURRENCIES. "I WOULDN"T BE SURPRISED IF IT GOES DOWN TO 3.5" AGAINST THE DOLLAR THIS YEAR, A WESTERN DIPLOMAT SAYS.

IT WAS PARTLY BECAUSE OF GROWING PRESSURE FROM FOREIGN INVESTORS THAT CHINESE OFFICIALS BEGAN TO LET THE YUAN FLUCTUATE. BEFORE THE YUAN"S SLIDE, JOINT-VENTURE INVESTMENTS INVOLVING FOREIGN CURRENCIES HAD A LOWER VALUE IN TERMS OF THE OVERVALUED CHINESE CURRENCY.

SOME FOREIGN INVESTORS REFUSED TO ENTER JOINT VENTURES WITH THE CHINESE UNLESS FOREIGN-CURRENCY INVESTMENTS WERE TRANSLATED INTO YUAN AT AN EXCHANGE RATE MORE IN LINE WITH THE CURRENCY"S TRUE VALUE. MANY PROVINCIAL CORPORATIONS QUIETLY AGREED TO THAT SORT OF ARRANGEMENT, THOUGH IT IS OFFICIALLY PROHIBITED.

DEVALUATION ALSO MADE SENSE BECAUSE OF THE NATURE OF MANY JOINT-VENTURE AGREEMENTS IN CHINA. FOREIGN BUSINESSMEN USUALLY USE FOREIGN CURRENCIES FOR SUCH VENTURES, AND THEIR CHINESE COUNTERPARTS PUT UP YUAN. THE YUAN"S DECLINE INCREASES THE VALUE OF THE FOREIGN BUSINESSMEN"S INVESTMENT RELATIVE TO THE CHINESE CURRENCY., THAT HAS HELPED TO STIMULATE FOREIGN INVESTMENT IN CHINA.

PEKING SAYS IT SIGNED 700 JOINT-VENTURE CONTRACTS WITH FOREIGN COMPANIES IN 1984. THAT IS MORE THAN THE TOTAL OF JOINT-VENTURE CONTRACTS SIGNED BETWEEN 1979 AND 1983.

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(DJ-02-12-85 0622GMT)

APART FROM CHINESE OFFICIALS" REALIZATION THAT THE YUAN HAS BEEN OVERVALUED, FOREIGN ECONOMISTS ATTRIBUTE THE YUAN"S FALLING EXCHANGE RATE TO MARKET FACTORS SUCH AS INCREASING DEMAND AMONG CHINESE CITIZENS FOR FOREIGN CURRENCIES, PEKING OFFICIALS" CONCERN OVER THE COMPETITIVENESS OF CHINESE GOODS IN OVERSEAS MARKETS, AND THE STRENGTHENING OF THE U.S. DOLLAR.

ECONOMISTS SAY A LEADING FACTOR IN THE DECISION TO DEVALUE HAS BEEN THE GROWING DESIRE FOR FOREIGN CURRENCIES AMONG CHINESE INDUSTRIAL ENTERPRISES.

THIS IS PARTICULARLY NOTICEABLE IN CHINA"S COASTAL AREAS, WHERE CHINESE CORPORATIONS SCRAMBLE FOR FOREIGN CURRENCIES TO PAY FOR IMPORTS. IN THE OPERATION OF THIS GRAY MARKET, SOME COASTAL ENTERPRISES ARE WILLING TO PAY SIX YUAN-MORE THAN DOUBLE THE OFFICIAL RATE-FOR ONE U.S. DOLLAR, ACCORDING TO DIPLOMATS WHO HAVE TRAVELED IN THAT PART OF THE COUNTRY.

IF CHINESE EXPORT AGENCIES CAN SELL THEIR FOREIGN EXCHANGE HOLDINGS IN THE GRAY MARKET AT THE SIX-YUAN RATE, FEW WILL BE INCLINED TO EXCHANGE THOSE HOLDINGS AT THE BANK OF CHINA"S OFFICIAL RATE. PEKING"S FOREIGN-EXCHANGE RESERVES WOULD SUFFER.

CONVERSELY, A DEVALUED YUAN SAVES LARGE AMOUNTS OF FOREIGN EXCHANGE BY MAKING IMPORTS MORE EXPENSIVE. CHINA POSTED A TRADE DEFICIT OF 1.1 BILLION DLRS FOR 1984.

IN ADDITION, A FIXED RATE HAS MADE IT DIFFICULT FOR CHINESE ENTERPRISES TO CALCULATE REAL COSTS AND PROFITS IN COMPARISON WITH THEIR COMPETITORS WORLD-WIDE.

SOME FOREIGN BANKERS SAY THE DEVALUATION OF THE YUAN HAS HELPED ELIMINATE CHINA"S "DUAL EXCHANGE-RATE SYSTEM," AND SOME BANKERS IN CHINA-OWNED BANKS IN HONG KONG SAY THE INTERNAL SETTLEMENT RATE HAS BEEN SCRAPPED RECENTLY BECAUSE THE OFFICIAL RATE ALREADY HAS DECLINED TO THE INTERNAL SETTLEMENT RATE OF 2.8.

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-(DJ-02-12-85 0625GMT)

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China

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75297 ECWEK HX
13/2/85

ATTN: MR TUN THIN
DIRECTOR, ASIAN DEPARTMENT
INTERNATIONAL MONETARY FUND

ORIG: ASD
CC: ETR

FROM: ROBERT DELFS
CHINA ECONOMY CORRESPONDENT
FAR EASTERN ECONOMIC REVIEW, HONGKONG
TX 75297 ECWEK HX

WORKING ON ANALYSES OF PATTERNS OF CHINA'S FOREIGN TRADE USING YR INVALUABLE 1984 DIRECTIONS OF TRADE STATISTICS YEARBOOK, AM CONFUSED BY WORLD PAGE ITEMS FOR KOREA AND SINGAPORE.

LINES 542, 576 SHOW WORLD IMPORTS FROM SAME IN PART A (CIF) TO BE LESS THAN THEIR EXPORTS TO THE WORLD FOB IN PART B (AND AS LISTED IN THEIR COUNTRY PAGES).

I CANNOT MAKE IMPORTS OF COUNTRIES LIKELY NOT TO REPORT PURCHASES FROM SAME ADD UP TO THE MAGNITUDE OF THE DISCREPANCY (WITH CIF ADJUSTMENT, I CALC GAP AT 25 PERCENT FROM PART A FOR KOREA AND 20 PERCENT FOR SINGAPORE. THAT INDONESIA LISTS 3.5 B IMPORTS FROM SPORE THAT SPORE DOES NOT WOULD SEEM TO MAKE DISCREPANCY WORSE. WOULD BE MOST GRATEFUL IF SOMEONE COULD CLARIFY THIS, NONATTRIBUTATIVELY.

REGARDS,

440040 FUND UI

75297 ECWEK HX

REPLY VIA ITT

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TIME: 22:32 02/12/85 ???
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INCOMING CABLE/TELEX

Berne Union: China--Briefing Note

1. Recent economic and financial developments

China's external payments position remains strong (Table 1). It is estimated that the current account will show another large surplus in 1984 (US$3.7 billion, equivalent to 1.5 percent of GDP), primarily as a result of a substantial trade surplus. Exports are estimated to have increased by 18 percent in 1984 to US$26.2 billion, while imports rose by 23 percent to US$23.3 billion. The overall payments position also was in surplus (US$3.4 billion). Total gross official reserves increased to US$17.6 billion at the end of October 1984, equivalent to 9 months of imports, from US$15.4 billion at the end of December 1983 (Table 2). China continues to be one of the largest depositors to the international banking system. Because of cautious borrowing policy, China's external debt increased little in recent years. Total disbursed debt is estimated to amount to some US$7 billion at end-1984 (3 percent of GDP). Most of China's foreign borrowing has been undertaken on concessionary terms. The debt service ratio declined to 4 percent of exports of goods and services in 1984 from 6 percent in 1983 and 11 percent in 1982.

Income growth since 1982 has been impressive (8 percent average growth), owing to a large extent to the extensive reforms implemented in the rural areas. Both rural and urban living standards have improved substantially. Price stability has also been maintained (2 percent average rate of inflation). Fiscal policies have remained cautious, with budget deficits averaging less than 2 percent of GDP, of which more than half has been financed by the banking system. Liquidity expansion, however, has been too fast (15 percent) and has contributed to excess demand pressures, persistent shortages and bottlenecks, and forced savings. The latter has been an important work disincentive. Also, enterprise efficiency has remained low, due to outdated equipment, overstaffing, a history of inadequate incentives, and most importantly, to an increasingly distorted price structure.

2. Prospects

China's external payments position is expected to remain strong in 1985. Both the external current account and the overall balance of payments are projected to be in surplus. It is anticipated, however, that the current account surplus will be lower than in 1984 (US$2.8 billion or 1.2 percent of GDP). The growth in export volumes is expected to decline from the exceptionally high level reached in 1984 (14 percent) to some 6 percent in 1985 (and beyond), in line with import demand in partner countries. The growth in import volumes is expected to exceed 10 percent in 1985 (and beyond), reflecting the implementation of several large import-intensive investment projects, the implementation of economic reform in the urban areas, and a continuing gradual liberalization of foreign trade. The overall surplus (US$3.4 billion) is projected to increase gross reserves to US$22.2 billion or 10 months of imports.

China's external payments position is also expected to remain strong over the medium term. In line with the authorities' investment policies and as a result of increasingly higher imports of capital goods, the present large current account surplus is expected to disappear by 1987 and widening deficits are projected for subsequent years (Table 3).

The steady deterioration in the current account is expected to be partly offset by capital inflows, in the form of higher medium- and long-term borrowing for project finance and increasingly large foreign direct investment. Total disbursed debt is projected to double in the second half of the decade to US$16 billion by the end of 1990, i.e., about the level of projected gross official reserves. In line with the authorities' stated policy intentions, the major part of the projected current account deficits beginning in 1987 would be financed by drawing down reserves from the present high level to some three months of imports by 1990.

It is also expected that the main thrust of external debt management policies will continue to be to attract concessional loans and limit foreign borrowing on commercial terms. The authorities have stated that China will continue to rely mainly on loans at concessional interest rates, including notably insured export credits from foreign governments and increased cofinancing with World Bank participation. 1/ Commercial borrowing is expected to be undertaken only for specific projects and on limited scale. Thus, debt service payments are projected to represent only 5 percent of exports of goods and services over the medium term.

3. Recent policy developments and economic reform

The 1984 Article IV consultation was completed on November 7, 1984. Since then, the Chinese authorities have implemented some of the policy measures discussed in the staff report (SM/84/221, 10/3/84), including the abolition of the internal settlement rate, a reform of the foreign

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1/ And, eventually, the Asian Development Bank, although access to such financing is unlikely to materialize in the near future.

trade system, and additional incentives for foreign direct investment. Effective January 1, 1985 1/ all foreign exchange transactions are effected at the official rate, which is adjusted in accordance with movements in the value of a basket of internationally traded currencies. The ongoing reform of the foreign trade system aims at separating the overall policy and regulatory framework from the daily conduct of foreign trade and giving greater autonomy to enterprises. Additional incentives for foreign direct investment include further improvements in preferential tax treatment and production and marketing conditions for joint ventures, especially in the four special economic zones and 14 coastal cities. The 10 percent exchange tax on remitted profits of joint ventures is now exempted for ventures established in the special economic zones and in designated economic and technological development areas in certain coastal cities.

Announced reform measures include the implementation in 1985 of a system of contracts and open market sales which will replace the present mandatory state purchases of grain. (It is expected that subsidies on essential food items will be continued.) The authorities have also announced a reform of the price and wage system, a key issue in China, which will be completed over the next five years (i.e., Seventh Plan Period, 1986-90). Price adjustments are expected to be implemented through a series of small steps, starting with the prices of industrial inputs and some agricultural products and continuing thereafter with the prices of major consumer goods and services. The pace and direction

1/ Prior to January 1, 1985 all foreign trade and related transactions had to be effected at the internal settlement rate of Y 2.80 = US$1.

of the price reform are still uncertain. The combination of price adjustments and liberalization may well lead to a higher rate of inflation in 1985. Regarding wages, the eight-grade system in state enterprises is to be abolished soon, while pay reform in state institutions is to be implemented by end-1985. The authorities announced in early January 1985 that they intended to grant further tax concessions for joint ventures and to open four additional areas to foreign direct investment. As part of the authorities' efforts to liberalize the economy, to foster economic development, and to enhance economic efficiency, greater reliance on macroeconomic policy instruments is expected rather than administrative orders. One step in that direction was the recent sale of Treasury bonds.

4. Fund relations

The staff mission for the next Article IV consultation is scheduled to take place in July 1985.

5. World Bank relations

The staff of the World Bank has just completed a draft report on "China: Long-Term Issues and Options," which is currently being discussed within the Bank and the Fund Asian Department. The report focuses on a number of policy issues that need to be addressed in the next 15 years in order to accelerate economic development, technology transfers, and attract further foreign direct investment. The report covers a wide range of topics, including economic growth and required policy changes, agricultural prospects and policies, energy, spatial issues, international economic strategy, human development, and mobilization of financial resources.

DISK #55, INDEX #17
EM - 1/31/85

Table 1. China: Balance of Payments, 1980-84

(In millions of U.S. dollars)

	1980	1981	1982	1983	1984 Est. 1/
Current account	-3,281	1,349	5,667	4,457	3,728
Exports, f.o.b.	18,492	22,027	22,476	22,223	26,223
Imports, f.o.b.	-22,049	-21,047	-17,113	-18,955	-23,315
Trade balance	-3,557	980	5,363	3,268	2,908
Services (net)	-294	-203	-167	678	290
(Credit)	(2,409)	(3,130)	(3,513)	(4,166)	(4,560)
(Debit)	(-2,703)	(-3,333)	(-3,680)	(-3,488)	(-4,270)
Net unrequited transfers	570	572	471	511	530
Net invisibles	276	369	304	1,189	820
Capital account (net)	1,836	93	123	186	210
Medium- and long-term borrowing (net)	695	335	202	899	740
Drawings	(1,096)	(1,372)	(2,382)	(1,572)	(1,580)
Repayments	(-401)	(1,037)	(-2,180)	(-673)	(-840)
Foreign direct investment (net)	57	265	359	478	540
Other medium- and long-term capital (net)	1,008	31	-383	-865	-770
Short-term capital (net)	76	-959	-55	-326	-300
Errors and omissions	1,671	762	485	-550	-550
Allocation of SDRs	146	142	--	--	--
Overall balance	372	1,925	6,275	4,093	3,388

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

1/ Prepared by the Asian Department for World Economic Outlook exercise in December 1984.

tbd4ch1 (1/10/85)

Table 2. China: Selected Economic and Financial Indicators, 1982-85

	1982	1983	1984 Est.	1985 Proj.
	(Year ending December)			
Growth				
Real GDP (change in percent)	8.3	9.1	8.0	7.0
Inflation				
GDP deflator (change in percent)	-0.6	0.5	1.9	2.5
CPI (average percent change)	2.0	2.0	2.0	2.5
Terms of trade (percent change)	14.6	-5.0	—	—
Central government budget 1/				
Revenue (growth in percent)	1.2	8.8	8.8	...
Expenditure (growth in percent)	2.0	10.1	8.2	...
Current account (percent of GDP)	5.8	6.2	7.1	...
Overall surplus or deficit (percent of GDP)	-1.3	-1.7	-1.5	...
Borrowing from the banking system (percent of GDP)	0.5	0.7	0.4	...
Foreign borrowing (net) (percent of GDP)	—	0.2	0.4	...
Concessional	—	0.2	0.4	...
Commercial	—	—	—	...
Money and credit (end of year, percent change)				
Total domestic credit	11.7	14.3	13.5	...
Currency in circulation	10.9	20.9	15.0	...
Balance of payments				
Exports (bn. dollars)	22.5	22.2	26.2	28.3
Of which: Oil	(3.3)	(2.7)	(3.2)	(3.3)
Imports (f.o.b., bn. dollars)	-17.1	-19.0	-23.3	-26.2
Of which: Oil	(--)	(--)	(--)	(--)
Current account (bn. dollars)	5.7	4.5	3.7	2.8
Current account (percent of GDP)	2.2	1.6	1.5	1.2
Of which: Interest payments	0.2	0.1	0.2	0.3
Overall balance (bn. dollars)	6.3	4.1	3.4	3.4
(Percent of GDP)	2.4	1.5	1.3	1.4
Reserves (end of year)				
Gross official reserves, including gold (mn. dollars)	11,840	15,451	18,839	22,191
(In months of imports)	8.3	9.8	9.7	10.1
Net foreign assets (mn. dollars)	8,394	12,090	15,478	18,830
External debt (end of year stock)				
Medium- and long-term (bn.$) 2/	5.6	6.4	7.1	8.2
Total (percent of GDP)	2.1	2.3	2.8	3.5
Debt service (bn. dollars) 3/	2.8	1.5 4/	1.3	1.4
(Percent of exports plus service credits)	(10.9)	(5.5) 4/	(4.4)	(4.3)
Use of Fund resources (mn. SDRs)				
EFF	—	—	—	—
SBA	—	—	—	—
CFF	—	—	—	—
RT	—	—	—	—
Repurchases	—	450	—	—
Fund holdings of currency (percent of quota)	125.0	93.0	89.1	...

