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October 3, 1984

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of China - Staff Report for the
1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the People's Republic of China. A draft decision appears on page 23.

It is proposed to bring this subject to the agenda for discussion on Wednesday, November 7, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Saito (ext. (5)7614) or Mr. De Wulf (ext. (5)7343).

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Consultation

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

October 3, 1984

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I. Introduction

Staff discussions for the 1984 Article IV consultation with China were held in Beijing from July 23 to August 4, 1984. The Chinese delegation was led by Mr. Shang Ming, Advisor to the People's Bank of China and member of its Council, and Mr. Wang Weicai, Secretary and member of the Council. It also included representatives of the following institutions: the People's Bank of China, the Ministries of Finance, Foreign Affairs, Foreign Economic Relations and Trade, and Commerce, the State Planning Commission, the State Economic Commission, the State Statistical Bureau, the State Price Bureau, the State Bureau of Labor, the State Administration of Exchange Control, the Bank of China, the Agricultural Bank of China, and the People's Capital Construction Bank. The staff team ^{1/} also met with Mr. Lu Peijian, President of the People's Bank of China. Mr. Zhang Zicun, Executive Director for China, participated as an observer.

II. The Background: Broad Direction of Systemic Reform and Economic Change

The Chinese economy has been the scene of change in recent years. First, the emphasis of economic policy has shifted from rapid growth and industrialization to a speedy improvement in living standards and relief from poverty. Striking progress had already been achieved in the provision of many basic needs. Further improvement in living conditions required primarily a faster increase in the supply of consumer goods and, therefore, a reduced allocation of resources to investment and less emphasis on heavy industry. Second, in pursuing the objective of increased output, the emphasis is now clearly on more efficient use of resources rather than on massive mobilization. To this end, incentives are being increasingly emphasized, and the economy is being opened to international trade and capital movements. Third, decision making and management of the allocation of resources are being decentralized, and new tools of macroeconomic management relying on market mechanisms are being developed. Finally, the authorities desire to consolidate the impressive gains already made in slowing population growth, so as to keep population from exceeding 1.2 billion by the year 2000.

The authorities are implementing policy reforms in a spirit of pragmatic experimentation designed to correct shortcomings of the existing economic structure, rather than being guided by a predetermined blueprint of a new structure. However, the thrust of the changes is clear. The scope of mandatory planning is being reduced while that of indicative planning and of market forces is being enlarged. A system of

^{1/} Messrs. Narvekar, Saito, De Wulf (all ASD), Goldsbrough (RES), Maciejewski (ETR), Fetherston (FAD), and Mrs. Francis (ASD).

contracts is being developed to replace many administrative directives. The best known of the reforms is the production responsibility system in agriculture, of which the cornerstone is a long-term contract with an individual farming unit, specifying the land to be cultivated and the type and volume of products to be supplied under quota; any excess production may be freely disposed of by the producer. From a small beginning a few years ago, this system has now spread to virtually the whole country, replacing previous arrangements based on collective production. In industry, managers are being given more independence, and enterprises are being held more accountable for their financial results. A system of fixed price contracts and open bidding has been introduced for construction projects. Small-scale private enterprise is being permitted in domestic trade and service industries. Also, distribution channels are being enlarged, and restrictions on the movement of goods between regions are being dismantled. The business of foreign trade has been decentralized; some producing enterprises are being permitted to engage in such trade directly; and foreign direct investment is being actively promoted.

With regard to the development of new tools of macroeconomic management, the system of taxation of enterprises is being reformed, and both enterprises and local governments have been given greater autonomy in their expenditures. The organizational structure of banking has been changed and a central bank established. The division of responsibilities between the budget and the banking system as providers of funds has been realigned, with the responsibilities of the latter increased.

While these changes are profound and wide-ranging, their scope must not be misunderstood. China remains a socialist, centrally planned economy. The scope of mandatory planning, although diminishing, remains large; and that of market forces, although increasing, remains small.

Despite the reforms, many weaknesses and inefficiencies remain in the economy. A conspicuous example is the structure of relative prices which, in many respects, does not reflect opportunity costs. Consumer preferences and the product mix of consumer goods remain mismatched. Also, improvements in efficiency in the industrial sector have so far been modest. However, in these areas, as elsewhere, the weaknesses are identified and publicized forthrightly, even if not always addressed sufficiently promptly.

The systemic reforms described above brought with them some excess demand pressures. To deal with these, the authorities in 1981 successfully carried out a stabilization program, the main element of which was a sharp reduction in the government budget deficit which slowed liquidity expansion. The budgetary retrenchment unfortunately entailed a cutback of budget-financed investment in the key sectors of energy and transportation. Subsidies and other current expenditures continued to rise, while the decentralization of public finances led to a stagnation

of revenues. The funds retained by state enterprises and local governments as a result of the decentralization were used for investment by them. However, such extrabudgetary investment, which in part was influenced by the inappropriate price structure, was often not in high priority sectors. In order to ameliorate the situation, the decentralization had to be partially reversed. This was done through the introduction of special tax measures, as well as through a tightening of direct administrative controls.

On the whole, of course, the systemic changes and stabilization efforts have made for a greatly improved economic performance. The rural areas have been virtually transformed. This has implications for various other aspects of the economy, including the need for better transport, distribution and storage systems; the movement of population; and the demand for money and the flow of savings. Industrial production has also been buoyant so that aggregate output has been growing strongly, considerably outperforming the Sixth Five-Year Plan targets. At the same time, recorded inflation has declined and the good agricultural performance has made it possible to eliminate rationing for many products. Shortages of energy, building materials, and a number of high-quality consumer goods and industrial raw materials remain prevalent.

The stabilization policies and the policy of opening the economy to the outside world have had the effect of greatly strengthening China's external financial position. Export performance has been strong, notwithstanding the adverse world economic situation and protectionist barriers. Imports declined in 1981 and 1982--reflecting cautious import licensing policies and the cutback in centrally-financed investment projects, which have a relatively high import content--but they have now been rising again. International reserves have been rising rapidly, and are now large, while total external debt and the debt service ratio remain low.