Exchange rate
Exchange rate regime: Trade weighted basket
Present rate Y 2.81 = US$1 (January 3, 1985)

Quota: SDR 2,391 million

1/ Fiscal year ending December.
2/ Includes some short-term debt.
3/ Includes early repayments.
4/ Includes repurchase of Fund credits.

Table 3. China: Medium-Term Outlook of the Balance of Payments, 1982-1990 1/

(In billions of U.S. dollars)

	1982 Actual	1983 Actual	1984 Est.	1985 Proj.	1986 Proj.	1987 Proj.	1988 Proj.	1989 Proj.	1990 Proj.
Balance of payments									
Current account	5.7	4.4	3.7	2.8	1.4	-0.2	-2.4	-5.3	-9.0
Exports, f.o.b.	22.5	22.2	26.2	28.3	31.0	35.1	39.8	45.2	51.2
Imports, f.o.b.	-17.1	-19.0	-23.3	-26.2	-30.3	-36.1	-43.1	-51.5	-61.4
Invisibles, net	0.3	1.2	0.8	0.7	0.8	0.8	0.9	1.0	1.2
Capital account, net	0.1	0.2	0.2	0.4	0.8	1.3	1.8	2.3	2.9
Long-term borrowing, net	0.2	0.9	0.7	1.0	1.2	1.4	1.6	1.8	2.1
Disbursements	(2.4)	(1.6)	(1.6)	(1.8)	(2.1)	(2.4)	(2.8)	(3.2)	(3.7)
Repayments	(-2.2)	(-0.7)	(-0.8)	(-0.8)	(-0.9)	(-1.0)	(-1.2)	(-1.4)	(-1.6)
Foreign direct investment, net	0.4	0.5	0.5	0.6	0.8	0.9	1.1	1.3	1.6
Inflows	(0.4)	(0.6)	(0.7)	(0.8)	(1.0)	(1.2)	(1.4)	(1.7)	(2.0)
Outflows	(--)	(-0.1)	(-0.1)	(-0.2)	(-0.2)	(-0.3)	(-0.3)	(-0.4)	(-0.4)
Other long-term capital, net	-0.4	-0.9	-0.8	-0.7	-0.5	-0.4	-0.4	-0.4	-0.4
Short-term capital, net	—	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Overall balance	6.3	4.1	3.4	3.4	2.4	1.3	-0.4	-2.8	-6.0
Total reserves (end of year)	11.8	15.4	18.8	22.2	24.6	25.9	25.5	22.7	16.6
(In months of imports)	(8.3)	(9.8)	(9.7)	(10.1)	(9.7)	(8.6)	(7.1)	(5.3)	(3.2)
External debt									
End-year stock	6.1	6.4	7.1	8.2	9.3	10.7	12.3	14.1	16.2
Debt service payments	2.8	1.5	1.3	1.4	1.6	1.7	2.0	2.3	2.6
Principal	(2.2)	(1.2)	(0.8)	(0.8)	(0.9)	(1.0)	(1.2)	(1.4)	(1.6)
Interest	(0.6)	(0.3)	(0.5)	(0.6)	(0.7)	(0.7)	(0.8)	(0.9)	(1.0)
Outstanding debt as percent of GDP	2.1	2.3	2.8	3.5	4.4	4.7	5.0	5.4	5.8
Debt service as percent of exports of goods and services	10.8 2/	5.5 3/	4.4	4.3	5.1	5.0	5.0	5.0	5.0

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

1/ This table is a revised version of Table 7 in the staff report (SM/84/221). It is based on projections prepared for the World Economic Outlook exercise, December 1984.
2/ The rate was unusually high in 1982 because of advanced repayments of commercial debts; excluding such early repayments, the ratio was 6.6 percent.
3/ Excluding repurchases of Fund credits, the ratio was 3.7 percent.

Kamlesh To
Please copy to
M/S Saito, Pettisoh, Stillbush
& ~~Brown~~
Tanks

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ETR Files

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MR. ZHANG ZICUN, ED OF CHINA
INTERFUND

10 PER CENT SURCHARGES ON THE REMITTED PROFITS APPLIED FOR THE JOINT VENTURES ARE STILL IN FORCE. FLEXIBLE PRACTICE, HOWEVER, IS ADOPTED FOR THOSE JOINT VENTURES IN THE SPECIAL ECONOMIC ZONES, I.E. THE 10 PER CENT SURCHARGES ARE EXEMPTED. SURCHARGES ARE ALSO EXEMPTED FOR THE JOINT VENTURES IN THE NEW DEVELOPMENT AREAS IN THE 14 COASTAL CITIES.
REGARDS.

PEOPLE'S BANK OF CHINA
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INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

me

1. ~~Mr. Guitian~~
2. ~~Mr. Brau~~

RECEIVED
JAN 2 1985
EXCHANGE & TRADE RELATIONS

With the Compliments of

Zhang Zicun

Executive Director

cc: Mr. Osunsade
Mr. Quirk

Office Memorandum

TO : Mr. Van Houtven

DATE: December 28, 1984

FROM : Zhang Zicun

SUBJECT : China - Internal Settlement Rate

I have received the following communication from my authorities:

"The Chinese authorities have decided that the internal settlement rate, which was introduced on an experimental basis on January 1, 1981, will be discontinued from January 1, 1985 as a result of changed circumstances."

Will you please inform the Board.

Mr. Bean
cc: Mr. Osunsade
Mr. Quirk

Office Memorandum

TO : The Managing Director

DATE: December 18, 1984

ETR files

FROM : Wang Enshao

SUBJECT : China - Exchange Rates

On behalf of Mr. Zhang Zicun, I would like to inform you that the internal settlement rate which was introduced by our authorities for all trade and related transactions as from January 1, 1981 on an experimental basis will be terminated as from January 1, 1985. From that date, all transactions in foreign currencies will be settled at the exchange rates published by the State Administration for Exchange Control.

cc: The Deputy Managing Director (o/r)
Mr. Finch
Mr. Habermeier
Mr. Tun Thin
Mr. Collins

INTERNATIONAL MONETARY

December 13, 1984

Mr. Brau:

Mr. Sidgwick brought to my notice the attached Dow-Jones report ~~notes~~ on relaxation of investment-related exchange controls by China. I have spoken to Kunio Saito on the matter of Executive Board notification--which might also mention the sharp narrowing of the spread between the renminbi and internal settlement rates that has almost eliminated the MCP. He will take it up with the Chinese office.

Attachment

Peter J. Quirk

CHINA

110663 -- EXCHANGE CONTROL POLICY RELAXED FOR OVERSEAS INVESTORS

BEIJING, NOVEMBER 6 (XINHUA) -- THE STATE EXCHANGE CONTROL ADMINISTRATION HAS DECIDED TO RELAX THE POLICY ON FOREIGN EXCHANGE CONTROL OVER OVERSEAS CHINESE AND FOREIGN ENTERPRISES IN CHINA AND CHINESE FOREIGN JOINT VENTURES, THE "ECONOMIC DAILY" REPORTS TODAY.

THIS IS PART OF THE EFFORTS TO ACCELERATE THE PACE OF INTRODUCING FOREIGN CAPITAL AND ADVANCED TECHNOLOGY, THE PAPER SAYS.

THE DECISION ALLOWS SUCH ENTERPRISES TO SELL THEIR PRODUCTS TO CHINESE FOREIGN TRADE DEPARTMENTS OR CHINESE COMMERCIAL AND OTHER PURCHASING AGENCIES IF NEW ADVANCED TECHNOLOGICAL PROCESSES OR EQUIPMENT ARE USED IN PRODUCTION; THE PRODUCTS WILL BE PRICED IN RENMINBI (CHINESE CURRENCY). IF THE PRODUCTS ARE IN SHORT SUPPLY IN CHINA, OR CHINA HAS TO IMPORT THEM IN LARGE QUANTITIES, THEY MAY BE SOLD IN CHINA AND PRICED IN FOREIGN CURRENCIES ACCORDING TO QUALITY.

OVERSEAS CHINESE- AND FOREIGN-FINANCED ENTERPRISES AND FOREIGN-CHINESE JOINT VENTURES WILL ALSO BE ALLOWED TO USE THE PROFITS IN RENMINBI AS ADDITIONAL INVESTMENT IN THEIR OWN ENTERPRISES OR AREAS AROUND THEIR ENTERPRISES, AND THIS WILL BE TREATED JUST AS INVESTMENT IN FOREIGN EXCHANGE.

IF THESE ENTERPRISES SELL THEIR PRODUCTS TO CHINA'S SPECIAL ECONOMIC ZONES OR SELL EACH OTHER'S PRODUCTS AMONG THEMSELVES, THEY MAY USE FOREIGN EXCHANGE FOR QUOTING PRICES AND SETTLING ACCOUNTS AND THE CHINESE INVESTORS IN THE ENTERPRISES WILL ALSO BE GIVEN PREFERENTIAL TREATMENT IN RETAINING THEIR FOREIGN EXCHANGE PROFITS. ENDITEM

ETR files
China

INTERNATIONAL MONETARY FUND

December 10, 1984

Mr. Narvekar:

For your information.

E. Maciejewski EM

Attachment

cc: ~~Mr. Brau~~
~~Mr.~~ Saito
Mr. Fetherston

MMMM
Mr. Macieljewski
Rm. 5-548

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

DEC 05 1984

Dear Mr. Song:

During the last Article IV consultation discussions, a number of points related to balance of payments methodology were raised with the Fund mission. In particular, further clarification was requested regarding the treatment of external transactions linked to offshore oil exploration and development, notably through joint ventures. The following note and examples address this issue.

The first step in identifying which transactions to include in the balance of payments is to determine the residency of the transactors. Under the conventions of the fourth edition of the Balance of Payments Manual, the territory of an economy includes "its territorial seas and those international waters beyond its territorial waters over which the economy has or claims to have exclusive jurisdiction" (paragraph 52). Enterprises engaging in oil exploration and development activities in China's territorial waters, therefore, should be regarded as Chinese enterprises and their transactions with nonresidents should be included in the Chinese balance of payments.

It is the Bureau of Statistics' understanding that these offshore activities are being undertaken as joint ventures between nonresident investors (49 percent equity) and the Government of China (51 percent equity). It is suggested, therefore, that these enterprises be treated as direct investment enterprises. The nonresident investors should then be regarded as direct investors, and their capital contributions to the ventures should be recorded as direct investment liabilities.

During the exploration phase, the enterprises will incur a number of current expenses for such items as materials, wages, surveying services, etc. If any of these items are purchased from nonresidents, they should be recorded in the appropriate current account items of the balance of payments in the same manner as for similar transactions by other resident enterprises. At the same time, the exploration phase generates no revenue for the enterprise, which therefore results in a loss being incurred. The proportion of this loss attributable to the direct investor (i.e., 49 percent) should be recorded as a negative debit entry under the current account item "reinvested earnings" and, correspondingly, as a debit entry in the capital account item "reinvestment of earnings." This treatment reflects the fact that the value of the investment has been reduced by the loss that is incurred.

A common feature of offshore oil exploration activity is that the drilling rigs used are leased, rather than purchased, by the operator. According to the Manual, if the drilling rig (or other mobile equipment) operates within an economy for at least one year, it should be shown as having changed ownership to an enterprise in the economy of the operator (paragraph 363(a)). This involves recording the value of the rig in imports and imputing a resident enterprise to own it. The imputed enterprise is then shown as having a direct investment liability to the lessor equal to the value of the rig. The lease payments should then be shown in two parts; an amount equivalent to the depreciation of the rig should be shown as a withdrawal of direct investment capital, and the remainder should be shown as distributed direct investment income. Example 1, below, illustrates the entries required for the types of transactions which often occur during the exploration phase.

Example 1: Exploration

Assume that during a particular year a joint venture operating in China engages in exploration activities and has the following income and expenditure transactions.

	Total	Residents	Unrelated Nonresidents
Income	--	--	--
Cost of exploration	245,000		
1. Materials	120,000	50,000	70,000
2. Wages and salaries	50,000	50,000	--
3. Office rental	15,000	15,000	--
4. Survey services	20,000	--	20,000
5. Lease of drilling rig	30,000	--	30,000
6. Depreciation	10,000	xxx	xxx

The joint venture, therefore, incurs a loss of 245,000. Of this amount, 120,000 (49 percent) is attributed to the foreign direct investor.

The drilling rig is being leased under a three-year contract. Its value is estimated to be 500,000, and the depreciation on it estimated to be 20,000. When a nominal enterprise, reflecting the imputation of a Chinese enterprise to own the leased drilling rig, is created, the lease payment of 30,000 would then comprise 20,000 for the withdrawal of direct investment capital, representing the depreciation on the drilling rig, and 10,000 for distributed earnings.

The entries in the balance of payments for China for that year would be as follows:

	Credit	Debit
Merchandise (materials)		70,000
(drilling rig)		500,000
Investment income		
Direct investment		
Reinvested earnings (joint venture)		-120,000
Distributed earnings (nominal enterprise)		10,000
Other goods, services and income		
Private, other (survey services)		20,000
Direct investment capital, in China		
Equity capital (nominal enterprise)	480,000	
Reinvestment of earnings (joint venture)		120,000
Reserves		
Foreign exchange holdings	120,000	

During the production phase, all the oil produced should be regarded as Chinese oil and that part which is sold, or transferred, to nonresidents should be recorded as exports. Again, any current expenses involving nonresidents should be recorded in the appropriate current account items of the balance of payments. The operating surplus (after tax) of the enterprise should be determined and allocated to the investors in proportion to their equity in the venture. The reinvested earnings of the foreign direct investor should be calculated as its share of the operating surplus less any earnings that have been distributed to it. (If the joint venture arrangement allows the foreign direct investor to receive part of the oil produced as a return on its investment, the value of the oil received should be included as part of distributed earnings.)

Unlike the drilling rig used for exploration, which is often leased, a production platform, which is not mobile equipment, is often purchased or acquired under a financial lease arrangement by the operator. This means that the value of the platform should be recorded in imports and that a corresponding entry should be made elsewhere, reflecting the method of financing the acquisition. If the production platform were the subject of a financial lease arrangement then, according to the Manual (paragraph 217), the basic nature of these transactions should be given precedence over their legal form, and the market value of the platform should be recorded in imports, with an offsetting entry made in the capital account to record the credit extended to the nominal lessee. The lease payments should then comprise two parts: repayment of the trade credit liability, equivalent to the depreciation of the platform, and interest on the liability, equivalent to the remainder. Example 2 illustrates the entries required to record transactions under a financial lease arrangement.

Example 2: Financial lease

The joint venture in China enters into a financial lease arrangement with Japan for the use of a production platform. Let us assume that the lease contract has a duration of five years and that:

(i) the value of the equipment is 300 units;

(ii) the lease fee is 70 units, which is estimated to comprise (a) 45 units for depreciation and (b) 25 units for carrying charges;

(iii) at the end of the fifth year the equipment will be sold to the enterprise in China for 75 units, the residual value.

The *Manual* recommends the following entries:

	Statement for the first year	
	Credit	Debit
Merchandise		300 (i)
Interest income		25 (iib)
Trade credit	300 (i)	45 (iia)
Foreign exchange	70 (ii)	

	Statements for the second, third, and fourth years	
	Credit	Debit
Interest income		25 (iib)
Trade credit		45 (iia)
Foreign exchange	70 (ii)	

	Statement for the fifth year	
	Credit	Debit
Interest income		25 (iib)
Trade credit		45+75=120 (iia + iii)
Foreign exchange	145 (ii+iii)	

With any offshore activity there are problems of covering all the transactions appropriate to the balance of payments. This is particularly true for merchandise imports, because they often do not cross the customs frontier but go directly to the oil field and, therefore, are omitted from trade statistics, which are derived from customs returns. It is essential that particular attention be given to the identification and recording of these transactions.

Also, during the Article IV consultation, clarification was sought about the treatment of various items included in "Other medium- and long-term capital" as well as "other short-term capital." The following notes address these items.

Remittances by joint ventures. If the joint venture is treated as a direct investment enterprise, any remittance of capital to the joint venturer abroad should be recorded as a reduction in direct investment liabilities and remittances of capital to other investors should be recorded as reductions in liabilities of other sectors. Otherwise, all remittances of capital should be shown as reductions in the liabilities of other sectors. Of course, any part of the remittance that relates to the distribution of earnings should be shown in the current account under investment income, rather than in the capital account.

Repayment of "U.S. frozen assets." These transactions should be recorded as decreases in the corresponding liabilities that China has to the United States.

Transfers for expenditure in China by joint ventures. These transactions increase China's external liabilities and should be classified as either direct investment in China, or liabilities of other sectors, depending upon the treatment accorded the joint venture.

Receipts on account of labor contracts abroad. These receipts appear to be more appropriate to the current account than the capital account. More information on the nature of the transactions is required before specific suggestions can be made about their treatment.

Goods sent to China by relatives residing abroad. These transactions should not be entered in the capital account, unless the Chinese resident has to pay for the goods and a liability to the relative abroad arises; if the goods are a gift, the credit entry should be made in other private unrequited transfers.