III. Developments Since the Last Consultation

1. The last consultation

During the last consultation held a year ago, there was a broad measure of agreement among Executive Directors on the following four points:

- the decentralized management and improved incentive structure in the economy and the determination of the authorities not to return to an over-centralized system were welcome;

- reform of the domestic pricing system was an urgent matter; such reform should provide an opportunity to establish a closer degree of

linkage between domestic and international prices by means of an appropriate exchange rate system;

- there was a need for the development of macroeconomic fiscal and monetary instruments; and,

- the success of the stabilization program was welcome but, given some intensification of demand pressures, there was again need for some slowing down of the relatively rapid monetary expansion.

In addition, several Directors, while commending China's cautious borrowing policy, expressed the view that a country in China's position should not permanently run balance of payments surpluses and that imports should be stepped up, albeit prudently.

2. Recent economic developments

Since the last consultation, the scope of economic reforms has been expanded, with the major emphasis now on reform of the industrial and commercial sectors; a number of price adjustments have been made, but no overall reform of the price structure has been initiated. Monetary expansion remains rapid, although the authorities have continued to adapt fiscal and monetary policy instruments to the changed economic structure. Most striking among recent developments are the continuation of remarkably rapid economic growth and of the strong balance of payments position. Recorded inflation remains low, but shortages and bottlenecks continue.

National income at constant prices grew by 9 percent in 1983 and the staff would estimate for 1984 a growth rate not much lower (Table 1 and Chart 1). Output in agriculture, the dominant sector of the economy, increased by over 9 percent in 1983, almost as fast as in 1982. Production of foodgrains and cotton showed particularly large increases, and there was a marked increase in yields. Available information indicates a further substantial increase in agricultural production in 1984.

Industrial production increased by almost 11 percent in 1983 and, on the basis of performance in the first half of 1984, a similar increase can be expected this year. There was strong demand for consumer goods, fueled by rising rural and urban incomes, and for producer goods, reflecting the continued sharp growth in investment. As in 1982, heavy industry grew somewhat faster than light industry. Profits in industrial enterprises also increased in 1983 after two years of stagnation, but more slowly than industrial output. The greater emphasis on efficiency contributed to a slight decline in costs, but the improvement was well below the 2 percent decline in average costs targeted by the authorities.

Table 1. China: Major Economic Indicators, 1980-84

(Changes in percent, unless otherwise indicated)

	1980	1981	1982	1983	1984 <u>1/</u>
<u>Macroeconomic variables</u>					
Nominal national income	10	7	8	10	10
Consumption	15	10	8	9	10
Investment	--	-3	10	14	11
Real national income	6	5	7	9	8
Gross industrial production	9	4	8	11	10
Gross agricultural production	4	7	11	9	6
Cost-of-living index	8	3	3	2	2
Current account (US\$ billion)	-3.3	1.3	5.7	4.4	4.2
(In percent of GDP)	(-1.2)	(0.5)	(2.2)	(1.6)	(1.5)
International reserves at end-year (US\$ billion)	3.1	5.6	11.8	15.4	19.8
(In months of imports)	1.7	3.2	8.3	9.8	11.3
<u>Policy variables</u>					
Public fixed assets investment	...	-10	27	11	10
Budget financed	...	-25	8	25	16
Extrabudgetary	...	5	40	6	4
Overall budget deficit in percent of GDP	3.4	1.2	1.3	1.7	1.5 <u>2/</u>
Domestic credit	27	13	12	14	13
Total liquidity	33	20	15	19	19
Wages <u>3/</u>	14	1	3	3	...

Sources: Data provided by the Chinese authorities; and Fund staff estimates. More detailed data are shown in Appendix Tables 2 (Output and Incomes), 3 (Investment and Savings), 4 (Budget), 5 (Money and Credit), 6 (Balance of Payments), and 7 (Medium-Term Scenario--Balance of Payments and External Debt).

1/ Staff estimates.

2/ Budget estimates.

3/ Annual average wages of workers and staff in state-owned enterprises.

The share of investment in GDP, after declining in previous years, rose in both 1982 and 1983. The increase in 1982 reflected sharply increased investment by local governments and state enterprises, made possible by the financial decentralization measures and higher bank lending for investment purposes. There was also a large increase in private housing construction, especially in the rural areas. In 1983, budget-financed investment picked up sharply while extrabudgetary investment again increased, albeit much more slowly, and the private investment boom accelerated. Stockbuilding and work-in-progress also rose, after declining in 1982. Measures taken to restrain extrabudgetary investment appear to have become increasingly effective in the first half of 1984, while budget-financed investment continued to increase strongly.

The renewed growth in investment and the surplus on external current account were accompanied by an increase in the share of savings in GDP, to around 32 percent in 1983. However, the savings ratio was still well below levels prevailing before its sharp fall during 1979-81, as a result of the increased emphasis on improving living standards.

The 1983 budget deficit, at 1.7 percent of GDP, widened slightly over the deficits of 1981 and 1982, but was substantially below those averaging over 4 percent of GDP reached in 1979 and 1980. Revenue rose by 9 percent, mainly on account of the newly introduced tax on extrabudgetary receipts, ^{1/} while expenditure rose by 10 percent, largely because of increased capital expenditures (Chart 2). Sales of Treasury bonds to the nonbank sectors and credit from the banking system each financed slightly less than half the deficit; a small amount of foreign finance was utilized.

After slowing in 1982, the growth of most monetary aggregates accelerated in 1983. Growth of domestic credit rose from 12 percent in 1982 to 14 percent in 1983. Currency in circulation, the monetary aggregate which the authorities monitor most closely, increased by 21 percent in 1983, almost twice as fast as in 1982 (Chart 2 and Appendix Table 5). Sight bank deposits of individuals increased by almost a third in 1983, much faster than in 1982, while time deposits of individuals increased at about the same rate in both years. The rate of growth of enterprise deposits doubled despite the new tax on extrabudgetary receipts, while that of other deposits declined slightly. The growth of total liquidity was 19 percent, up from 15 percent in 1982. It accelerated further to 23 percent in the first half of 1984, largely reflecting a sharp acceleration of deposits with the People's Capital

^{1/} Extrabudgetary receipts comprise revenues of the public sector which are not included in the consolidated government budget, such as retained profits and depreciation funds of enterprises, various fees and charges levied by administrative agencies, and surcharges by local governments on certain taxes.

CHART 1
 CHINA
 OUTPUT, CONSUMPTION, AND INVESTMENT, 1979-84

(Percentage changes over the previous year, unless indicated otherwise)

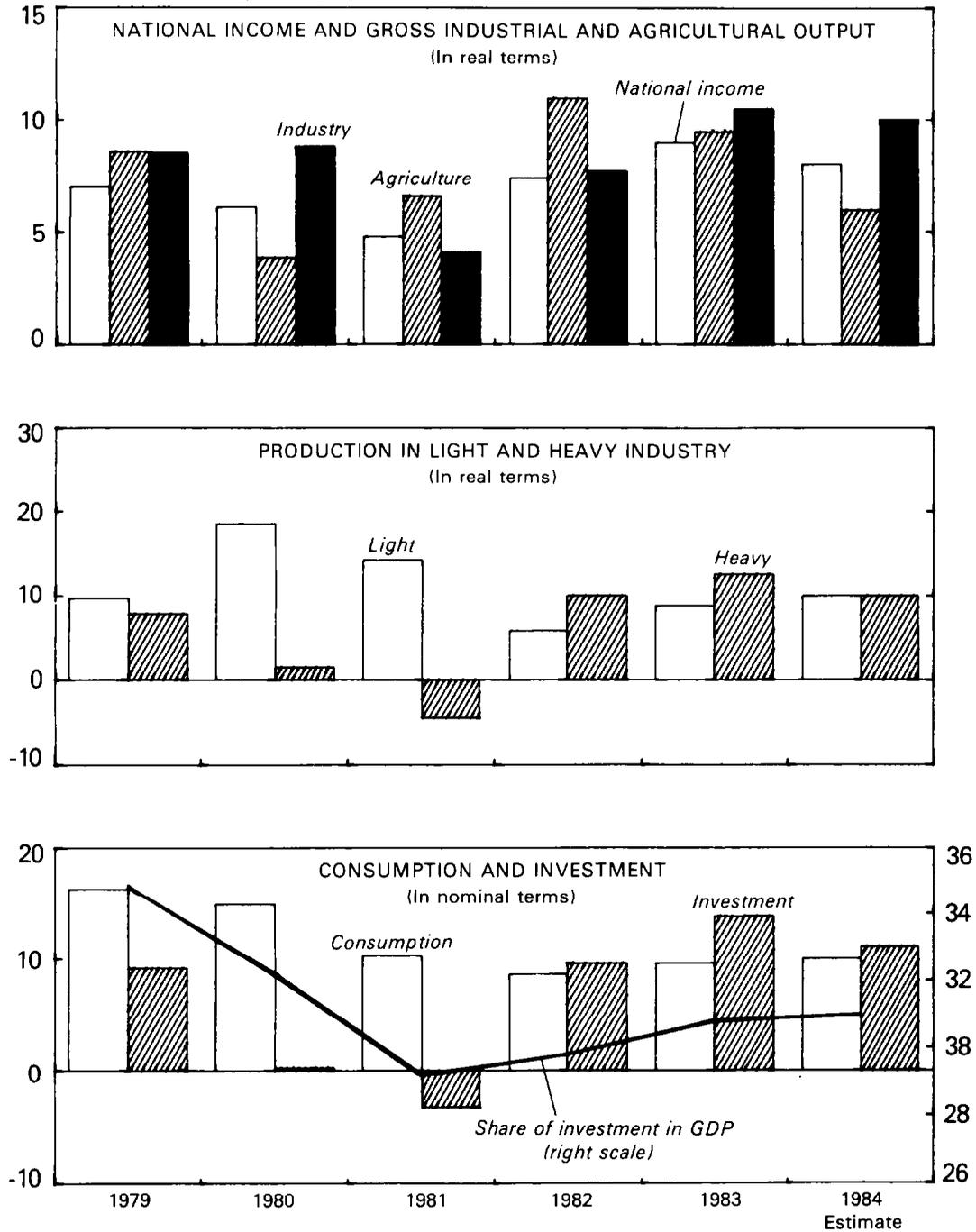
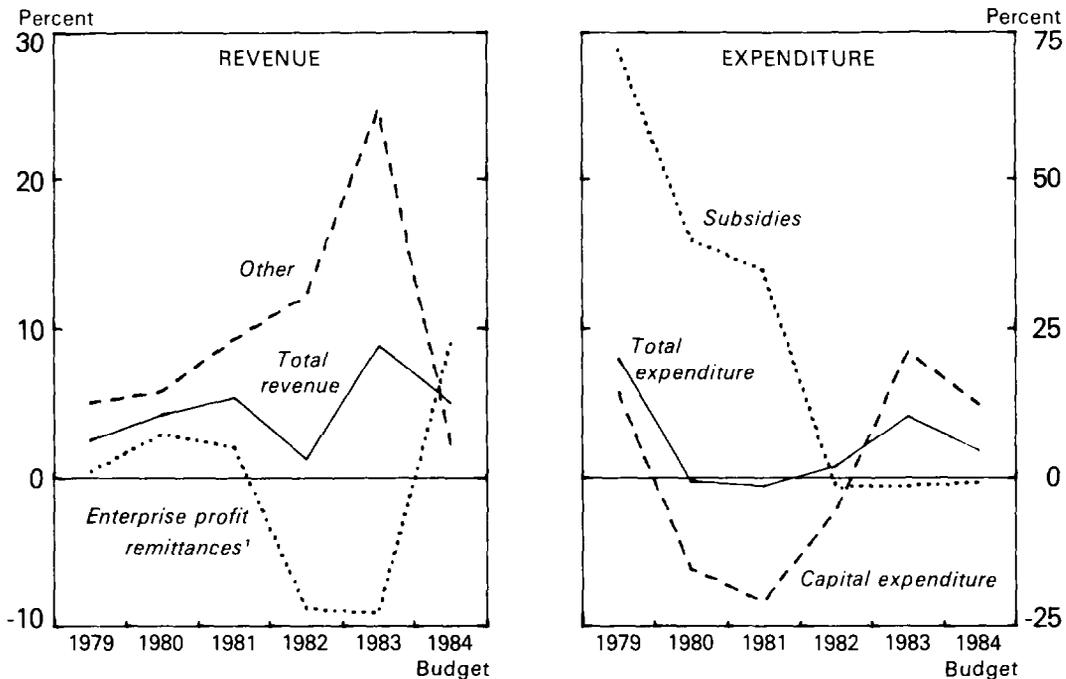