Deposits of foreign diplomats in China. These should be shown as short-term liabilities of the deposit money banks.

Guarantee funds for joint ventures. The joint venture should be regarded as a Chinese enterprise and, therefore, only its transactions with nonresidents should be recorded in the balance of payments. That is, the original inflow of foreign exchange should be recorded as an increase in China's external liabilities (either as direct investment in China, or as liabilities of other sectors) and a corresponding increase in China's external assets, representing the increase in foreign exchange holdings. The classification of the external asset can be made in either of three ways depending upon which institution holds the foreign exchange. (a) If the foreign exchange is held by the joint venture it should be recorded initially in short-term assets of other sectors. The subsequent prepayment to the Bank of China for imports should then be recorded as an increase in reserve assets and a decrease in the short-term assets of other sectors. (b) If the foreign exchange is deposited in a bank account, and the foreign exchange holdings of deposit money banks are not included as part of reserves, then it should be recorded initially as an increase in short-term assets of the deposit money banks. The subsequent prepayment of imports should then be recorded as a decrease in the short-term assets of deposit money banks and an increase in reserve assets. (c) If the foreign exchange is deposited in a bank account, and the foreign exchange holdings of deposits money banks <u>are</u> included as part of reserves, then it should be recorded immediately as an increase in reserve assets, and the prepayment of imports would not affect the balance of payments.

It is hoped that the above explanations will clarify your queries. Should you have any further questions on these or any other items, or should you have any questions in connection with the meeting on the revision of the balance of payments reporting system that will be convened in Beijing, please do not hesitate to write. The Bureau is prepared to extend any further assistance you may require in your efforts to compile the balance of payments for China.

Sincerely yours,

W Dannemann

Werner Dannemann
Director
Bureau of Statistics

Mr. Song Guangwei
Division Chief
IMF Division
The People's Bank of China
Beijing, People's Republic of China

cc: Mr. Zicun Zhang, IMF, Rm. 13-400
Mr. Maciejewski, IMF, Rm. 5-548

Office Memorandum

To: Mr. Peter Quirk October 30, 1984

From: Philine R. Lachman

Subject: China - Multiple Currency Practice

1. The conclusion in SM/84/221, "People's Republic of China - Staff Report for the 1984 Article IV Consultation" (October 3, 1984) that the existence of the internal settlement rate constituted a multiple currency practice subject to approval under Article VIII was based on the fact that the margin between that rate and the official exchange rate was in excess of 2 per cent. Your note of October 19, 1984 asks whether, if the spread between the official and internal settlement rates were reduced to less than 2 per cent (a) China's multiple currency practice subject to Article VIII would have been eliminated, and (b) the remaining spread would constitute a measure subject to Article VIII, Section 2.

2. Decision No. 6790-(81/43), (Selected Decisions, Tenth Issue, page 257) provides in paragraph 1 that:

> "a. (i) Action by a member or its fiscal agencies that of itself gives rise to a spread of more than 2 per cent between buying and selling rates for spot exchange transactions between the member's currency and any other member's currency would be considered a multiple currency practice and would require the prior approval of the Fund."

Under the policy laid down in that Decision, official action resulting in a spread of less than 2 per cent between buying and selling rates for spot exchange transactions between the member's currency and another member's currency would not be considered a multiple currency practice. It follows that if the spread between the two rates is reduced to less than 2 per cent China would no longer be engaging in a multiple currency practice subject to Article VIII, Section 3.

3. With respect to the question whether the remaining spread would constitute a measure subject to Article VIII, Section 2, the following considerations are relevant. As early as 1947 the Fund adopted the position that "In most cases multiple currency practices are both systems of exchange rates and restrictions or payments and transfers for current international transactions" (Decision No. 237-2, Selected Decisions, Tenth Issue, page 247). Official action which gives rise to a system of rates that does not constitute a multiple currency practice because the spread is less than 2 per cent does not give rise to an exchange restriction associated with a multiple currency practice. There would be a restriction, however, if the official action constituted an impediment to the availability of exchange as such. In the absence

of evidence that this is the case it is concluded that when the spread between the two rates is reduced to less than 2 per cent the remaining spread would not be a practice subject to approval under Article VIII, Section 2(a).

ETR files

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

October 31, 1984

FROM: P. R. Narvekar PRN

SUBJECT: People's Republic of China: 1984 Article IV Consultation--Revised Supplementary Information

Based on additional information just received concerning new monetary measures, we have revised the paragraph on financial developments in the draft supplement to the Staff Report, which you have just approved. The additional information relates to the introduction of a differentiation between the interest rates on deposits with and loans from the Central Bank. As mentioned in the Staff Report, an increase in the cost of borrowing by the specialized banks from the Central Bank was suggested by the staff during the consultation discussions.

In view of the pressure of time--the paper should be distributed to Directors by Friday--we thought we would take the liberty of proceeding to send the paper to press. We hope you can approve.

The revised paragraph (pp. 6-7) reads as follows:

"2. Financial developments

Because of the improved performance of the enterprise sector, contributions to the budget rose rapidly, and the targets for budgetary revenue will most likely be exceeded. In the area of monetary policy, new measures were recently announced for implementation in 1985. The redeposit requirements that were imposed on the specialized banks when the Central Bank was established at the beginning of 1984 will be lowered, and differential interest rates on the specialized banks' deposits with and loans from the Central Bank will be introduced. No specifics are available at this time. These measures were discussed during the staff's visit to China. Previously, as the result of the high redeposit requirements, the specialized banks required continuous advances from the Central Bank. However, the authorities have recognized that such continuous recourse was not necessary to assure the implementation of the desired credit policy, and the redeposit requirements have consequently been reduced. The differential interest rates are designed to strengthen credit control by discouraging borrowing by the specialized banks."

cc: Mr. Collins
Mr. Brau

Mr. Brau
ETR files

Office Memorandum

TO : Mr. Narvekar DATE: October 26, 1984

FROM : E. Maciejewski EM

SUBJECT : China's Balance of Payments: Medium-Term Projections of the Capital Account and Interest Payments

1. Capital account

A number of steps were involved in the projection of gross disbursements on medium- and long-term foreign borrowing.

(a) Unlike in previous years and until the last visit to China, a distinction was made between four types of (nonmonetary) capital inflows (and outflows), namely medium- and long-term foreign borrowing, foreign direct investment, other medium- and long-term capital (e.g., stocks and bonds, due payments for processing and official loans extended) and short-term capital. As a result, the results initially obtained through the use of the internally consistent framework developed at the headquarters before the mission's departure had to be adapted.

(b) The estimate of gross disbursements on medium- and long-term foreign borrowing for 1984 is based on actual information provided by the Chinese authorities; beyond 1984, as indicated in the footnotes to the three scenarios on the medium-term balance of payments outlook (Attachment 1), such gross disbursements were projected to increase at an average annual rate of 15 percent, consistent with the projected 15 percent annual growth for imports of capital goods and the external financing requirements of the large development projects to be launched in the next few years.

(c) The estimate of amortization for 1984 and 1985 is based on the debt amortization schedule (See attached RED Appendix Table 56), which was derived on the basis of the outstanding disbursed debt at end-1983, of information on a number of individual loans (including buyers' credits) granted by the Japanese and other foreign governments provided to the mission during the previous Article IV Consultations, and of available information on the general terms and conditions of deferred payments (or suppliers' credits); the information related to borrowing from banks was assumed to be applicable to nonbank borrowing, while firm information on the terms and conditions of bonds, international organizations (World Bank) and Trust Fund (Fund) were readily available. It was assumed that new drawings on medium- and long-term foreign borrowing (including new bank credits and buyers' credits) in 1984 and 1985 would not give rise to additional repayments before 1986. Hence, for 1984 and 1985, no adjustment was made to the estimates of repayments included in the above mentioned amortization schedule.

(d) The projections for amortization beyond 1985 include adjustments to the projections of repayments included in the above mentioned amortization schedule. Such adjustments reflect increasingly large repayments on drawings made in 1984, 1985, and 1986 on account of new commercial loans used to finance development projects, including onshore and offshore energy-related development projects. It is possible that such adjustments are overestimated, as China, given its creditworthiness, may obtain terms on its new commercial loans more favorable than those I assumed in this exercise.

Regarding foreign direct investment, as indicated in the attached tables on the medium-term balance of payments outlook, a 20 percent average annual growth was assumed for inflows starting in 1984. Outflows were assumed to increase more or less in line with inflows.

The projected decline in net other medium- and long-term capital outflows reflect declining outflows on account of decreasing reserve-related placements in the form of stocks and bonds in international capital markets, as available reserves will be increasingly used to finance growing imports.

Net short-term capital outflows in each year starting in 1985 were projected to be no more than the level recorded in 1983.

2. Interest payments

(a) I assumed that about 45 percent of the stock was in the form of concessional loans and 55 percent in the form of nonconcessional loans. This assumption is based on the composition of the stock of debt at end-1983.

(b) I assumed an average interest rate of 5 percent for concessional loans and an average interest rate of 11 percent on nonconcessional loans. These assumptions are based on generally available information on the average terms and conditions of various types of concessional and nonconcessional loans and on related information provided by the Chinese authorities or drawn from other sources (e.g., Bank of Tokyo, Nomura Securities, Agefi).

Attachments

cc: Mr. Brau
Mr. Saito
Mr. De Wulf
Mr. Goldsbrough (o/r)
Mr. Fetherston (o/r)

EM ATTACHMENT 1

INTERNATIONAL MONETARY FUND

August 21, 1984

TO : Mr. Saito

FROM: E. Maciejewski EM

Subject: China--Tables and Charts for Staff Report

Attached please find a few tables and charts for inclusion in the staff report. Could we review them at your convenience?

Attachments

cc: Mr. Narvekar
Mr. De Wulf
Mr. Goldsbrough
Mr. Fetherston

Table . China: Medium Term Balance of Payments Projections, 1982-90--"Basic Scenario"

(In billions of U.S. dollars)

	Assumed Change Percent	1982 Actual	1983 Actual	1984 Est.	1985 Proj.	1986 Proj.	1987 Proj.	1988 Proj.	1989 Proj.	1990 Pro
Balance of payments										
Exports, f.o.b.	9 1/	22.48	22.22	24.22	26.40	28.78	31.37	34.19	37.27	40.6
Imports, f.o.b.	15 2/	-17.11	-18.96	-21.17	-24.33	-28.01	-32.21	-37.04	-42.59	-48.9
Trade balance		5.37	3.26	3.05	2.07	0.77	-0.84	-2.85	-5.32	-8.3
Invisibles (net)		0.30	1.19	1.12	1.02	0.52	0.12	0.64	-1.42	-2.0
Service receipts		(3.51)	(4.17)	(4.56)	(4.82)	(4.78)	(4.65)	(4.72)	(4.61)	(4.7
Service payments		(-3.68)	(-3.49)	(-3.97)	(-4.38)	(-4.88)	(-5.45)	(-6.11)	(-6.86)	(-7.7
Unrequited transfers (net)		(0.47)	(0.51)	(0.53)	(0.58)	(0.62)	(0.68)	(0.75)	(0.83)	(0.9
Current account		5.67	4.45	4.17	3.09	1.29	-0.96	-3.49	-6.74	-10.4
Capital account net		0.13	0.19	0.21	0.40	0.83	1.37	1.89	2.36	2.9
Medium- and long-term debt net		0.20	0.90	0.74	0.89	1.05	1.23	1.45	1.70	1.9
Gross disbursements	15 3/	(2.38)	(1.57)	(1.58)	(1.82)	(2.09)	(2.40)	(2.76)	(3.18)	(3.6
Amortization		(-2.18)	(-0.67)	(-0.84)	(-0.93)	(-1.04)	(-1.17)	(-1.31)	(-1.48)	(-1.6
Foreign direct investment net		0.36	0.48	0.54	0.66	0.78	0.94	1.14	1.36	1.6
Inflows	20	(0.38)	(0.57)	(0.68)	(0.82)	(0.98)	(1.18)	(1.42)	(1.70)	(2.0
Outflows		(-0.02)	(-0.09)	(-0.14)	(-0.16)	(-0.20)	(-0.24)	(-0.28)	(-0.34)	(-0.4
Other medium- and long-term capital net		-0.38	-0.87	-0.77	-0.85	-0.70	-0.50	-0.40	-0.40	-0.4
Official credits extended		(-0.40)	(-0.27)	(-0.30)	(-0.35)	(-0.40)	(-0.40)	(-0.40)	(-0.40)	(-0.4
Stocks and bonds		(0.02)	(-0.62)	(-0.50)	(-0.50)	(-0.30)	(-0.10)	(—)	(—)	(—
Other		(—)	(-0.02)	(0.03)	(—)	(—)	(—)	(—)	(—)	(—
Short term capital net		-0.05	-0.33	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.3
Errors and omissions		0.47	-0.54	—	—	—	—	—	—	—
Overall balance		6.27	4.10	4.38	3.49	2.12	0.41	-1.60	-4.38	-7.5
Total reserves (end of year)		11.83	15.45	19.83	23.32	25.44	25.85	24.25	19.87	12.3
(In months of imports)		(8.27)	(9.78)	(11.26)	(11.49)	(10.92)	(9.65)	(7.85)	(5.60)	(3.0
External debt										
End year stock		6.06	6.40	7.34	8.43	9.68	11.11	12.76	14.65	16.8
Debt service payments		2.82	1.46	1.39	1.54	1.84	1.97	2.23	2.54	2.8
Principal		(2.18)	(1.16)	(0.84)	(0.93)	(1.04)	(1.17)	(1.31)	(1.48)	(1.6
Interest		(0.64)	(0.30)	(0.55)	(0.61)	(0.80)	(0.80)	(0.92)	(1.06)	(1.2
Outstanding debt as percent of GDP		2.33	2.34	2.65	2.85	2.94	3.03	3.13	3.23	3.3
Debt service as percent of export of goods and services		10.85 4/	5.53 5/	4.83	4.93	5.48	5.47	5.73	6.06	6.3

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

1/ Assumes that non-oil exports (about 80 percent of the total) will rise by 10 percent per annum (or some increase in China's market share during 1985-90; 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 rapid expansion of imports of capital goods financed through stepped up foreign borrowing, totaling, US$45 billion in the ten year beginning 1985.

3/ See footnote 2.

4/ The rate was unusually high in 1982 because of advanced repayments of commercial debts; excluding such early repayment the ratio was 6.6 percent.

5/ Excluding repurchase of Fund credits, the ratio was 3.7 percent.

Table . China: Medium Term Balance of Payments Projections, 1982-90--"Basic Scenario"

(In billions of U.S. dollars)

	Assumed Change Percent	1982 Actual	1983 Actual	1984 Est.	1985 Proj.	1986 Proj.	1987 Proj.	1988 Proj.	1989 Proj.	1990 Proj.
Balance of payments										
Current account		5.7	4.4	4.1	3.1	1.3	-1.0	-3.5	-6.7	-10.4
Exports, f.o.b.	9 1/	22.5	22.2	24.2	26.4	28.8	31.4	34.2	37.3	40.6
Imports, f.o.b.	15 2/	-17.1	-19.0	-21.2	-24.3	-28.0	-32.2	-37.0	-42.6	-49.0
Invisibles, net		0.3	1.2	1.1	1.0	0.5	-0.2	-0.7	-1.5	-2.0
Capital account, net		0.1	0.2	0.2	0.4	0.8	1.4	1.9	2.4	2.9
Long-term borrowing, net		0.2	0.9	0.8	0.9	1.0	1.2	1.5	1.7	2.0
Disbursements	15 3/	(2.4)	(1.6)	(1.6)	(1.8)	(2.0)	(2.4)	(2.8)	(3.2)	(3.7)
Repayments		(-2.2)	(-0.7)	(-0.8)	(-0.9)	(-1.0)	(-1.2)	(-1.3)	(-1.5)	(-1.7)
Foreign direct investment, net		0.4	0.5	0.5	0.7	0.8	1.0	1.1	1.4	1.6
Inflows	20	(0.4)	(0.6)	(0.7)	(0.8)	(1.0)	(1.2)	(1.4)	(1.7)	(2.0)
Outflows		(--)	(-0.1)	(-0.1)	(-0.2)	(-0.2)	(-0.2)	(-0.3)	(-0.3)	(-0.4)
Other long-term capital, net		-0.4	-0.9	-0.8	-0.8	-0.7	-0.5	-0.4	-0.4	-0.4
Short-term capital, net		--	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Overall balance		6.3	4.1	4.4	3.5	2.1	0.4	-1.6	-4.4	-7.5
Total reserves (end of year)		11.8	15.4	19.8	23.3	25.4	25.8	24.2	19.9	12.4
(In months of imports)		(8.3)	(9.8)	(11.3)	(11.5)	(10.9)	(9.6)	(7.8)	(5.6)	(3.0)
External debt										
End year stock		6.1	6.4	7.3	8.4	9.7	11.1	12.8	14.6	16.8
Debt service payments		2.8	1.5	1.4	1.5	1.8	2.0	2.2	2.6	3.0
Principal		(2.2)	(1.2)	(0.8)	(0.9)	(1.0)	(1.2)	(1.3)	(1.5)	(1.8)
Interest		(0.6)	(0.3)	(0.6)	(0.6)	(0.8)	(0.8)	(0.9)	(1.1)	(1.2)
Outstanding debt as percent of GDP		2.3	2.3	2.6	2.8	2.9	3.0	3.1	3.2	3.3
Debt service as percent of export of goods and services		10.8 4/	5.5 5/	4.8	4.9	5.5	5.5	5.7	6.1	6.4

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

1/ Assumes that non-oil exports (about 80 percent of the total) will rise by 10 percent per annum (or some increase in China's market share during 1985-90); 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 rapid expansion of imports of capital goods financed through stepped up foreign borrowing, totaling US$45 billion in the ten year beginning 1985.
3/ See footnote 2.
4/ The rate was unusually high in 1982 because of advanced repayments of commercial debts; excluding such early repayments, the ratio was 6.6 percent.
5/ Excluding repurchase of Fund credits, the ratio was 3.7 percent.