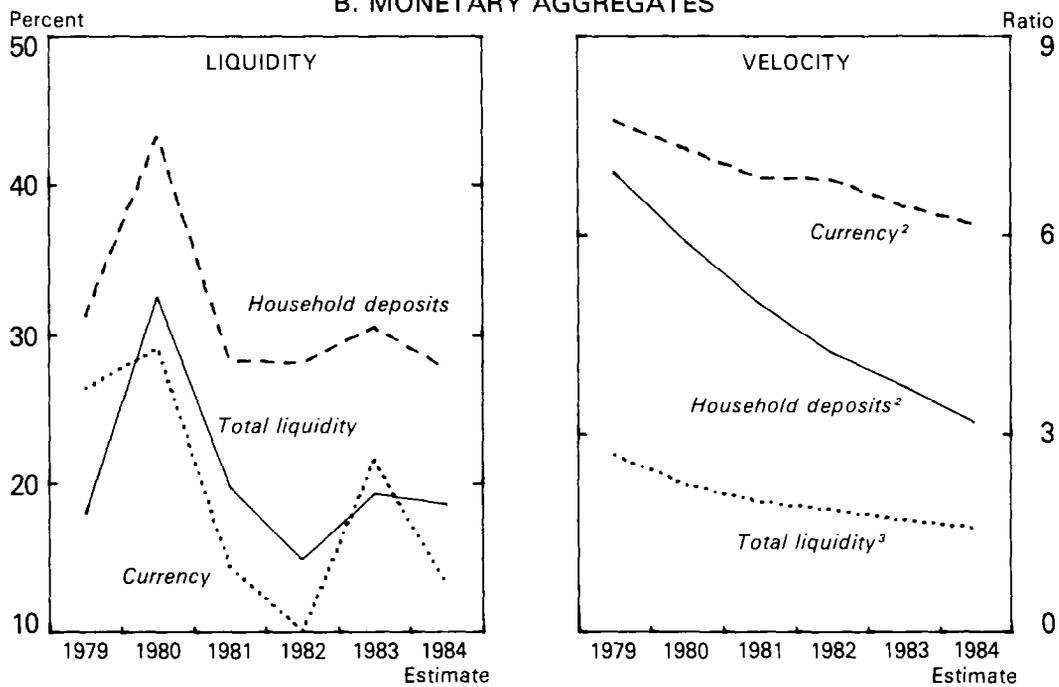
CHART 2
CHINA
FINANCIAL DEVELOPMENTS, 1979-84

(Percentage changes, unless otherwise indicated)

A. BUDGET



B. MONETARY AGGREGATES



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

¹Including income tax on state enterprises introduced in 1983.

²Measured against household cash income.

³Measured against GDP.



Construction Bank. Growth of currency in circulation as well as household and enterprise deposits slowed somewhat during this period.

The balance of payments remained strong in 1983 and the first half of 1984, although the overall surplus in 1983 was smaller than in 1982 (Chart 3). Total gold and foreign exchange reserves increased from \$11.8 billion at the end of 1982 to \$17.1 billion at the end of June 1984. Strong domestic production contributed to continued growth in export volumes and a further increase in China's market share, despite weak demand in many overseas markets; but because of a marked fall in prices, the value of exports declined slightly in 1983. Export earnings accelerated further in the first half of 1984, largely because of a further increase in volumes.

A notable recent change has been the resumption of growth in imports following the decline in 1981-82. The value of imports increased by 11 percent in 1983, but a substantial decline in import prices implied that the underlying increase in volume was much higher. In the first half of 1984 imports were 12 percent higher than a year earlier. There has been a marked change in the composition of imports: the substantial growth in agricultural production caused a sharp fall in imports of agricultural products, while growth in investment expenditures resulted in a significant increase in imports of manufactures.

The surplus on account of services and unrequited transfers increased sharply in 1983, mainly as a result of increased net investment income and another good performance in tourism; the large increase in net investment income resulted from higher earnings on the enlarged holdings of foreign exchange reserves and from the reduction in the stock of commercial debt. The current account showed a surplus of \$4.5 billion (1.6 percent of GDP) in 1983 compared with a surplus of \$5.7 billion (2.2 percent of GDP) in 1982.

The capital account continued to be in virtual balance in 1983. Net foreign direct investment inflows increased to almost \$0.5 billion. Net disbursements on long-term foreign loans rose to \$0.9 billion, partly as a result of a sharp fall in amortization following the advance repayments of commercial loans in 1981 and 1982. Drawings on loans from foreign governments on concessional terms almost doubled. New disbursements on borrowing from commercial banks were limited to a small amount and recourse to deferred payments was sharply reduced. Net inflows of foreign direct investment and borrowing were broadly offset by outflows of Chinese capital, primarily in the form of a substantial investment in foreign bonds--mostly Euro-bonds and bonds of the Japanese government.

Balance of payments data other than those for merchandise trade are not yet available for any period in 1984. However, staff estimates would suggest another sizable current account surplus of about \$4 billion and an overall surplus of about the same magnitude. If such an

overall surplus were to materialize, international reserves would rise to about \$20 billion by end-December, or about 11 months of estimated 1984 imports.

IV. Policy Discussions

1. Reform of economic management

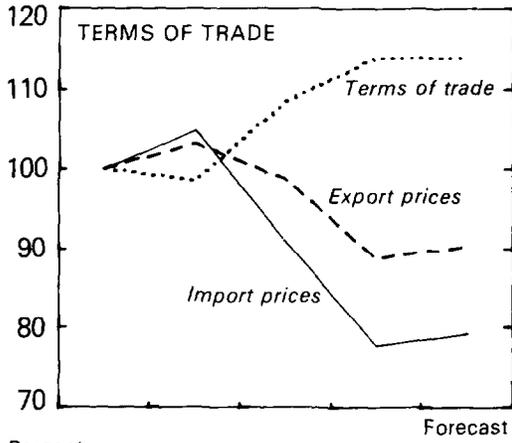
The Chinese authorities stated that they intended to continue the reforms of the economic system. The scope of mandatory planning would be further reduced and the share of production subject to market forces increased. Consequently, the role of indicative planning and market-related economic policy instruments would be expanded. However, just how far this process should be taken was still the subject of considerable discussion within China. The authorities stressed the need to implement reforms carefully, to experiment, and to learn from their mistakes so as to develop the system most appropriate to China's particular situation.

So far, the most extensive reforms have been in agriculture where the State mandatory plan now covers only the procurement of a proportion of output of foodgrains, vegetable oils, and cotton. The sustained rapid growth in agricultural production since the introduction of the responsibility system stems from the greater operational freedom that farmers now have to pursue comparative advantage. The new system, together with the substantial increase in procurement prices, has also greatly increased individual incentives. The internal terms of trade for agriculture improved by a third between 1978 and 1983. These higher relative prices have made it possible for farmers to apply more sophisticated agro-technology, including high-yielding seed varieties, chemical fertilizers, and pesticides, and achieve a major improvement in yields. The strong agricultural performance led to a doubling of rural per capita income between 1978 and 1983, which helped narrow the gap between rural and urban incomes.

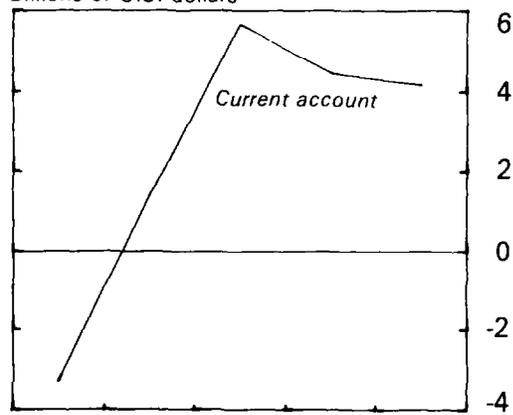
However, these developments have also entailed a number of new policy issues for the authorities. Increases in procurement prices of staple foods, with no corresponding increase in final consumer prices, have resulted in a heavy burden of subsidy payments. The rapid increase in rural incomes requires a substantial expansion in the supply of manufactured consumer goods, agricultural inputs, and construction materials in the rural areas. Also, the increased production and specialization in the rural economy have placed great pressures on storage, transportation, and distribution systems that were designed to serve less productive, more self-sufficient regional economies. Finally, the reforms have released about one third of the labor force that used to be employed in agriculture. As the authorities want to avoid large migration to the urban areas, they are actively promoting nonagricultural employment in the rural areas, through an expansion of

CHART 3 CHINA EXTERNAL SECTOR, 1980-84

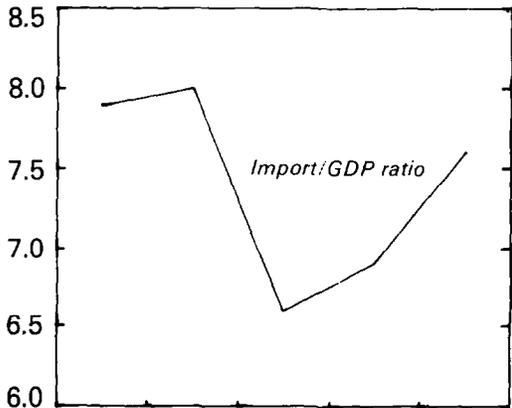
Index: 1980 = 100



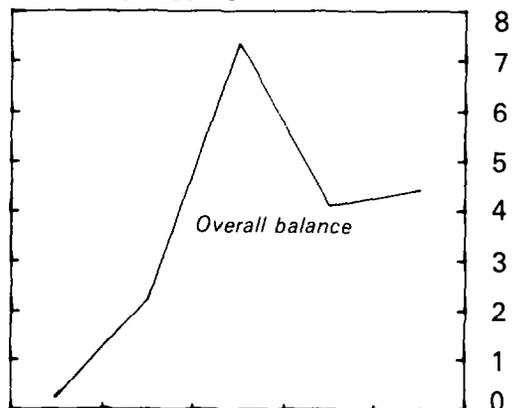
Billions of U.S. dollars



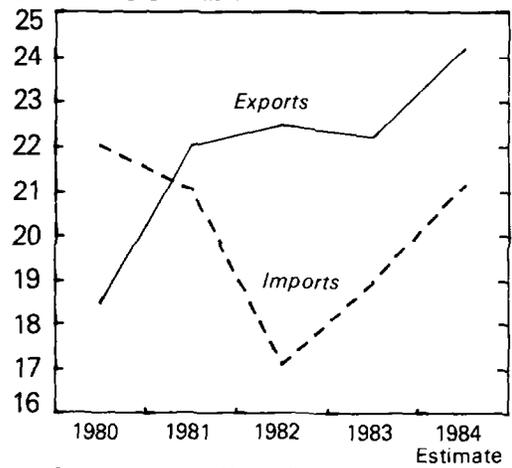
Percent



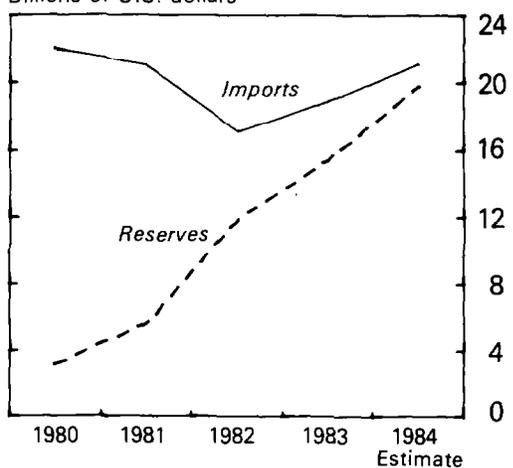
Billions of U.S. dollars



Billions of U.S. dollars



Billions of U.S. dollars



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



rural industry and through the encouragement of collective and small-scale private undertakings in the service, transportation, and construction sectors.