Note: This table is not intended as a forecast of balance of payments developments. The assumed growth rates are chosen to illustrate the strength of the balance of payments at present, and are not predicted values.

Table . China: Medium Term Balance of Payments Projections, 198[illegible]--Alternative Scenarios 1/

(In billions of U.S. dollars)

	1982 (Actual)	1983 (Actual)	1984 (Est.)	1985 (Proj.)			1986 (Proj.)			1987 (Proj.)			1988 (Proj.)			1989 (Proj.)			1990 (Proj.)		
				I	II	III	I	II	III	I	II	III	I	II	III	I	II	III	I	II	III
nce of payments																					
ports, f.o.b.	22.5	22.2	24.2	26.4	25.9	26.4	28.8	27.7	28.8	31.4	29.7	31.4	34.2	31.7	34.2	37.3	34.0	37.3	40.6	36.4	40.6
ports, f.o.b.	-17.1	-19.0	-21.1	-24.3	-24.3	-23.7	-28.0	-28.0	-26.6	-32.2	-32.2	-29.7	-37.0	-37.0	-33.3	-42.6	-42.6	-37.3	-49.0	-49.0	-41.8
Trade balance	5.4	3.2	3.1	2.1	1.6	2.7	0.8	-0.3	2.2	-0.8	-2.5	1.7	-2.8	-5.3	0.9	-5.3	-8.6	—	-8.4	-12.6	-1.2
visibles, net	0.3	1.2	1.1	1.0	1.0	1.1	0.5	0.5	0.7	-0.1	-0.1	—	-0.6	-0.6	-0.6	-1.4	-1.4	-1.4	-2.1	-2.0	-2.1
Of which: service receipts	(3.5)	(4.2)	(4.6)	(4.8)	(4.8)	(4.8)	(4.8)	(4.8)	(4.8)	(4.7)	(4.6)	(4.7	(4.7)	(4.6)	(4.7)	(4.6)	(4.5)	(4.6)	(4.7)	(4.6)	(4.7)
Current account	5.7	4.4	4.2	3.1	2.6	3.8	1.3	0.2	2.9	-1.0	-2.7	1.7	-3.5	-5.9	0.3	-6.7	-10.0	-1.4	-10.4	-14.6	-3.3
pital account	0.1	0.2	0.2	0.4	0.4	0.4	0.8	0.8	0.8	1.4	1.4	1.4	1.9	1.9	1.9	2.4	2.4	2.4	2.9	2.9	2.9
Of which:																					
gross disbursements on medium- and long-term debt 2/	(2.4)	(1.6)	(1.6)	(1.8)	(1.8)	(1.8)	(2.1)	(2.1)	(2.1)	(2.4)	(2.4)	(2.4)	(2.8)	(2.8)	(2.8)	(3.2)	(3.2)	(3.2)	(3.7)	(3.7)	(3.7)
gross inflows of foreign direct investment 3/	(0.4)	(0.6)	(0.7)	(0.8)	(0.8)	(0.8)	(1.0)	(1.0)	(1.0)	(1.2)	(1.2)	(1.2)	(1.4)	(1.4)	(1.4)	(1.7)	(1.7)	(1.7)	(2.0)	(2.0)	(2.0)
Overall balance	6.3	4.1	4.4	3.5	3.0	4.2	2.1	1.0	3.7	0.4	-1.3	3.1	-1.6	-4.0	2.2	-4.4	-7.6	1.0	-7.5	-11.7	-0.4
rves at end of year	11.8	15.5	19.8	23.3	22.8	24.0	25.4	23.9	27.7	25.8	22.6	30.8	24.2	18.6	33.0	19.9	11.0	34.0	12.4	-0.7	33.6
n months of imports, (f.o.b.)	(8.3)	(9.8)	(11.3)	(11.5)	(11.3)	(12.1)	(10.9)	(10.2)	(12.5)	(9.6)	(8.4)	(12.4)	(7.8)	(6.0)	(11.9)	(5.6)	(3.1)	(10.9)	(3.0)	(...)	(9.6)
rnal debt	6.1	6.4	7.3	8.4	8.4	8.4	9.7	9.7	9.7	11.1	11.1	11.1	12.8	12.8	12.8	14.7	14.7	14.7	16.8	16.8	16.8
d-year stock																					
bt service as percent of exports of goods and services	10.8 4/	5.5 5/	4.8	4.9	5.0	4.9	5.5	5.7	5.5	5.5	5.9	5.5	5.7	6.1	5.2	6.1	6.6	6.1	6.4	7.0	6.4
tstanding debt as percent of GDP	2.3	2.3	2.6	2.8	2.8	2.8	2.9	2.9	2.9	3.0	3.0	3.0	3.1	3.1	3.1	3.2	3.2	3.2	3.3	3.3	3.3

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

/ Three scenarios (I, II, and III) are presented in this table. Differences between them relate to different assumptions for the average annual growth rates for total exports (f.o.b.) and imports (f.o.b.); imports f.o.b. are lower than rts c.i.f. by 8.3 percent. Scenario I assumes an average annual growth rate of 9 percent for total exports (f.o.b.) and verage annual growth rate of 15 percent for total imports during 1985-90; Scenario II assumes average annual growth s of 7 and 15 percent respectively, during 1985-90; and Scenario III assumes average annual growth rates of 9 and 12 per-, respectively, during 1985-90. Some increase in China's market share for non-oil exports is assumed under Scenarios I III, while no change in China's market share for non-oil exports is assumed under Scenario II.

/ A 15 percent average annual growth in gross disbursements on medium- and long-term foreign borrowing is assumed under three scenarios beginning 1985.

/ A 20 percent average annual growth in gross inflows of foreign direct investment in China is assumed under the three arios.

/ The rate was unusually high in 1982 because of advanced repayments of commercial debts; excluding such early repayments, ratio was 6.6 percent.

/ Excluding repurchase of Fund credits, the ratio was 3.7 percent.

Table 56. China: Debt Amortization Schedule, 1983-90

(In millions of U.S. dollars)

Type of Loan	Outstanding Dec. 31, 1983	Amortization Due In 1984	1985	1986	1987	1988	1989	1990 and beyond
Bonds	60	—	—	—	—	—	40	20
International organizations	80	—	—	—	—	—	3	77
Energy credit	1,344	—	—	84	168	168	168	756
Japanese commodity loans	465	—	—	—	—	—	223	242
Other intergovernmental loans	407	—	—	—	—	—	144	263
Buyers' credit	666	167	181	146	77	38	38	19
Deferred payments	1,592	417	496	372	202	105	—	—
Borrowing from banks	1,290	223	212	211	228	184	115	117
Nonbank borrowing	168	36	42	38	22	12	12	6
	6,072	843	931	851	697	507	743	1,500
Trust Fund	325	—	—	65	65	65	130	—
Total	6,397	843	931	916	762	572	873	1,500

Source: Staff estimates partly based on data obtained from the Ministry Ministry of Foreign Economic Relations and Trade and the Bank of China.

Mr. Brau
EOP files

Office Memorandum

TO : Mr. Narvekar

DATE: October 26, 1984

FROM : E. Maciejewski EM

SUBJECT : China--Available Data on External Indebtedness

1. Outstanding disbursed debt

Relatively detailed capital account data on drawings and repayments on medium-and long-term foreign borrowing for 1982 and 1983 have been made available to the mission for its internal use, together with the other balance of payments data. However, as you know, no comprehensive official debt data are yet available; very little progress has been made in collecting such data both in China and by the Debt Reporting System of the World Bank. To date, available official data cover only outstanding disbursed amounts at the end of the last few years, mainly by typesof borrowings.

According to the official data provided to the mission in the context of the last Article IV consultation (Table 1--RED text table 31), medium- and long-term debt at end-1983 was $6.4 billion (compared with $6.1 billion at end-1983). Excluding borrowing from the Fund, total medium- and long-term debt was $6.1 billion at end-1983 (compared with $5.2 billion at end-1982).

According to the semi-annual data of the Bank for International Settlements, China's short-, medium-, and long-term external indebtedness to banks in the BIS reporting area was $2.1 billion at end-1983 (Table 2), compared with $1.3 billion at end-1982. (Quarterly data--see also Table 3-- indicate lower amounts, as a result of narrower coverage). The figure for end-1983 is well above the corresponding official figure on borrowing from banks of $1.3 billion provided by the Chinese authorities (Table 1) and well below the Fund figure of $4.1 billion (international banking statistics).

According to the data compiled by the International Union of Credit and Investment Insurers (the "Berne Union"), China's outstanding external debt to the "Berne Union" was $5.8 billion at end-1983, compared with $5.7 billion at end-1982 and $5.9 billion at end-1981. The numbers for end-1983 compare relatively well with the official figure for China's external debt of $5.9 billion, defined as excluding bonds, credits from international organizations, and borrowing from the Fund (Table 1), while significant discrepancies arise regarding numbers for previous years.

According to data on bank and trade-related nonbank external claims compiled jointly by the OECD and the BIS, China's external indebtedness to banks and official creditors was estimated at $5.1 billion at end-June 1983 and $3.9 billion at end-December 1982 (Table 4). External bank claims on China were estimated to total $1.4 billion at end-June 1983, compared with $1.3 billion at end-1982; these amounts include identified guaranteed claims, estimated at $0.4 billion and $0.3 billion, respectively. Nonbank-related credits (i.e., official debt) were estimated to total $3.7 billion at end-June 1983 and $2.5 billion at end-December 1982. These data should be used with caution as the underlying compilation procedures are not yet fully established.

2. Data on new bank credit commitments and bond issues

Available undrawn foreign credits, mostly on concessional terms, were estimated (by the Chinese authorities) to amount to around $30 billion by end-June 1984. No similar data for the end of December of the last two or three years and no breakdown by creditors are yet available. A significant proportion of the undrawn credits at end-June 1984 is likely to be accounted for by credits made available by the Japanese Eximbank and OECF.

According to the BIS semiannual data on the maturity distribution of international bank lending, undisbursed bank credit commitments totaled $3.7 billion at end-1983, compared with $3.1 billion at end-1982 and $5.0 billion at end-1981 (Table 2).

According to data on new publicized medium- and long-term international bank credit commitments and bond issues published by the OECD, funds raised by China totaled $128 million in 1983, including $21 million in the form of traditional foreign bond issues; $360 million in 1982, including $45 million in the form of traditional foreign bond issues; and $453 million in 1982, all in the form of medium- and long-term bank credit commitments. New funds raised during the first half of 1984 totaled $123 million, all in the form of new medium- and long-term bank credit commitments.

According to Agefi (International Financial Review), new commercial loans signed by China totaled $188 million in 1983, compared with $378 million in 1982 (Attachment 1), and $191 million during the first eight months of 1984 (Attachment 2).

3. Maturity of China's foreign debt

No official data on the maturity of China's foreign debt are yet available. The Debt Reporting System of the World Bank and the Chinese authorities have not yet established the list of foreign loans obtained by China, even for the last three or four years, and are apparently still discussing the procedures required for collecting such data as well as other relevant data (outstanding disbursed and undisbursed debt, new commitments, disbursements, and interest and principal payments) on China's medium-and long-term public and publicly-guaranteed external debt by major creditor groups.

The only available data on the maturity of China's external debt are the semiannual data on external assets of banks in the BIS reporting area (Group of Ten countries, Switzerland, Austria, Denmark, and Ireland), collected by the Bank for International Settlements (BIS).

According to these data (Table 2), the amount of debt maturity in one year or less (remaining maturity) was $1.3 billion (around three-fifths of the total) at end-1983, compared with $0.6 billion (less than half of the total) at end-1982 when large advance repayments were made.

4. China's net creditor position vis-a-vis nonresident deposit banks

Tables 2 and 3 provide some useful indications on the net creditor position of China (bank and nonbank sectors) vis-a-vis nonresident deposit banks. The discrepancies shown in Table 2 between the BIS and the Fund figures result mainly from differences in coverage.

Attachments

cc: Mr. Brau
Mr. Saito
Mr. De Wulf
Mr. Goldsbrough (o/r)
Mr. Fetherston (o/r)

Table 1. China: External Medium- and Long-term Debt by Type of Credit, 1980-83

(In millions of U.S. dollars)

	Outstanding at the End of the Year			
	1980	1981	1982	1983
Bonds	—	—	40	60
International organizations 1/	—	46	97	80
Intergovernmental loans	446	926	1,479	2,216
Of which:				
Energy credit	(435)	(895)	(1,109)	(1,344)
Japanese commodity loans	(—)	(—)	(223)	(465)
Buyers' credit	142	343	638	666
Deferred payments	1,038	1,108	1,590	1,592
Borrowing from banks 2/	3,612	2,277	1,232	1,290
Of which: short-term	(...)	(...)	(43)	(24)
Nonbank borrowing	195	200	144	168
Total disbursements	5,433	4,900	5,220	6,072
Borrowing from the Fund:				
Credit tranche	—	524	496	—
Trust Fund	—	361	342	325
Overall total	5,433	5,785	6,058	6,397
Memorandum items:				
Total debt as percent of GDP	1.9	2.2	2.3	2.3
Total outstanding official debt 3/	...	...	...	3,200
Foreign exchange borrowed by Bank of China	...	...	...	— 4/
Buyers' credits	...	...	...	265
Government-to-government loans	...	...	...	2,216
Loans from international organizations	...	...	...	405
Other 5/	...	...	...	134

Sources: State Administration of Exchange Control; and Ministry of Foreign Economic Relations and Trade.

1/ Excluding debt owed to the International Monetary Fund.

2/ Including some short-term debt.

3/ According to the definition of the Ministry of Finance.

4/ $181 million at end-September 1983.

5/ That is, changes in valuation on account of exchange rate changes.

Table 2. China's External Assets and Liabilities on Banks in the BIS Reporting Area, 1977-1983

(In billions of U.S. dollars)

	1977 end-Dec.	1978 end-Dec.	1979 end-Dec.	1980 end-Dec.	1981 end-Dec.	1982 end-Dec.	1983 end-Dec.	1984 end-June
Semiannual BIS data 1/								
Totals								
Assets	2.48	2.44	2.66	2.62	5.57	10.08	12.15	n.a.
Liabilities	0.46	0.99	2.46	2.63	2.29	1.34	2.06	n.a.
Net assets 2/	2.02	1.45	0.20	-0.01	3.28	8.74	10.09	n.a.
Maturity (based on semiannual data)								
Liabilities, total	0.46	0.99	2.46	2.63	2.29	1.34	2.06	n.a.
Up to and including one year	0.39	0.78	1.29	0.92	1.11	0.61	1.26	n.a.
Over one year and up to and including two years	--	--	0.04	0.08	0.13	0.11	0.11	n.a.
Over two years	0.06	0.03	0.96	1.34	0.80	0.42	0.52	n.a.
Unallocated	--	0.18	0.17	0.28	0.25	0.21	0.16	n.a.
Undisbursed credit commitments (based on seminannual data)	0.45	1.22	3.84	4.04	5.01	3.11	3.74	n.a.
Quarterly BIS data 1/								
Total assets	2.43	2.41	2.66	2.53	4.97	7.91	9.24	n.a.
Total liabilities	0.48	0.92	2.13	2.23	1.80	1.22	1.63	n.a.
Net assets 2/	1.95	1.49	0.53	0.30	3.17	6.69	7.61	n.a.
Fund International Banking Statistics (IBS)								
Total assets	2.35	1.56	2.15	2.26	4.97	11.50	14.65	16.86
Cross-border interbank assets 3/	2.35	1.56	2.15	2.26	4.77	11.13	14.34	16.48
Cross-border bank deposits of nonbanks 4/	n.a.	n.a.	n.a.	n.a.	.20	.37	.31	.38
Total liabilities	1.92	2.54	4.37	5.67	4.51	3.68	4.13	4.65
Cross-border interbank liabilities 5/	1.92	2.54	4.37	5.67	3.87	2.91	3.34	3.65
Cross-border bank credit to nonbanks 6/	n.a.	n.a.	n.a.	n.a.	.64	.77	.79	1.00
Net assets 2/	0.43	-0.98	-2.22	-3.41	-0.46	7.82	10.52	12.21

Sources: BIS, The Maturity Distribution of International Bank Lending (semiannual data), International Banking Development (quarterly data); and IMF, International Financial Statistics (International Banking Statistics).