The major focus of reform efforts has now shifted to the urban areas. The authorities recognize that there is considerable scope for improving efficiency in industry and that increased autonomy for enterprises can play a major role in reducing costs and improving returns. A program to restructure many state-owned enterprises is also underway and a number of units with high costs or inefficient energy utilization have been closed, merged, or required to switch to other product lines. Investments in technical improvements have expanded rapidly and the use of advanced foreign technology, either through imported equipment or foreign direct investment, is increasing. Workers' pay is being increasingly linked to their own performance as well as the overall performance of the enterprise, while managers now have greater power to dismiss workers who do not perform well.

Administrative barriers to the internal movement of goods, which had given rise to large inventories and excessive transportation costs, are being dismantled and a more rational distribution system is being put into place. A multichannel distribution system, where state, collective, and private economic units coexist is being promoted. The share of total retail trade conducted by private traders, at prices that are freer to react to changes in supply and demand, has increased from under 10 percent in 1979 to 13 percent in 1983. The rationing of cotton cloth was eliminated in 1983 and now only 6 household commodities 1/ are rationed nationwide, compared with 73 in 1978; additional supplies of the remaining rationed commodities are made available at higher prices. An increasing proportion of transactions between enterprises is being regulated by contractual arrangements rather than administrative assignments. Enterprises are encouraged to enter into contracts with commercial departments to sell part of their output themselves, at more flexible prices, and to choose their own suppliers for most of their inputs.

The authorities recognize that the effectiveness of the reform measures depends increasingly on a price system that provides correct signals for investment and production decisions, and that the existing price system does not yet provide such signals. At present, fixed prices are set for important industrial inputs, consumer goods, and services; such prices, which apply to about two thirds of total retail sales, have in many cases been unchanged for many years. Prices of some other industrial inputs are allowed to float within certain margins (generally up to 20 percent) of a fixed price, while those of a number of less important industrial goods can now be set through consultation between producers and commercial units. Procurement prices for agricultural production covered by the mandatory plan are fixed by the

1/ Foodgrains, edible oils, gasoline, kerosene, diesel oil, and coal.

State, but output in excess of the plan can be sold to the State at a fixed or negotiated premium over these prices, or can be sold on free markets.

The authorities stated that they intend eventually to reform the structure of prices so as to reflect more closely relative costs of production. However, they indicated that such a reform would not take place before the next Five-Year Plan period (1986-90). In the meantime, emphasis would be on a gradual correction of the most distorted relative prices and on widening the coverage of floating and negotiated prices. A major readjustment of the structure of textile prices took place in early 1983 and helped improve the balance of supply and demand between various products, without affecting the general price level. Some transport prices have been increased recently in an effort to reduce losses, and prices of a number of subsidized items, including cotton wadding, chemical fertilizers, and diesel fuel for agricultural use, were also raised. While welcoming these measures and recognizing the complexity of the problem, the staff team stressed the advantages of early action on a more comprehensive reform and of linking domestic prices for traded goods to their international prices.

2. Investment and savings

One element of the new economic strategy was to reduce the comparatively large share of investment in GDP, ^{1/} making more resources available for consumption, and to concentrate on achieving a more efficient utilization of resources so as to lay the foundation for sustained rapid economic growth. However, the principal avenue chosen for achieving greater efficiency--decentralization of financial resources and decision making to enterprises and local governments--also reduced the Central Government's direct control over the level and composition of investment, while more indirect means of economic management had not yet been developed. The rapid growth in extrabudgetary investment through mid-1983 worsened the already tight supply situation for construction materials, causing further delays in project completion, illicit price increases, and diversion of supplies.

To tackle these problems, the authorities introduced a number of measures. These involved the use of indirect economic instruments, although procedures for the approval of investment projects and their financing were also tightened. A special tax (initially 10 percent, but raised to 15 percent in mid-1983) was imposed on most extrabudgetary receipts, including retained profits of enterprises; from October 1983, an additional 10 percent tax was levied on investments financed from

^{1/} China's gross domestic investment amounted to almost 30 percent of GDP in 1982, compared with average ratios of 25 percent for Asian developing countries, 13 percent for the category of low-income countries, and 23 percent for middle-income countries (IBRD, World Development Report, 1984).

such extrabudgetary funds, although investments in the priority energy and transport sectors were exempted. Limits on the extension of bank credit for fixed investment were strengthened, and the use by enterprises and local governments of their own funds for capacity-expanding investment was constrained by requiring their prior deposit with the People's Capital Construction Bank. These measures succeeded in slowing the growth of extrabudgetary investment in 1983 and provided additional budgetary resources for investment in bottleneck sectors. These measures became increasingly effective in the first half of 1984.

A major reform of the construction industry has been started, in an effort to reduce costs and shorten construction cycles. A system of contracts based on fixed prices arrived at through open competitive bidding is being introduced. For this purpose, independent enterprises are being formed, to tender for entire projects; they will then be responsible for sub-contracting specialized work to other enterprises.

Certain aspects of the economic reforms caused a major change in the composition of savings, particularly during 1979-81. The greater decentralization of financial resources resulted in a dramatic decline in the importance of budgetary savings, although this decline was halted in 1983. In contrast, savings by households, especially in rural areas, and by enterprises and local governments have increased substantially in importance and in 1983 accounted for about two thirds of total savings. In particular, household financial savings more than doubled between 1979 and 1983, largely reflecting the rapid increase in incomes. This change has greatly increased the importance of providing adequate financial intermediation, and underscores the importance of the reforms of the banking system. In addition, trial sales of shares in a few state enterprises have been conducted, but the amounts involved have been small. Also, construction and sale of urban housing on a commercial basis is being gradually introduced, in an effort to tap individual savings and help alleviate the housing shortage.