1/ Discrepancies between semiannual and quarterly BIS data on external assets and liabilities result principally from differences in coverage.
2/ Plus denotes a net creditor position vis-a-vis nonresident deposit banks.
3/ Assets or claims of resident Chinese banks on nonresident deposit banks.
4/ Deposits of resident Chinese nonbank entities with nonresident deposit banks.
5/ Deposits and loans received by resident Chinese banks from nonresident deposit banks.
6/ Credits received by resident Chinese nonbank entities from nonresident deposit banks.

Table 3. China: External Assets and Liabilities of Banks and Nonbanks on Banks in the BIS Reporting Area, 1982-84

	1982		1983		1984
	end-June.	end-Dec.	end-June.	end-Dec.	end-March
Assets	5.81	7.80	8.66	9.30	10.73
Banks	5.53	7.45	8.41	9.01	10.47
Nonbanks	0.28	0.35	0.25	0.29	0.26
Liabilities	1.10	1.18	1.26	1.60	1.77
Banks	0.63	0.58	0.74	0.96	1.12
Nonbank	0.47	0.60	0.52	0.64	0.65
Net assets	4.71	6.62	7.40	7.70	8.96
Banks	4.90	6.87	7.67	8.05	9.37
Nonbanks	-0.19	-0.25	-0.27	-0.35	-0.39

Source: BIS, International Banking Developments.

Table 4. China: External Indebtedness to Banks and Nonbank Trade-Related Credits, 1982-83

(In billions of U.S. dollars)

	1982 end-Dec.	1983 end-June	1983 end-Dec.
To banks	1.31	1.44	n.a.
Of which: identified guaranteed claims 1/	(0.31)	(0.43)	(n.a.)
Nonbank trade-related credits 2/	2.54	3.68	n.a.
Total	3.85	5.12	n.a.

Sources: BIS, OECD, Statistics on External Indebtedness: Bank and Trade-Related Nonbank External Claims on Individual Borrowing Countries and Territories.

1/ Trade-related bank claims under official insurance or guarantee.
2/ Under official insurance or guarantee, or extended directly to the foreign buyer by the official sector of the exporting country.

China, PR of

Loans

	Amount	Terms	Market Position
Civil Administration of China (1983/21-16) *California First Bk* 2016	US$58.00m	15 yrs at undisclosed	Completed December
Garden Hotel Holdings Ltd (1983/21-13) *CCIC Finance (ar & a)* 901/949/986/1073/1107/1153/1293/1628	HK$700.00m (US$94.11m)	5 yrs at 3/4% (HK) 5 yrs at 1% (HK)	Signed 24/11/83
Golden Flower Hotel Co (1982-83/21-7) *Nordic Bk (b & a)* 49/111/708	US$10.00m	8-9 yrs at 1 1/4%-2%	Signed 14/5/83
Great Wall Hotel Joint Venture of Beijing (1983/21-12) *Gtd: Bank of China* *LTCBJ (a)* 774	Yen823.00m (US$3.44m)	5 yrs at 0.1% (LTPR)	Signed 3/6/83
Guandong Trust & Investment (1983/21-14) *IBJ* 1016	US$10.00m	1/8%-1/2% undisclosed	Signed 15/7/83
Guangzhou Rubber Tyre Factory China National Chemicals Import & Export Corp (acting jointly through the Bank of China — 1983/21-11) *Gtd: ECGD* *Midland Bk* 49	£4.50m (US$6.96m)	Undisclosed	Signed 7/1/83
Landtrade Co Ltd (1983/21-15) *Takugin Int'l (Asia) (a)*	HK$40.00m (US$5.12m)	2 1/2 yrs at 1 1/2% (HK)	Signed 14/11/83
Total loans for the year ending December 31, 1983:	US$187.63m		

Total loans for the year 1982: US$377.61m

Bonds

	Amount	Classification	Maturity	Interest Payment	Issue Price
Fujian Investment *Gtd: Bank of China* *Sanyo* 366/889/935/1234	Yen5,000.00m (US$20.52m)	Shibosai	1993	8 1/2%	100
Total bonds for year ending December 31, 1983:	US$20.52m				

Total bonds for the year 1982: US$43.38m

TOTAL OF LOANS AND BONDS FOR THE YEAR ENDING DECEMBER 31, 1983: US$208.15m

Total Hard Currency Debt as at end-1980: US$3,500.00m—US$4,500.00m

Estimated source: US Government

 Source: AGEFI (AGEFI Country and General Index; International loans and bonds, 1983).

ATTACHMENT 2

China, PR of — Loans

		Amount	Terms	Market Position
March	**Meishek (China) Investment Co Ltd** (84/HK/MEI001/01) *Gtd: China Nanhai Oil Joint Service Corp* *Soc Gen (b & a)* 321/375/467	US$76.65m	6 yrs at 5/8% 7 1/2 yrs at 3/4%	Signed 19/3/84
April	**Bigful Co Ltd** (84/CHIN/BIG001/01) *Gtd: Zhuhai Brewery Co Ltd, China International Trust & Investment Corp* *Crocker (a)* 508/554/605	HK$ equivalent of US$30.00m	8 yrs at 5/8% (HK)	Signed 6/4/84
May	**Carveston Co Ltd (Hong Kong)** (84/CHIN/CAR004/01) *Gtd: Guangdong Province Foreign Trade Corp* *Wardley Ltd* 545/977	HK$160.00m (US$20.47m)	10 yrs at 3/4% (HKP)	Signed 28/5/84
August	**Gladhover Ltd** (84/CHIN/GLA001/01) *Gtd: Gladhover Ltd, Zhuhai Special Economic Zone Dev Co China Nanhai Oil Joint Service Corp* *LBI HK (a)* 1019/1238/1278/1362/1405	US$63.96m in 2 tranches A-US$27.00m B-US$37.00m	A-5 yrs at 5/8% 5 yrs at 3/4% B-2 yrs at 5/8% 4 yrs at 3/4%	Signed 8/8/84
	Total loans for the first 8 months of 1984:	**US$191.12m**		

Source: AGEFI, October 1984.

Office Memorandum

TO : Ms. Lachman

DATE: October 19, 1984

FROM : Peter J. Quirk

SUBJECT : China--Multiple Currency Practice

The attached memoranda by Mr. Maciejewski note the likelihood that China will soon eliminate a multiple currency practice subject to the Fund's Article VIII by reducing the spread between the official and internal settlement rates to less than 2 percent. I would appreciate your confirmation that the multiple currency practice would be so eliminated, and that the remaining spread would not constitute a measure subject to either Section 2 or Section 3 of Article VIII.

Attachments

cc: Mr. Brau
Mr. Saito
Mr. Maciejewski

Mr. Brau
ETR files

Office Memorandum

TO : Mr. Narvekar

DATE: October 18, 1984

FROM : E. Maciejewski EM

SUBJECT : China--Exchange Rate

Further to my memorandum to Mr. Brau of October 16, 1984, you asked me to calculate the rate at which the maximum spread between the buying official rate and the internal settlement rate would be reduced to 2 percent.

According to the methodology used in China and elsewhere to calculate the premium provided by the internal settlement rate (ratio of the internal settlement rate over the official rate), the buying official rate would have to be set at Y 2.745 per US$1. According to the standard methodology used for calculating the percentage of the depreciation (or appreciation) of a given currency (see attached), the buying official rate would have to be set at Y2.744 per US$1.

Attachment

cc: Mr. Brau
Mr. Saito
Mr. Quirk
Mr. De Wulf
Mr. Goldsbrough (o/r)
Mr. Fetherston (o/r)

How to Calculate Percentage Changes in Currency Values

Devaluation or revaluation of a currency represents the decrease or increase in the value of a unit of that currency expressed in terms of gold, SDRs or a foreign currency. A decline in the value of one unit of currency in these terms would correspond to an increase in the number of units of that currency per ounce of gold, per SDR or per unit of foreign currency. (The percentage figures would not be the same in the two ways of stating the change; for example, with the value of the dollar being reduced by 10 per cent, it is equivalent to raising the price of gold by 10/90 or 11.1 per cent.)

For currencies which are traditionally quoted in terms of the value that one unit has in terms of gold, SDRs or another currency, calculating the percentage of devaluation or revaluation involves subtracting the old rate from the new rate and expressing the difference as a per cent of the old rate. When, for instance, the gold content of the Finnish markka was recently reduced from about 0.1996 gram to about 0.1889 gram, this meant a devaluation of:

$$\frac{.1889 - .1996}{.1996} = \frac{-.0107}{.1996} = -5.4 \text{ per cent.}$$

(The minus sign in the answer here indicates it is a devaluation. If the sign were positive it would be a revaluation or appreciation.)

To obtain the percentage of devaluation or revaluation for currencies traditionally quoted the other way around, i.e., as so many units of national currency per unit of gold or per U.S. dollar, one can interchange the new and old rates, and proceed as in the example above. Thus, when the rate for the Finnish markka was revised from 4.1 to the U.S. dollar to 3.9, the value of one markka in terms of dollars appreciated by 5.1 per cent, which is calculated as:

$$\frac{4.1 - 3.9}{3.9} = \frac{0.2}{3.9} = +5.1 \text{ per cent.}$$

(This result is reconciled with the preceding example by noting that if the markka devalued by 5.4 per cent in terms of gold, its value declined to 94.6 per cent of the previous level, while the 10 per cent devaluation of the dollar reduced it to 90 per cent of its previous level. The markka in relation to the dollar then became $\frac{94.6}{90.0} = 105.1$ representing a relative appreciation of the markka by 5.1 per cent against the dollar.)

IMF Treasurer's Department

cc: ETR files

Office Memorandum

TO : Mr. ~~Brau~~

DATE: October 16, 1984

FROM : E. Maciejewski EM

SUBJECT : China--Exchange Rate

Attached please find a copy of a press report on the latest quotations of the official exchange rate for the Renminbi.

As a result of the further depreciation of the official rate to Y 2.7075 per US$1 (middle rate), the margin implicit in the internal settlement rate has narrowed from the original 80 percent to slightly more than 3 percent. Further, there appear to be no small taxes/commissions on foreign exchange that are additive to this spread. Therefore, according to the provisions of paragraph 1 a (i) of Decision No. 6790--(81/43) of March 20, 1981 on "Policy on Multiple Currency Practices," if the maximum spread between the internal settlement and the official rates is narrowed further to less than 2 percent, the maintenance of the two rates would no longer give rise to a multiple currency practice subject to Fund approval. However, the maintenance by China of an exchange tax on remitted profits of joint ventures continues to give rise to a multiple currency practice subject to approval under Article VIII, Section 3.

Attachment

cc: Mr. Narvekar
Mr. Saito
Mr. Quirk
Mr. De Wulf
Mr. Fetherston (o/r)
Mr. Goldsbrough (o/r)

160028 .FM-CURRENCY

CHINA SEEN MOVING TO ELIMINATE ITS DUAL EXCHANGE RATE

BY JEREMY CLIFT

PEKING, OCT 16, REUTER - CHINA MOVED TOWARDS TOTAL ELIMINATION OF ITS DUAL EXCHANGE RATE SYSTEM TODAY BY ALLOWING THE OFFICIAL RATE FOR THE RENMINBI TO SLIP TO A NEW LOW OF UNDER 2.70 TO THE U.S. DOLLAR, DIPLOMATS SAID.

THE OFFICIAL RATE HAS FALLEN BY A THIRD IN THE PAST NINE MONTHS, FROM AROUND 2.00 RENMINBI TO THE DOLLAR AT THE BEGINNING OF THE YEAR. TODAY'S RATE, PUBLISHED BY THE STATE EXCHANGE CONTROL ADMINISTRATION, WAS 2.701/2.714.

CHINA HAS MAINTAINED TWO EXCHANGE RATES, USING AN INTERNAL RATE OF 2.80 TO THE DOLLAR FOR CHINESE FIRMS WANTING TO CHANGE FOREIGN CURRENCY, FOR THE PAST THREE YEARS. FOREIGN TOURISTS AND COMPANIES USE THE OFFICIAL RATE.

THE DUAL SYSTEM HAS PROVOKED ALLEGATIONS BY U.S. COMPANIES THAT CHINA IS SUBSIDISING ITS TEXTILE EXPORTS.

WESTERN DIPLOMATS AND BANKERS IN PEKING SAID THEY BELIEVED THE GOVERNMENT WANTED THE TWO RATES TO CONVERGE SO THAT IT COULD THEN ABOLISH THE INTERNAL RATE AND THE OFFICIAL ONE WOULD BE USED FOR ALL FOREIGN CURRENCY TRANSACTIONS.

THEY SAID THEY EXPECTED THE OFFICIAL RATE TO SLIP TO 2.80 SOON.

THE RENMINBI IS NOT FREELY CONVERTIBLE AND CANNOT BE TAKEN OUT OF THE COUNTRY, BUT IN THEORY ITS RATE IS LINKED TO AN UNDISCLOSED BASKET OF CURRENCIES.

THE EXCHANGE CONTROL ADMINISTRATION, WHICH IS UNDER THE BANK OF CHINA, REGULARLY ADJUSTS THE RENMINBI AGAINST HARD CURRENCIES. THE DECLINE OF THE OFFICIAL RATE HAS ALSO REFLECTED THE STRENGTH OF THE U.S. CURRENCY ON INTERNATIONAL MARKETS, BANKERS SAY.

THE BANK OF CHINA HAS REMAINED SILENT ABOUT THE REASONS FOR THE DRAMATIC FALL, WHICH GIVES A MAJOR BOOST TO FOREIGN TOURISTS. BUT AS CHINA MOVES TO ENTER GATT (THE GENERAL AGREEMENT ON TARIFFS AND TRADE) WESTERN DIPLOMATS SAY THEY BELIEVE THE GOVERNMENT WANTS TO ELIMINATE POSSIBLE GROUNDS FOR ALLEGATIONS OF SUBSIDISING EXPORTS.

BECAUSE THE INTERNAL RATE IS USED FOR ALL FOREIGN EXCHANGE TRANSACTIONS BY CHINESE COMPANIES, ELIMINATION OF THE DUAL SYSTEM WOULD HAVE LITTLE IMPACT ON FOREIGN TRADE, DIPLOMATIC ECONOMIC SPECIALISTS SAY.

BUT IT WOULD REMOVE WHAT WESTERN DIPLOMATS REGARDED AS AN ADDITIONAL TAX ON FOREIGNERS, WHO EARLY THIS YEAR WERE LOSING A THEORETICAL 80 RENMINBI FOR EVERY 100 DOLLARS THEY CHANGED BECAUSE THEY WERE CHARGED AT THE OFFICIAL RATE INSTEAD OF THE INTERNAL RATE.

-(DJ-10-16-84 0624GMT)

CHINESE CURRENCY RENMINBI FELL 4 PC AGAINST DOLLAR IN LAST WEEK, 8 PC IN PAST MONTH, 37 PC THIS YEAR

PEKING -(DJ)--THE CHINESE CURRENCY RENMINBI SANK TO 2.70 TO THE U.S. DOLLAR TUESDAY, REPRESENTING A DECLINE OF 4 PC IN A WEEK, 8 PC IN THE PAST MONTH AND 37 PC THIS YEAR.

THE "PEOPLE"S CURRENCY," WHICH CIRCULATES ONLY IN COMMUNIST CHINA AND ISN"T CONVERTIBLE, WAS QUOTED BY THE STATE EXCHANGE CONTROL ADMINISTRATION AT 2.701-2.714 TO 1 U.S. DOLLAR, COMPARED WITH ABOUT 2.60 A WEEK AGO, 2.50 LAST MONTH AND 1.98 AT THE START OF 1984.

CHINESE OFFICIALS HAVE ATTRIBUTED THE RENMINBI"S DECLINE TO THE STRONG DOLLAR.

BUT IT IS ALSO REPORTED THAT THE BANK OF CHINA, THE CENTRAL BANK, IS LETTING THE RATE DRIFT TOWARD THE OFFICIAL IMPORT-EXPORT "SETTLEMENT RATE" OF 2.80 TO THE DOLLAR, WHICH SINCE 1981 HAS APPLIED TO ALL DOMESTIC FOREIGN EXCHANGE TRANSACTIONS.

LAST OCTOBER, AMERICAN TEXTILE MANUFACTURERS DEMANDED A U.S. COMMERCE DEPARTMENT INVESTIGATION OF CHINA"S DUAL EXCHANGE RATE, WHICH THEY SAID UNFAIRLY SUBSIDIZED CHINESE EXPORTS. THE CASE WASN"T PURSUED, FOLLOWING GOVERNMENT INTERVENTION AND SPECULATION THAT THE CHINESE HAD AGREED TO AMEND THEIR SYSTEM.

THE FALLING RENMINBI IS OF SHORT-TERM BENEFIT TO FOREIGN TOURISTS IN CHINA WHO CAN BUY MORE FOR LESS FOREIGN EXCHANGE, ALTHOUGH LOCAL PRICES ARE REGULARLY RAISED TO COMPENSATE.

-0-

-(DJ-10-16-84 0631GMT)

ETR files

Office Memorandum

TO : Mr. Bouter

DATE: September 6, 1984

FROM : E. Maciejewski EM

CONFIDENTIAL

SUBJECT : China: Technical Questions Relating to the External Sector

During the last Article IV consultation, a number of points relating to balance of payments methodology were discussed. These points, listed below, could usefully be followed up through the Bureau of Statistics' monthly correspondence.

1. They asked in particular how external transactions (merchandise exports and imports, invisibles, and nonmonetary capital flows) linked to offshore oil exploration and development, notably through joint ventures, should be treated in the balance of payments. Their question related to the issue of residency and the types of transactions that should be included (or not) in the balance of payments. I indicated that these aspects were discussed in sections 50, 68-71, 220 (i) and (iii), 221 (v), and 363 (a) of the Fourth Edition of the Balance of Payments Manual. In light of the interest shown by the Chinese participants, further clarification of this issue would appear useful.

2. Suggestions regarding the treatment of the various items included in "other medium- and long-term capital" as well as "other short-term capital," as noted in my memorandum for files of August 29, 1984 (attached), would also be appreciated.

3. Data on import and export price and volume indices tend to deviate from underlying developments. This problem stems from their coverage as well as the methodology used by the Ministry of Foreign Economic Relations and Trade to compile the indices. Detailed data on both value and volume are now collected by the General Administration of Customs; such data for 1983 as a whole and the first quarter of 1984 have just been published in "China's Customs Statistics, 1984-11." It might be useful to suggest that new series of import and export price and volume indices be compiled on the basis of the Customs data.

Attachment

cc: Mr. Narvekar
Mr. McLenaghan
Mr. Saito
Mr. DeWulf
ETR files /

EM Chron

Office Memorandum

CONFIDENTIAL

August 29, 1984

MEMORANDUM FOR FILES

Subject: China--Methodological Aspects Relating to the Balance of Payments

1. Introduction and principal finding

This memorandum summarizes the information gathered during the technical meeting on the balance of payments of July 30, 1984 (in Beijing). It includes (in a first part) information on items which have been subject to specific recommendations made by the staff of the Bureau of Statistics in September 1983 and March-April 1984.

It may be noted that the reserves data provided by the Chinese authorities during the last Article IV consultation discussions in Beijing include World Bank bonds and some short-term securities issued by the U.S. Government (though this latter element has not yet been firmly established and, unlike for the World Bank bonds, the amounts remain unspecified). These reserves data do not include securities issued by the Japanese and German Governments, notably in 1983, which are included in "stocks and bonds" (debit) of the capital account. Data on the amounts of these securities have not been made available to the Fund. The Chinese participants in the technical meeting were not in a position to indicate whether the securities issued by the Japanese and German Governments were holdings by China International Trust and Investment Corporation and, hence, be excluded from the reserves data reported to the Fund.

2. Items subject to specific recommendations made by the Bureau of Statistics

a. Portfolio investment

World Bank bonds are included in the reserves data provided by the Chinese authorities during the last Article IV consultation discussions (July-August 1984) and reflected in the changes in reserves and related items of the balance of payments. This change is expected to be reflected in the reserves data to be reported to the Fund, starting with end-June 1984 data. This change is in agreement with the recommendation made by the staff of the Fund's Bureau of Statistics in their report on the September 1983 visit and in their latest visit in March-April 1984.

Government securities issued by foreign governments, notably those of Japan and the Federal Republic of Germany, are not included in the reserves data provided to the mission during the last Article IV consultation. During a technical session, it was mentioned that certain short-term bonds issued by the Government of the United States were included in the reserves data; however, this information could not be confirmed before the mission's departure from Beijing and has not yet been confirmed. The staff of the Fund's Bureau of Statistics has recommended both in September 1983 and March-April 1984 that asset holdings such as government securities, other than holdings by China International Trust and Investment Corporation, be included in the reserves component of balance of payments data reported to the Fund. However, the required data on such asset holdings could not be provided to the mission (mostly on account of confidentiality); hence, it was not possible to make the required adjustments in the capital account and reserves data of the balance of payments. (The 1983 number on outflow on account of "stocks and bonds," i.e., $773 million, includes the bonds issued by the Japanese and German Governments as well as commercial bonds; it was also mentioned that an unspecified amount of short-term bonds was included in the reported amount of $773 million.)

b. <u>Shipment</u>

The data provided to the mission exclude internal transportation costs. 8.3 percent of the value of imports c.i.f. (which exclude internal transportation costs) was added to the data on shipment provided by the Chinese authorities. This adjustment includes some insurance payments on account of freight. This treatment of shipment is broadly in line with the related recommendations made by the staff of the Bureau of Statistics.

c. <u>Official goods, services, and income</u>

This item continues to exclude outlays of foreign embassies located in China as well as expenditures by foreign diplomats and their dependents. The related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

d. <u>Travel</u>

This item continues to include international passenger services rendered (notably by CAAC), while such services should be included in "other transportation." The related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

e. <u>Goods for processing</u>

No adjustments have yet been made. Hence the related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

f. <u>Reserves</u>

Valuation changes are currently not calculated and the counterpart to these changes continues to be included implicitly in net errors and omissions. The suggestions of the staff of the Bureau of Statistics have not yet been put into practice.

3. Other findings

a. Capital account

(i) "Bank borrowing" means borrowing by banks in China, essentially the Bank of China. This entry covers drawings on (or gross disbursements) and repayments on account of energy loans, buyers' credits, and interbank loans. Numbers for credit (or gross inflow) e.g., $241 million in 1983, consist of gross disbursements on buyers' credits (e.g., $158 million in 1983) and short- and medium-term deposits on a net basis (e.g., $63 million in 1983).

(ii) "Official loans" means borrowing by the Government of the People's Republic of China. This entry covers drawings on and repayments on account of direct government-to-government loans (also called in China "official loans" or "bilateral government loans") and of loans received from international financial institutions, including the International Monetary Fund (Trust Fund and credit tranche credits). Hence, appropriate adjustments (e.g., on account of repayment of Fund credits in 1983) had to be made. The Chinese authorities agreed to make such adjustments.

(iii) "Nonbank borrowing" means in fact borrowing by nonbanks in China.

(iv) "Other" medium- and long-term capital includes, on the debit side, remittances by joint ventures ($444,000 only in 1983), 1/ and repayments on account of "U.S. frozen assets" (US$10 million in 1983). On the credit side, it includes transfers for expenditure in China by joint ventures, which were described as financing items (amounts are believed to be small), receipts on account of labor contracts abroad ($60 million in 1982 and $86 to 100 million in 1983—tentative estimates which could not be confirmed before the mission's departure from Beijing), and the value of goods bought and paid abroad by Chinese relatives residing abroad and sent to China (US$1.2 million in 1983). 1/

(v) "Nonbank borrowing" under short-term capital means borrowing by China International Trust Company.

(vi) "Other" under short-term capital includes deposits by foreign diplomats in China (amounts not specified), and guarantee funds for joint ventures (amounts unspecified); 1/ these latter funds take the form of "earnest money" which is part of the foreign exchange owned by the joint ventures and is used to prepay the Bank of China in settling import payments.

1/ I wondered whether these various items were adequately classified.

(vii) "Foreign aid" covers all official loans extended by China, including loans used to finance Chinese exports of capital goods (including military equipments). 1/

A reorganization of available data on the capital account (nonmonetary) items and related data for 1982 and 1983 provided by the Chinese authorities for internal use is presented in the attached Table 1 (China: Key to Capital Account).

b. Merchandise exports and imports

Available data on merchandise exports do not include exports of military equipments (the amounts were said to be relatively small); such exports will be included in total exports starting in 1984. The counterpart items will be fully reflected in the balance of payments (under "unrequited public transfer" and/or "official loans extended"). Available data on merchandise imports include imports of military equipments.

c. Resident foreign deposits

They are not included in the reserves data. Such deposits totaled $2.5 billion at end-1982 and $3.4 billion at end-1983. These resident foreign deposits exclude the retention quotas which represent "rights to buy" in yuan.

Edouard Maciejewski
Economist
International Capital Markets Division
Exchange and Trade Relations Department

Attachment

cc: Mr. Narvekar
Mr. McLenaghan
Mr. Saito
Mr. De Wulf
Mr. Saunders
Mr. Goldsbrough
Mr. Fetherston
ETR Files

1/ I suggested that "foreign aid" be replaced by "official loans extended," since, in light of the explanation given by the Chinese participants such a concept would cover more accurately the transactions involved.

Working Table
EM #43

Table 1. China: Key to Capital Account

(In millions of U.S. dollars)

	1982	1983
Medium- and long-term borrowing net		
Drawing	2,382	1,572
Borrowing by government (official loans)	333	789
including international organizations	(3)	(73)
Borrowing by banks	560	241
Energy loans	(225)	(...)
Buyers' credits	(335)	(...)
Interbank loans	(—)	(...)
Deferred payments	1,434	481
Borrowing by nonbanks	55	61
Repayments	-2,180	-673
Borrowing by government	—	—
(official loans) including international organizations	—	—
Borrowing by banks	-1,131	-130
Energy loans	(—)	(...)
Buyers' credits	(-42)	(...)
Interbank loans	(-1,089)	(...)
Deferred payments	-952	-479
Borrowing by nonbanks	-97	-64
Foreign direct investment	359	478
Inflows	384	571
Outflows	-25	-93
Other medium- and long-term capital net	-383	-865
Inflows	174	390
Stocks and bonds	(40)	(153)
Due payments for processing	(106)	(137)
Official loans extended	(18)	(14)
Others	(10)	(86)
Outflows	-557	-1,255
Stocks and bonds	(-20)	(-773)
Due payments for processing	(-59)	(-57)
Official loans extended	(-413)	(-279)
Others	(-65)	(-146)
Short term capital net	-55	-326
Deferred payments (net)	177	4
Deferred receipts (net)	-318	-250
Short-term borrowing by banks	43	-24
Short-term borrowing by nonbanks	-13	27
Bilateral payments assets	56	-83

Source: Staff estimates based on data provided by the Chinese authorities in July/August 1984.

ETR Files

Office Memorandum

TO : Mr. Narvekar DATE: August 31, 1984

FROM : E. Maciejewski EM

SUBJECT : China's Import and Export Volume Indices

Attached is a new memorandum for files on China's import and export volume indices (in terms of annual percentage changes). These indices were calculated on the basis of the import and export value data provided by the Ministry of Foreign Economic Relations and Trade (MFERT) and the estimates of import and export price indices summarized in my memorandum for files of August 23,1984 (China's Import and Export Price and Volume Indices).

The new estimates for import volume indices (in terms of annual percentage changes) are broadly comparable with the former estimates for 1983 and 1981 but differ significantly for 1980 and 1982. Estimates for 1983 were bound to be broadly similar, since the same underlying import value data was used. (The MFERT data was replaced by the General Administration of Customs data.)

The new estimates for export volume indices (in terms of annual percentage changes) differ significantly from the former estimates. In particular, in 1982 and 1983, they exceed the former estimates by significant margins. These latest estimates reflect the higher annual percentage growth rate of export value in 1982 and an increase (instead of a decline) in export value in 1983. The new estimates also exceed by substantial margins the WEO estimates of non-oil import volume by China's partner countries (see Table 1) in each of the four years reviewed.

Table 1. China's Export Volume Indices--
Comparative Estimates, 1980-83

(Annual percentage changes)

	1980	1981	1982	1983
Imports, in volume, of trading partners	+6.3	+4.1	+0.9	+5.5
New estimates 1/	+12.0	+19.1	+11.1	+7.5
Former estimates 1/	+13.3	+24.1	+8.5	+4.5
Memorandum item:				
Official indices 1/	+14.8	+10.9	+9.2	+13.0

1/ See b. (2) of attached memorandum for files.

Attachment

cc: Messrs. Saito, De Wulf, Goldsbrough, Fetherston
ETR Files

Office Memorandum

August 30, 1984

MEMORANDUM FOR FILES

Subject: China's Import and Export Price and Volume Indices (II)

As noted in my memorandum for files of August 15, 1984, available official data on China's import and export prices and volumes overstate underlying developments in import and export prices and volumes. My memorandum of August 23, 1983 summarizes various estimates of import and export price and volume indices derived on the basis of alternative estimation methods and using balance of payments data for import and export values. This memorandum (1) summarizes various estimates of import and export price and volume indices derived on the basis of alternative estimation methods and using import and export value data provided by the Ministry of Foreign Economic Relations and Trade; and (2) compares these estimates with those contained in my memorandum for files of August 23, 1984.

Import and export value indices (in terms of U.S. dollars) under (1) are those derived from the balance of payments data and under (2) those derived on the basis of import and export value data provided by the Ministry of Foreign Economic Relations and Trade. Unit value indices (also in terms of U.S. dollars) are derived on the basis of alternative estimation methods, though the underlying price index is always a Laspeyres price index. Volume indices are derived implicitly, i.e., by dividing the value indices by the corresponding unit value indices. The results, in terms of annual percentage changes, are shown subsequently according to the estimation methods used; data shown in parentheses refer to the corresponding official data; 1980 is used as the base year for the price indices.

a. Import unit value and volume indices

(i) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, and (2) Japan's export price index (in terms of U.S. dollars) used as a proxy for the import price of manufactured goods (including machinery and equipment), accounting for 40 percent of the total value of imports:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+11.5	+11.5	-4.4	-4.4	-11.1	-11.1	-9.1	-9.1
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+22.1	+12.0	-8.5	-8.1	-8.4	+1.0	+23.3	+21.8
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(ii) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, (2) Japan's export price index used as a proxy for the import price of imported machinery and equipment, accounting for 20 percent of the total value of imports, and (3) the United Nations' export price index for manufactured goods, used as a proxy for the import price of other imported manufacturing goods, also accounting for 20 percent of the total value of imports:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+12.7	+12.7	+2.4	+2.4	-10.0	-10.0	-9.2	-9.2
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+20.6	+10.7	-6.7	-6.2	-9.8	-0.4	+22.0	+22.1
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(iii) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, and (2) the United Nations' export price index for manufactured goods used as a proxy for the import price of imported manufactured goods (including imports of machinery and equipment), accounting for 40 percent of the total value of imports

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+14.2	+14.2	+0.4	+0.4	-8.7	-8.7	-9.7	-9.7
	(16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+19.2	+9.4	-4.9	-4.4	-11.0	-1.8	+22.8	+23.4
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(iv) Based on the geographical structure of imports and the export unit value of the major suppliers:

(1) Seven largest suppliers (i.e., Japan, representing 39 percent of the total value of imports, United States--representing 31 percent, Hong Kong--representing 11 percent, Canada--representing 9 percent, Australia--representing 5 percent, United Kingdom--representing 3 percent, and the Federal Republic of Germany--representing 2 percent).

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+11.5	+11.5	+4.6	+4.6	-3.2	-3.2	-1.6	-1.6
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+22.1	+12.0	-8.7	-8.2	-16.1	-7.4	+12.7	+12.6
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(2) Three largest suppliers (i.e., Japan--representing 48 percent of the total value of imports, United States--representing 38 percent, and Hong Kong--representing 14 percent).