3. Macroeconomic balance and domestic finance

a. Macroeconomic balance

Excess demand pressures in China's economy do not necessarily lead to open inflation or external deficits, but frequently cause illicit price increases and shortages, which in turn result in capacity underutilization and delays in the completion of investment projects. The most recent period of serious macroeconomic imbalance was in 1980, and policies to reduce excess demand since then have included fiscal and monetary restraint, as well as direct controls. They have also involved economic reforms designed to increase the financial responsibility of enterprises, whose deficits tended in the past to be covered automatically by budgetary transfers and bank credits.

By the first half of 1983, however, there were signs that macroeconomic imbalances had begun to re-emerge. Liquidity grew strongly, as did extrabudgetary investment. This led to sectoral demand pressures, straining the supply of construction materials, energy, and other key inputs. Since then, some measures have been taken to slow the growth of investment expenditures. However, it is not yet clear whether these were sufficient to restore fully the macroeconomic balance. There is no clear evidence that sectoral shortages have grown worse over the past year, but growth in liquidity continues to be rapid. The authorities stated that, in their view, there was no particular cause for concern at the present time, although they expected excess demand for some industrial inputs and consumer durables to persist.

b. Budget

Reform measures introduced in the late 1970s dominated budgetary developments up to 1982. Revenues were sluggish, falling from 32 percent of GDP in 1979 to 28 percent in 1982, due to larger profit retentions by enterprises. Efforts to reduce the budget deficit were, therefore, focused on expenditure restraint. With the burden of subsidies growing rapidly, this restraint was achieved through large cuts in investment, which fell by over one third between 1979 and 1982.

In 1983, the emphasis of fiscal policy shifted toward expanding revenues, with the introduction of a new tax on extrabudgetary receipts. This tax raised Y 9.3 billion, accounting for three quarters of the increase in budgetary revenues in that year. Also, an income tax on state enterprises was introduced to replace profit transfers, marking the first stage of a comprehensive reform of enterprise taxation. With this new emphasis on revenue, budgetary receipts rose by 9 percent, faster than in any of the previous several years; however, with the recovery of capital expenditures, total outlays rose slightly faster, so that the budget deficit increased marginally (to 1.7 percent of GDP in 1983 from 1.3 percent in 1982).

The 1984 budget maintains the basic policy objective of containing the overall deficit, budgeted to be about 1.5 percent of GDP. Revenue is budgeted to increase broadly in line with planned output growth (4.6 percent) as is expenditure; the latter includes a further 12 percent increase in capital outlays, while current expenditure is budgeted to rise only slightly. In light of the faster growth in output in the first half of 1984 and a buoyant revenue performance thus far, it is likely that the revenue target for the year will be exceeded. However, the Chinese representatives stated that this could facilitate a corresponding increase in expenditure, leaving the deficit more or less as budgeted. As in 1983, nonbank financing from Treasury bond sales is budgeted at Y 4 billion. The staff team suggested that to reduce recourse to bank financing for the budget and so contain liquidity expansion, bond issues could be increased, possibly accompanied by measures to increase their attractiveness.

The second stage of the tax reform initiated in 1983 is to be implemented in the latter part of this year. The reform is intended to reconcile the potentially conflicting aims of increasing the buoyancy of tax revenues and stimulating enterprises to achieve greater efficiency. Ultimately, in conjunction with a price reform, the new system should simplify the taxation of enterprise profits and provide clearer incentives. For the time being, however, the tax system is being used to cope with the wide variations in enterprise profitability caused by the present price structure. The resulting system is, therefore, highly complex, with a large number of effective rates. In addition, in late 1984, commodity taxes will be adjusted, with increases for some highly profitable commodities, reductions for less profitable ones, and expanded application of the value-added tax; also, a resource tax will be introduced for enterprises benefiting from favorable access to natural resources.

Price subsidies, mainly for grain and edible oil, amount to about one fifth of total budgetary expenditure and about one third of the total urban wage bill. The authorities are concerned about the resulting budgetary burden and efficiency costs, and intend gradually to reduce the scope of subsidies. Since late 1983, subsidies have been reduced for some agricultural inputs, transportation, and a few consumer goods, for a total annual saving of Y 2 billion. However, more extensive reductions in subsidies will require an adjustment to the complex wage system. The authorities are concerned that full compensation for those wage earners with more than the average number of dependents may require a wage increase that overcompensates most, entailing a heavy budgetary burden. The staff team expressed understanding of these difficulties, but suggested that the authorities seek a means to alleviate hardship cases, while avoiding the need to overcompensate most workers. They also suggested that the present situation, characterized by strong income growth for both the urban and rural population and a very favorable agricultural performance, presents a unique opportunity to initiate action in this area.

c. Money and credit

The banking system and sources of enterprise finance are in the process of considerable change. In the past, the budget supplied investment funds and the normal working capital of enterprises as grants, while the banking system supplied only working capital for seasonal or temporary needs. Now, the budget has begun to supply investment funds for revenue-yielding projects in the form of loans rather than grants and limits its supply of working capital only to a few entities. The banks supply virtually all new working capital and, since mid-1983, also have extended their supervision of the use of working capital to such capital derived from all sources. In addition, the banking system now makes substantial loans to finance fixed investment.

As from January 1984, the central banking functions of the People's Bank were separated from its commercial banking functions, which were transferred to the newly-formed Industrial and Commercial Bank. This new arrangement is expected to permit a greater separation between macroeconomic policymaking and the day-to-day concerns of credit management and to allow a better control of credit flows. Initially, the principal policy instruments available to the People's Bank in its new role as a central bank are its control over the credit and deposit plans of the specialized banks, and its ability to set redeposit requirements. At present, the Industrial and Commercial Bank and the Bank of China are required to redeposit 40 percent and 20 percent of household and enterprise deposits, respectively, and the Agricultural Bank is required to redeposit 25 percent; all government deposits are made directly at the People's Bank. In practice, all of the specialized banks have so far been permanent borrowers from the People's Bank. As this is expected to continue, the rate charged on this borrowing is potentially an important instrument of credit control. At present, however, the People's Bank charges the same rate on borrowing by specialized banks as it pays on their redeposits (0.36 percent a month), so that there is no effective penalty on such borrowing. The authorities pointed out that the new system is still experimental, and that changes would be made whenever deemed appropriate.