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+10.1	+10.1	+5.8	+5.8	-2.9	-2.9	-1.5	-1.5
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+23.6	+13.4	-9.7	-9.3	-16.3	-7.4	+12.4	+12.5
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(v) Based on the broad composition of imports and <u>IFS</u> data on commodity prices (with foodstuffs representing 16 percent of the total value of imports, agricultural raw materials 7 percent, and metals 7 percent); and

(1) With the import prices of manufactured goods proxied by the export unit value indices of industrial countries taken as a group; manufactured goods account for 70 percent of the total value of imports:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+14.9	+14.9	-6.6	-6.6	-6.9	-6.9	-0.8	-0.8
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+18.3	+8.6	+2.2	+2.8	-12.7	-3.7	+11.8	+11.6
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(2) With import prices of manufactured goods proxied by the export unit value indices of Japan and the United States; Japan accounts for 40 percent of the total value of imports and the United States for 30 percent:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+12.5	+12.5	+1.3	+1.3	-6.6	-6.6	+1.1	+1.1
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+20.9	+11.0	-5.7	-3.2	-13.0	-4.0	+9.8	+9.7
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(3) With the import prices of manufactured goods, accounting for 70 percent of the total value of imports, proxied by the United Nations' export price index for manufactured goods:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+13.1	+13.1	-8.1	-8.1	-5.2	-5.2	-0.6	-0.6
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+20.3	+10.4	+3.9	+4.5	-14.2	-5.5	+11.4	+11.5
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

(4) With the import prices of manufactured goods, accounting for 70 percent of the total value of imports, proxied by the unit labor costs in manufacturing in Japan and the United States:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+36.1	+24.8	-4.5	-0.4	-18.7	-10.3	+10.8	+10.8
Unit value	+8.5	+8.5	+1.3	+1.3	-4.6	-4.6	+3.0	+3.0
	(+16.3)		(+4.7)		(-13.2)		(-14.4)	
Volume	+25.4	+15.1	-5.7	-3.2	-14.8	-6.0	+7.6	+7.6
	(+7.4)		(-4.9)		(+3.3)		(+29.4)	

b. <u>Export unit value and volume indices</u>

(i) Based on (1) the export price indices provided by the Chinese authorities, accounting for 55 percent of the total value of exports, and (2) the United Nations' export price index for manufacturing goods, used as a proxy for China's export prices of manufactured products, accounting for 45 percent of the total value of exports:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+35.3	+33.7	+19.1	+14.3	+2.0	+4.5	-1.1	+1.7
Unit value	+14.0	+14.0	-1.0	-1.0	-2.9	-2.9	-7.0	-7.0
	(+16.5)		(+3.1)		(-4.4)		(-10.0)	
Volume	+18.6	+17.2	+20.3	+15.5	+5.1	+7.5	+6.4	+9.3
	(+14.7)		(+10.9)		(+9.2)		(+13.0)	

(2) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, coal for 2 percent, other mineral fuels for 3 percent, foodstuffs for 13 percent, tea for 2 percent, cereals fo 2 percent, other agricultural raw materials for 8 percent, textiles for 5 percent, clothing for 5 percent, and other manufactured goods for 45 percent; (2) China volume and price data for crude oil, coal, tea, textiles, and clothing; and (3) World Economic Outlook (WEO) data for other mineral fuels, foodstuffs, and other agricultural raw materials, and the United Nations' export price index (also used in WEO) for industrial and manufactured goods:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+35.3	+33.7	+19.1	+14.3	+2.0	+4.5	-1.1	+1.7
Unit value	+19.3	+19.3	-4.0	-4.0	-6.1	-6.1	-5.3	-5.1
	(+16.5)		(+3.1)		(-4.4)		(-10.0)	
Volume	+13.3	+12.0	+24.1	+19.1	+8.5	+11.1	+4.5	+7.5
	(+14.7)		(+10.9)		(+9.2)		(+13.0)	

(3) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, coal for 2 percent, other mineral fuels for 3 percent, foodstuffs for 13 percent, agricultural raw materials for 12 percent, and

manufactured products for 55 percent; and (2) Chinese volume and price data for crude oil and coal and WEO export price data for the other broad categories of commodities:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+35.3	+33.7	+19.1	+14.3	+2.0	+4.5	-1.1	+1.7
Unit value	+20.0	+20.0	-5.1	-5.1	-5.4	-5.4	-3.4	-5.3
	(+16.5)		(+3.1)		(-4.4)		(-10.0)	
Volume	+12.7	+11.4	+25.5	+20.4	+7.8	+10.5	+2.4	+5.2
	(+14.7)		(+10.9)		(+9.2)		(+13.0)	

(4) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, other mineral fuels for 5 percent, foodstuff for 13 percent, agricultural raw materials for 12 percent, and manufactured goods for 55 percent and (2) Chinese volume and price data for crude oil and WEO data for the other broad categories of commodities:

	1980		1981		1982		1983	
	(1)	(2)	(1)	(2)	(1)	(2)	(1)	(2)
Value	+35.3	+33.7	+19.1	+14.3	+2.0	+4.5	-1.1	+1.7
Unit value	+20.8	+20.8	-5.2	-5.2	-5.7	-5.7	-3.3	-3.3
	(+16.5)		(+3.1)		(-4.4)		(-10.0)	
Volume	+12.0	+10.8	+25.6	+20.6	+8.2	+10.8	+2.3	+5.1
	(+14.7)		(+10.9)		(+9.2)		(+13.0)	

Maciejewski

E. Maciejewski
Economist
International capital Markets Division
Exchange and Trade Relations Department

ETR Files

Office Memorandum

TO : Mr. Narvekar DATE: August 30, 1984

FROM : E. Maciejewski EM

SUBJECT : China: Treatment of Securities by Foreign Governments in the Balance of Payments

I discussed this issue with Mr. McLenaghan and other staff members of the Bureau of Statistics. The "general approach" has been to include securities issued by foreign governments in the reserves data reported to the Fund. Hence, in the case of China, the Bureau of Statistics would continue to recommend that such asset holdings, except those held by China International Trust and Investment Corporation, be included in the reserves data reported to the Fund.

This recommendation reflects a position which is in line with the definition of foreign exchange. Foreign exchange is defined to include "monetary authorities' claims on foreigners in the form of bank deposits, treasury bills, short-term and long-term government securities, and other claims usable in the event of a balance of payments deficit, including nonmarketable claims arising from intercentral and intergovernmental arrangements, without regard to whether the claim is denominated in the currency of the debtor or the creditor" (IFS, Section 3 "International Liquidity," page 9). Mr. McLenaghan suggested that this definition should be adhered to; he would concur with the view that the explanations and guidelines included in Chapter 21 on Reserves of the Fourth Edition of the Balance of Payments Manual are not sufficiently clearcut and felt that the above IFS definition would provide a better basis for the recommendation.

The Bureau of Statistics would not, however, "press" for an early implementation of the above recommendation, especially in light of the position taken by the Chinese authorities in March/April 1984. Mr. McLenaghan felt that at that time the Chinese authorities had not clearly agreed to implement this particular recommendation, at least in the near future. He also mentioned that maturity (rather ownership) considerations might have to be taken into account in making a final decision. He suggested that we indicate in our Balance of Payments table (staff report and RED) and reserves table (RED) that the Chinese definition of reserves does differ from the standard IFS definition cited above.

I indicated to Mr. McLenaghan that data on the amounts of securities issued by the Japanese and German Governments and held by the Chinese monetary authorities had not been disclosed to the staff. Hence, for the purposes of the staff report and RED, the balance of payments will reflect the reserves and portfolio investment data reported to the mission. Mr. McLenaghan concurred with this approach.

cc: Mr. Saito
Mr. De Wulf
Mr. Goldsbrough
Mr. Fetherston
ETR Files

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Office Memorandum

CONFIDENTIAL

August 29, 1984

MEMORANDUM FOR FILES

Subject: China--Methodological Aspects Relating to the Balance of Payments

1. Introduction and principal finding

This memorandum summarizes the information gathered during the technical meeting on the balance of payments of July 30, 1984 (in Beijing). It includes (in a first part) information on items which have been subject to specific recommendations made by the staff of the Bureau of Statistics in September 1983 and March-April 1984.

It may be noted that the reserves data provided by the Chinese authorities during the last Article IV consultation discussions in Beijing include World Bank bonds and some short-term securities issued by the U.S. Government (though this latter element has not yet been firmly established and, unlike for the World Bank bonds, the amounts remain unspecified). These reserves data do not include securities issued by the Japanese and German Governments, notably in 1983, which are included in "stocks and bonds" (debit) of the capital account. Data on the amounts of these securities have not been made available to the Fund. The Chinese participants in the technical meeting were not in a position to indicate whether the securities issued by the Japanese and German Governments were holdings by China International Trust and Investment Corporation and, hence, be excluded from the reserves data reported to the Fund.

2. Items subject to specific recommendations made by the Bureau of Statistics

a. Portfolio investment

World Bank bonds are included in the reserves data provided by the Chinese authorities during the last Article IV consultation discussions (July-August 1984) and reflected in the changes in reserves and related items of the balance of payments. This change is expected to be reflected in the reserves data to be reported to the Fund, starting with end-June 1984 data. This change is in agreement with the recommendation made by the staff of the Fund's Bureau of Statistics in their report on the September 1983 visit and in their latest visit in March-April 1984.

Government securities issued by foreign governments, notably those of Japan and the Federal Republic of Germany, are not included in the reserves data provided to the mission during the last Article IV consultation. During a technical session, it was mentioned that certain short-term bonds issued by the Government of the United States were included in the reserves data; however, this information could not be confirmed before the mission's departure from Beijing and has not yet been confirmed. The staff of the Fund's Bureau of Statistics has recommended both in September 1983 and March-April 1984 that asset holdings such as government securities, other than holdings by China International Trust and Investment Corporation, be included in the reserves component of balance of payments data reported to the Fund. However, the required data on such asset holdings could not be provided to the mission (mostly on account of confidentiality); hence, it was not possible to make the required adjustments in the capital account and reserves data of the balance of payments. (The 1983 number on outflow on account of "stocks and bonds," i.e., $773 million, includes the bonds issued by the Japanese and German Governments as well as commercial bonds; it was also mentioned that an unspecified amount of short-term bonds was included in the reported amount of $773 million.)

b. <u>Shipment</u>

The data provided to the mission exclude internal transportation costs. 8.3 percent of the value of imports c.i.f. (which exclude internal transportation costs) was added to the data on shipment provided by the Chinese authorities. This adjustment includes some insurance payments on account of freight. This treatment of shipment is broadly in line with the related recommendations made by the staff of the Bureau of Statistics.

c. <u>Official goods, services, and income</u>

This item continues to exclude outlays of foreign embassies located in China as well as expenditures by foreign diplomats and their dependents. The related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

d. <u>Travel</u>

This item continues to include international passenger services rendered (notably by CAAC), while such services should be included in "other transportation." The related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

e. <u>Goods for processing</u>

No adjustments have yet been made. Hence the related recommendation of the staff of the Bureau of Statistics has not yet been implemented.

f. <u>Reserves</u>

Valuation changes are currently not calculated and the counterpart to these changes continues to be included implicitly in net errors and omissions. The suggestions of the staff of the Bureau of Statistics have not yet been put into practice.

3. Other findings

a. Capital account

(i) "Bank borrowing" means borrowing by banks in China, essentially the Bank of China. This entry covers drawings on (or gross disbursements) and repayments on account of energy loans, buyers' credits, and interbank loans. Numbers for credit (or gross inflow) e.g., $241 million in 1983, consist of gross disbursements on buyers' credits (e.g., $158 million in 1983) and short- and medium-term deposits on a net basis (e.g., $63 million in 1983).

(ii) "Official loans" means borrowing by the Government of the People's Republic of China. This entry covers drawings on and repayments on account of direct government-to-government loans (also called in China "official loans" or "bilateral government loans") and of loans received from international financial institutions, including the International Monetary Fund (Trust Fund and credit tranche credits). Hence, appropriate adjustments (e.g., on account of repayment of Fund credits in 1983) had to be made. The Chinese authorities agreed to make such adjustments.

(iii) "Nonbank borrowing" means in fact borrowing by nonbanks in China.

(iv) "Other" medium- and long-term capital includes, on the debit side, remittances by joint ventures ($444,000 only in 1983), 1/ and repayments on account of "U.S. frozen assets" (US$10 million in 1983). On the credit side, it includes transfers for expenditure in China by joint ventures, which were described as financing items (amounts are believed to be small), receipts on account of labor contracts abroad ($60 million in 1982 and $86 to 100 million in 1983--tentative estimates which could not be confirmed before the mission's departure from Beijing), and the value of goods bought and paid abroad by Chinese relatives residing abroad and sent to China (US$1.2 million in 1983). 1/

(v) "Nonbank borrowing" under short-term capital means borrowing by China International Trust Company.

(vi) "Other" under short-term capital includes deposits by foreign diplomats in China (amounts not specified), and guarantee funds for joint ventures (amounts unspecified); 1/ these latter funds take the form of "earnest money" which is part of the foreign exchange owned by the joint ventures and is used to prepay the Bank of China in settling import payments.

1/ I wondered whether these various items were adequately classified.

(vii) "Foreign aid" covers all official loans extended by China, including loans used to finance Chinese exports of capital goods (including military equipments). 1/

A reorganization of available data on the capital account (nonmonetary) items and related data for 1982 and 1983 provided by the Chinese authorities for internal use is presented in the attached Table 1 (China: Key to Capital Account).

b. Merchandise exports and imports

Available data on merchandise exports do not include exports of military equipments (the amounts were said to be relatively small); such exports will be included in total exports starting in 1984. The counterpart items will be fully reflected in the balance of payments (under "unrequited public transfer" and/or "official loans extended"). Available data on merchandise imports include imports of military equipments.

c. Resident foreign deposits

They are not included in the reserves data. Such deposits totaled $2.5 billion at end-1982 and $3.4 billion at end-1983. These resident foreign deposits exclude the retention quotas which represent "rights to buy" in yuan.

Maciejewski

Edouard Maciejewski
Economist
International Capital Markets Division
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Attachment

cc: Mr. Narvekar
Mr. McLenaghan
Mr. Saito
Mr. De Wulf
Mr. Saunders
Mr. Goldsbrough
Mr. Fetherston
ETR Files

1/ I suggested that "foreign aid" be replaced by "official loans extended," since, in light of the explanation given by the Chinese participants such a concept would cover more accurately the transactions involved.

Working Table
EM #43

Table 1. China: Key to Capital Account

(In millions of U.S. dollars)

	1982	1983
Medium- and long-term borrowing net		
Drawing	2,382	1,572
Borrowing by government (official loans)	333	789
including international organizations	(3)	(73)
Borrowing by banks	560	241
Energy loans	(225)	(...)
Buyers' credits	(335)	(...)
Interbank loans	(--)	(...)
Deferred payments	1,434	481
Borrowing by nonbanks	55	61
Repayments	-2,180	-673
Borrowing by government (official loans)	--	--
including international organizations	--	--
Borrowing by banks	-1,131	-130
Energy loans	(--)	(...)
Buyers' credits	(-42)	(...)
Interbank loans	(-1,089)	(...)
Deferred payments	-952	-479
Borrowing by nonbanks	-97	-64
Foreign direct investment	359	478
Inflows	384	571
Outflows	-25	-93
Other medium- and long-term capital net	-383	-865
Inflows	174	390
Stocks and bonds	(40)	(153)
Due payments for processing	(106)	(137)
Official loans extended	(18)	(14)
Others	(10)	(86)
Outflows	-557	-1,255
Stocks and bonds	(-20)	(-773)
Due payments for processing	(-59)	(-57)
Official loans extended	(-413)	(-279)
Others	(-65)	(-146)
Short term capital net	-55	-326
Deferred payments (net)	177	4
Deferred receipts (net)	-318	-250
Short-term borrowing by banks	43	-24
Short-term borrowing by nonbanks	-13	27
Bilateral payments assets	56	-83

Source: Staff estimates based on data provided by the Chinese authorities in July/August 1984.

ETR files

Office Memorandum

TO : Mr. Narvekar DATE: August 23, 1984

FROM : E. Maciejewski EM

SUBJECT : China's Import and Export Price and Volume Indices

Attached please find a memorandum for files, which summarizes various estimates of import and export price and volume indices (in terms of U.S. dollars and annual percentage changes). As you know, owing to the limited coverage of the indexes and compilation procedures used by the Ministry of Foreign Economic Relations and Trade, available official data (in terms of U.S. dollars), overstate underlying developments in import and export prices and volumes, especially in 1983.

Regarding import price and volume indices, the estimates suggest that import unit value could have declined in 1983 by as much as 9 percent, on the basis of estimation methods that take into account official import price indices accounting for 60 percent of the total value of imports, or as little as 1 percent, on the basis of other "independent" estimation methods. As a result, imports could have increased in volume terms by as much as 22-23 percent or as little as 11 percent (see memorandum for files; 2.a.(i) and (iii); and 2.a.(v).(3), respectively). This compares with a 14 percent decline in prices and a 29 percent increase in volume in 1983, according to official data.

Regarding export price and volume indices, the estimates suggest that export unit value could have declined in 1983 by as much as 7 percent, on the basis of an estimation method that takes into account official export price indices accounting for 55 percent of the total value of exports, or by as little as 3 percent, on the basis of other "independent" estimation methods. As a result, exports could have increased in volume terms by as much as 6 percent or as little as 2 percent (see memorandum for files; 2.b.(1); and 2.b.(3) and (4), respectively). This compares with a 10 percent decline in prices and a 13 percent increase in volume in 1983, according to official data.

For the purpose of the staff reports, it might be advisable to use estimates of import and export price and volume indices, which are partly based on the official import and export price indexes. Available information on the coverage of the official price indexes suggest that these indexes, which cover mostly primary products and some industrial goods (notably materials for industrial and processing use), and "independent" price indexes for manufactured goods only are to a large extent complementary. A composite price index combining these two complementary indexes is likely to be more representative than the corresponding official price index, mainly on account of the improved coverage. It should be noted, however, that it would still be based to a large extent on official price indices whose weights do not reflect the relative importance of the group of commodities whose price movements they are intended to represent. Such a composite index is actually a combination of Laspeyres and Paasche indexes having more or less similar weights. Because of this inherent difficulty, the possible use of estimates derived on the basis of estimation methods which do not use at all the official price indexes should also be considered.

Attachments

cc: Mr. Saito
Mr. De Wulf
Mr. Goldsbrough
Mr. Fetherston
ETR Files ✓

ETR. Files

Office Memorandum

August 23, 1984

MEMORANDUM FOR FILES

Subject: China's Import and Export Price and Volume Indices

As noted in my memorandum for files of August 15, 1984, available official data on China's import and export prices and volumes overstate underlying developments in import and export prices and volumes. This memorandum summarizes various estimates of import and export price and volume indices derived on the basis of alternative estimation methods.

1. Available official data on import and export prices and volumes

Official import and export price indices are calculated by the Ministry of Foreign Economic Relations and Trade (MFERT). The underlying official import price index is based on 93 goods, accounting for about 60 percent of the total value of imports. Imports of machinery and equipments as well as a significant proportion of other imported manufactured goods are not included in the official import price index. The underlying official export price index is based on 145 major commodities, representing approximately 55 percent of the total value of exports. A significant proportion of manufactured goods is not covered by the index.

The unit value (in terms of U.S. dollars) and volume indices for imports and exports are in principle compiled independently from value and quantity data collected by the MFERT and utilize the chainlinked method. Weights used in the calculation of the indices reflect the actual prices (in the case of volume indices) or quantities (for the unit value indices) of the commodities included. Hence, the weights do not reflect the relative importance of the group of commodities whose price, or volume, movements they are intended to represent.

During the last Article IV consultation the MFERT provided a revised series of import and export price indices (in terms of annual percentage changes) covering 1980-83. The MFERT also provided separate indications on import and export volumes for 1983 only, which are equivalent to estimates derived by dividing the dollar value indices by the corresponding unit value indices. Import and export price and volume indices (in terms of annual percentage changes) were compiled (see also Table 1 of my memorandum of August 15, 1984), on the basis of the information provided by the Chinese authorities during the last and previous Article IV consultations. These data are the following:

	1980	1981	1982	1983
Imports				
Value 1/	24.8	-0.4	-10.3	10.8 2/
Volume	7.4	-4.9	3.3	29.4
Price	16.3	4.7	-13.2	-14.4
Exports				
Value 1/	33.7	14.3	4.5	1.7
Volume	14.7	10.9	9.2	13.0
Price	16.5	3.1	-4.4	-10.0

1/ MFERT data in U.S. dollars.
2/ Balance of payments data in U.S. dollars.

2. Staff estimates of import and export price and volume indices

Import and export value indices (in terms of U.S. dollars) are derived from the balance of payments data. Unit value indices (also in terms of U.S. dollars) are derived on the basis of alternative estimation methods, though the underlying price index is always a Laspeyres price index. Volume indices are derived implicitly, i.e., by dividing the value indices by the corresponding unit value indices. The results, in terms of annual percentage changes, are shown subsequently according to the estimation methods used; data shown in parentheses refer to the corresponding official data; 1980 is used as the base year for the price indices.

a. Import unit value and volume indices

(i) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, and (2) Japan's export price index (in terms of U.S. dollars) used as a proxy for the import price of manufactured goods (including machinery and equipment), accounting for 40 percent of the total value of imports:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+11.5	-4.4	-11.1	-9.1
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+22.1	-8.5	-8.4	+23.3
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(ii) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, (2) Japan's export price index used as a proxy for the import price of imported machinery and equipment, accounting for 20 percent of the total value of imports, and (3) the United Nations' export price index for manufactured goods, used as a proxy for the import price of other imported manufacturing goods, also accounting for 20 percent of the total value of imports:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+12.7	+2.4	-10.0	-9.2
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+20.6	-6.7	-9.8	+22.0
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(iii) Based on (1) the import price indices provided by the Chinese authorities, accounting for 60 percent of the total value of imports, and (2) the United Nations' export price index for manufactured goods used as a proxy for the import price of imported manufactured goods (including imports of machinery and equipment), accounting for 40 percent of the total value of imports

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+14.2	+0.4	-8.7	-9.7
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+19.2	-4.9	-11.0	+22.8
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(iv) Based on the geographical structure of imports and the export unit value of the major suppliers:

(1) Seven largest suppliers (i.e., Japan, representing 39 percent of the total value of imports, United States--representing 31 percent, Hong Kong--representing 11 percent, Canada--representing 9 percent, Australia--representing 5 percent, United Kingdom--representing 3 percent, and the Federal Republic of Germany--representing 2 percent).

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+11.5	+4.6	-3.2	-1.6
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+22.1	-8.7	-16.1	+12.7
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(2) Three largest suppliers (i.e., Japan--representing 48 percent of the total value of imports, United States--representing 38 percent, and Hong Kong--representing 14 percent).

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+10.1	+5.8	-2.9	-1.5
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+23.6	-9.7	-16.3	+12.4
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(v) Based on the broad composition of imports and IFS data on commodity prices (with foodstuffs representing 16 percent of the total value of imports, agricultural raw materials 7 percent, and metals 7 percent); and

(1) With the import prices of manufactured goods proxied by the export unit value indices of industrial countries taken as a group; manufactured goods account for 70 percent of the total value of imports:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+14.9	-6.6	-6.9	-0.8
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+18.3	+2.2	-12.7	+11.8
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(2) With import prices of manufactured goods proxied by the export unit value indices of Japan and the United States; Japan accounts for 40 percent of the total value of imports and the United States for 30 percent:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+12.5	+1.3	-6.6	+1.1
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+20.9	-5.7	-13.0	+9.8
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(3) With the import prices of manufactured goods, accounting for 70 percent of the total value of imports, proxied by the United Nations' export price index for manufactured goods:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+13.1	-8.1	-5.2	-0.6
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+20.3	+3.9	-14.2	+11.4
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

(4) With the import prices of manufactured goods, accounting for 70 percent of the total value of imports, proxied by the unit labor costs in manufacturing in Japan and the United States:

	1980	1981	1982	1983
Value	+36.1	-4.5	-18.7	+10.8
Unit value	+8.5	+1.3	-4.6	+3.0
	(+16.3)	(+4.7)	(-13.2)	(-14.4)
Volume	+25.4	-5.7	-14.8	+7.6
	(+7.4)	(-4.9)	(+3.3)	(+29.4)

b. Export unit value and volume indices

(i) Based on (1) the export price indices provided by the Chinese authorities, accounting for 55 percent of the total value of exports, and (2) the United Nations' export price index for manufacturing goods, used as a proxy for China's export prices of manufactured products, accounting for 45 percent of the total value of exports:

	1980	1981	1982	1983
Value	+35.3	+19.1	+2.0	-1.1
Unit value	+14.0	-1.0	-2.9	-7.0
	(+16.5)	(+3.1)	(-4.4)	(-10.0)
Volume	+18.6	+20.3	+5.1	+6.4
	(+14.7)	(+10.9)	(+9.2)	(+13.0)

(2) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, coal for 2 percent, other mineral fuels for 3 percent, foodstuffs for 13 percent, tea for 2 percent, cereals fo 2 percent, other agricultural raw materials for 8 percent, textiles for 5 percent, clothing for 5 percent, and other manufactured goods for 45 percent; (2) China volume and price data for crude oil, coal, tea, textiles, and clothing; and (3) World Economic Outlook (WEO) data for other mineral fuels, foodstuffs, and other agricultural raw materials, and the United Nations' export price index (also used in WEO) for industrial and manufactured goods:

	1980	1981	1982	1983
Value	+35.3	+19.1	+2.0	-1.1
Unit value	19.3	-4.0	-6.1	-5.3
	(+16.5)	(+3.1)	(-4.4)	(-10.0)
Volume	+13.3	+24.1	+8.5	+4.5
	(+14.7)	(+10.9)	(+9.2)	(+13.0)

(3) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, coal for 2 percent, other mineral fuels for 3 percent, foodstuffs for 13 percent, agricultural raw materials for 12 percent, and manufactured products for 55 percent; and (2) Chinese volume and price data for crude oil and coal and WEO export price data for the other broad categories of commodities:

	1980	1981	1982	1983
Value	+35.3	+19.1	+2.0	-1.1
Unit value	+20.0	-5.1	-5.4	-3.4
	(+16.5)	(+3.1)	(-4.4)	(-10.0)
Volume	+12.7	+25.5	+7.8	+2.4
	(+14.7)	(+10.9)	(+9.2)	(+13.0)

(4) Based on (1) the broad composition of exports, with crude oil accounting for 15 percent of the total value of exports, other mineral fuels for 5 percent, foodstuff for 13 percent, agricultural raw materials for 12 percent, and manufactured goods for 55 percent and (2) Chinese volume and price data for crude oil and WEO data for the other broad categories of commodities:

	1980	1981	1982	1983
Value	+35.3	+19.1	+2.0	-1.1
Unit value	+20.8	-5.2	-5.7	-3.3
	(+16.5)	(+3.1)	(-4.4)	(-10.0)
Volume	+12.0	+25.6	+8.2	+2.3
	(+14.7)	(+10.9)	(+9.2)	(+13.0)

E. Maciejewski
Economist
International capital Markets Division
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Office Memorandum

CONFIDENTIAL

MEMORANDUM FOR FILES

August 15, 1984

Subject: China--Basket of Currencies Used to Set the Official Rate for the Yuan

In a dinner conversation with Mr. Chen Quangeng (SAEC) on August 4, 1984, Mr. De Wulf learned that the basket of currencies used to set the official rate for the Yuan includes the following currencies: U.S. dollar, with a weight of 25 percent ("firm" indication), Japanese Yen, with a weight of around 20 percent ("tentative" indication), and Hong Kong dollar, with a weight of around 20 percent ("tentative" indication). He was also told that about 60 percent of China's foreign trade is denominated in U.S. dollars, around 20 percent in Japanese Yen, around 20 percent in Hong Kong dollars, and a marginal proportion in "convertible" Yuans.

Edouard Maciejewski
Economist
International Capital Markets Division
Exchange and Trade Relations Department

cc: Mr. Narvekar
Mr. Guitian
Mr. Brau (o/r)
Mr. De Wulf
Mr. Goldsbrough
Mr. Fetherston
ETR Files

Office Memorandum

MEMORANDUM FOR FILES

August 15, 1984

Subject: China: Exports and Imports--Value, Volume and Prices

Attached are two tables summarizing a number of indicators relating to China's exports and imports.

The background data (in terms of U.S. dollars) are those provided by the Bank of China (BOC), the State Administration of Exchange Control (SAEC), and the Ministry of Foreign Economic Relations and Trade (MFERT) during the 1984 Article IV Consultation discussions (see Minutes No. 5 of July 24 and No. 12 of July 28, and Table IV-7 of the Questionnaire). I cross checked some of these data with corresponding value data of the MFERT published in the summary version (in Chinese) of the 1984 Statistical Yearbook.

The only significant discrepancy which arises is with respect to the growth of imports in value and volume terms in 1983. BOC and SAEC indicated on July 24 that the growth of imports in 1983 was 10.8 percent in value (U.S. dollar) terms and 29.4 percent in volume terms. According to the 1984 Statistical Yearbook and the MFERT the growth of imports in 1983 was only 6 percent in value (U.S. dollar) terms, implying a growth of 23.8 percent in volume terms; as shown in Table 2, the underlying number for the value of imports (i.e., U.S.$18.5 billion) is significantly lower than the numbers provided by the BOC and SAEC on July 24 (i.e., US$20.7 billion), which is used in the balance of payments, and by the General Administration of Customs (i.e., US$21.3 billion). Differences in coverage may explain part of the discrepancy involved.

For the purpose of the 1984 Article IV Consultation reports, I would suggest that the data on the growth of imports in value and volume terms provided by the BOC and the SAEC on July 24, 1984 be used together with the revised price data (in U.S. dollar terms) provided by the MFERT (see Table IV-7 of the Questionnaire). Regarding exports, I would suggest that the data provided by the MFERT on July 28, which are those published in the 1984 Statistical Yearbook, be used.

As already noted, owing to the MFERT compilation procedures, available data on export and import prices as well as on the growth of exports and imports in volume terms are likely to be overstated.

Edouard Maciejewski
International Capital Markets Division
Exchange and Trade Relations Department

Attachments

cc: Messrs. Narvekar, Saito, De Wulf, Goldsbrough, and Fetherston
ETR Files

Table 1. China: Export and Import Behavior, 1980-84

	1980	1981	1982	1983 Prel.	1984 Est.
			(1980 = 100)		
Exports					
Value	100.0	114.3	119.4	121.4	132.3
Volume	100.0	110.9	121.1	136.9	146.5
Price	100.0	103.1	98.6	88.7	90.3
Imports					
Value	100.0	99.6	89.3	98.9	110.4
Volume	100.0	95.1	98.2	127.1	139.4
Price	100.0	104.7	90.9	77.8	79.2
Terms of trade	100.0	98.5	108.5	114.0	114.0
			(Annual percentage change)		
Exports					
Value	33.7	14.3	4.5	1.7	9.0
Volume	14.7	10.9	9.2	13.0	7.0
Price	16.5	3.1	-4.4	-10.0	1.8
Imports					
Value	24.8	-0.4	-10.3	10.8	11.6
Volume	7.4	-4.9	3.3	29.4	9.7
Price	16.3	4.7	-13.2	-14.4	1.8
Terms of trade	-0.2	-1.5	10.1	5.1	--

Source: Staff estimates based on data (in terms of U.S. dollars) provided by the Chinese authorities.

Table 2. China: Available Export (f.o.b.) and Import (c.i.f.) 1/ Data, 1979-83

(In millions)

	1979	1980	1981	1982	1983
Exports					
GAC 2/					
Yuans	N.A.	27,119	36,761	41,433	43,833
(Annual percentage change)	(N.A.)	(N.A.)	(35.5)	(12.7)	(5.6)
U.S. dollars 3/	N.A.	18,099	21,561	21,937	22,169
(Annual percentage change)	(N.A.)	(N.A.)	(19.1)	(1.7)	(1.1)
MFERT 4/					
Yuans	21,170	27,240	37,120	42,000	43,450
(Annual percentage change)	(26.2)	(28.7)	(36.3)	(13.1)	(3.5)
U.S. dollars 5/	13,660	18,270	20,890	21,820	22,220
(Annual percentage change)	(40.1)	(33.7)	(14.3)	(4.5)	(1.7)
BALANCE OF PAYMENTS					
U.S. dollars 6/	13,658	18,492	22,027	22,476	22,223
(Annual percentage change)	(42.2)	(35.4)	(19.1)	(2.0)	(-1.1)
Imports					
GAC 2/					
Yuans	N.A.	29,884	36,773	35,769	42,182
(Annual percentage change)	(N.A.)	(N.A.)	(23.1)	(-2.7)	(17.9)
U.S. dollars 3/	N.A.	19,944	21,568	18,938	21,334
(Annual percentage change)	(N.A.)	(N.A.)	(8.1)	(-12.2)	(12.7)
MFERT 4/					
Yuans	24,290	29,140	34,620	33,640	36,270
(Annual percentage change)	(29.6)	(20.0)	(18.8)	(-2.8)	(7.8)
U.S. dollars 5/	15,670	19,550	19,480	17,480	18,530
(Annual percentage change)	(43.9)	(24.8)	(-0.4)	(-10.3)	(6.0)
BALANCE OF PAYMENTS					
U.S. dollars 6/	16,212	22,049	21,047	17,113	18,955
(Annual percentage change)	(50.9)	(36.0)	(-4.5)	(-18.7)	(10.8)

Source: 1984 Statistical Yearbook--summary version in Chinese (pp. 84-85).

1/ Unless indicated otherwise.
2/ General Administration of Customs.
3/ Converted into U.S. dollars by using the annual average exchange rates published in International Financial Statistics (IFS).
4/ Ministry of Foreign Economic Relations and Trade.
5/ Converted into U.S. dollars by the MFERT; the implicit annual average exchange rates differ from those published in the IFS.
6/ F.o.b. basis; excluding service fees due on account of shipment by resident shipping companies. The underlying data for 1982 and 1983 are the Customs (GAC) data.

Mr. Guitian

B/F

Office Memorandum

April 17, 1984

MEMORANDUM FOR FILES

SUBJECT: Meeting of Chinese Delegation with the Managing Director, April 10, 1984

Mme. Qiu, Vice President of the People's Bank and leader of the Chinese delegation to the Interim Committee meeting stressed China's economic achievements in recent years. She said that the new policies adopted by the Communist Party since 1981 had yielded results much greater than earlier anticipated. This was particularly evident in the agricultural sector where, thanks to the new responsibility system, grain output had increased by 7 per cent in 1983. In industry, too, whereas there had been a debate last year whether output was likely to increase by 4 per cent or 5 per cent, output has in fact increased by 10 per cent, so that the Plan target was realized two years ahead of schedule. All this did not mean that there were no problems--bottlenecks in key infrastructure facilities, especially energy supplies, had emerged.

The Managing Director said that he was impressed by the results achieved by the incentive system, especially in agriculture. Clearly, however, rapid economic growth had led to pressures on resources. To deal with this problem, macro-economic policies needed to be assigned an important role. The recent establishment of the Central Bank and the ongoing tax reform would help in this respect. Mme. Qiu said that it was very much the intention of the Chinese authorities to develop and use tools of macro-economic management.

The Managing Director noted that the next Article IV Consultation discussions were planned for July and he hoped that the opportunity would be used for a two-way dialogue between the Chinese authorities and the Fund staff. The effects of decentralization, the role of prices and import policies were among the subjects that could be discussed fruitfully.

Mme. Qiu responded that these subjects were also being discussed among the Chinese authorities. The authorities intended to develop China's socialist economy with Chinese characteristics. Theoretically, the system is a socialist one but a policy reform has been set in motion. The objective was to develop the economy at a much faster pace than in the past. The main problem in relaxing the energy and other infrastructure growth was financial. Although China had large foreign exchange reserves, they were likely to be quickly drawn down once large scale projects were initiated.

The Managing Director commented briefly on the principal topics before the Interim Committee.

P.R. Narvekar
P.R. Narvekar

cc: Mr. Collins