Interest rates on household savings deposits were raised three times during 1979-82 and range from just under 3 percent for sight deposits, to 5 3/4 percent for one-year time deposits, and to a maximum of 9 percent for eight-year deposits, well above the recorded rate of inflation. Interest is now paid on deposits held by enterprises and local governments, and in 1982 these institutions were also allowed to open time deposits; however, the rates paid are below those on household deposits. Rates on loans have also been increased in recent years, and are now normally about 7 1/4 percent for working capital loans and 5-6 1/2 percent for short- and medium-term equipment loans. ^{1/} Concessional rates exist for high-priority activities, although the number of these rates is being reduced; preferential rates on most loans extended by the Agricultural Bank were abolished in January 1984, increasing the cost of such borrowing by 1-2 percentage points.

In assessing monetary developments, the Chinese authorities have traditionally monitored most closely the expansion of currency in circulation, particularly in relation to trends in total retail sales. Until the introduction of the economic reforms, the authorities considered a velocity in terms of the ratio between retail sales and currency in circulation of about 7 to be normal. However, recent institutional changes have greatly increased the demand for currency, especially in rural areas, and the authorities stated that they no

^{1/} Most deposits are sight and one-year time deposits with interest rates of less than 5 3/4 percent, while most lendings are for working capital with interest rates of 7 1/4 percent.

longer used a specific guideline in assessing trends in currency holdings; in fact, the ratio of retail sales to currency declined steadily to 5.9 in 1983.

The staff team expressed the view that more attention should be given to a broader concept of household liquidity, namely currency plus sight and time deposits, which had increased even more rapidly than currency alone in recent years (Chart 2). Moreover, the increased financial autonomy of enterprises and local governments also meant that developments in their liquidity should be of more concern than in the past. If developments in 1983 and the first half of 1984 are assessed in terms of movements in total liquidity, ^{1/} there is cause for caution. Liquidity growth accelerated in both periods and considerably exceeded the growth of economic activity. Income velocity, measured as a ratio of GDP to total liquidity, fell to 1.7 in 1983 compared with 1.9 in 1982, and 2.7 in 1979; a further decline is projected for 1984. The principal sources of this liquidity growth were a moderate acceleration in enterprise credit and the continued growth in net foreign assets resulting from the strong balance of payments.

In the authorities' view, this sustained liquidity expansion must be judged in the context of the major institutional changes that are occurring. The shift to agricultural production based on individual farming units and the expansion of private and cooperative units in the distribution and service sectors have led to a major increase in demand for money. Also, there has been a continuing rapid growth in money demand associated with the increased procurement of larger harvests and the rapid increase in household incomes. Nevertheless, efforts are being continued to hold down growth in household liquidity by increasing supplies of consumption goods and materials for housing construction, particularly in the rural areas. Agricultural credit has been tightened, through both quantitative controls and an increase in interest rates. Also, enterprises are now required to deposit all funds intended for capacity-expanding investment with the People's Capital Construction Bank; funds deposited after July 1984 may not be utilized until 1985.

The staff team recognized that it was difficult to make a firm judgment about the development of overall liquidity, but suggested that it was better to err on the side of caution and to assess carefully whether some further restraint might not be appropriate. This could include the sale of a larger volume of Treasury bonds to reduce or eliminate the need for bank credit to the budget. They also suggested that the cost of borrowing by the specialized banks from the People's Bank could be raised, so as to increase the effectiveness of control

^{1/} Currency plus sight and time deposits of households, enterprises, and local governments, including deposits with the People's Capital Construction Bank earmarked for investment.

over credit expansion. The authorities said that they would give serious consideration to both suggestions.

4. Relations with the outside world

The authorities stated that the policy of opening the economy to the outside world was part of China's long-term economic strategy and as such would be continued in the coming years. Reflecting this policy, foreign trade has expanded greatly; the combined ratio of exports and imports to GDP rose from 10 percent in 1978 to almost 16 percent in 1983, similar to that of other countries with a large population, such as Brazil and India. Strong growth in export volumes has meant that China's share of world markets has increased steadily since 1978, a trend which the authorities expect to continue over the medium-term. China's present share of total world trade, at just over 1 percent, is still relatively small, although it is greater in respect of particular commodities. For instance, China's exports of textiles and clothing account for about 5 percent of world trade in these products, and for a much larger share for particular items.

Additional measures are being taken to promote foreign trade. The trade system is being reformed to separate the overall policy and regulatory framework from the direct conduct of trade. Foreign trade corporations have been given greater autonomy in their operations and an increasing number of industrial enterprises are being authorized to export directly. Formation of joint ventures between foreign trade corporations and industrial enterprises is also being encouraged to improve supplies of imported inputs and the marketing of products abroad.

On the side of capital, the main thrust of policies is to attract direct investment and concessional loans and to limit foreign borrowing on commercial terms. In the authorities' view, direct investment is an efficient means to help meet China's need for foreign capital, advanced technology, and improved management. New, more favorable treatment for foreign investment in 14 coastal cities was recently announced; patent protection has been introduced; tax incentives for foreign investment have been improved; and regulations governing the purchase of inputs and the sale of a proportion of output on the domestic market have been liberalized. ^{1/} As for foreign debt, China made substantial early repayments of commercial debt in 1981 and 1982 and early repurchases from the Fund in 1983. The authorities stated that China will continue to rely mainly on loans at concessional interest rates, although a small amount of commercial borrowing would be undertaken for specific projects. Total external debt at the end of 1983 was \$6.4 billion or

^{1/} A detailed description of the changes in regulations and incentives for foreign direct investment is contained in an Annex to the accompanying Recent Economic Developments paper.

2.3 percent of GDP and the debt service ratio (including repurchases from the Fund) was 5.5 percent in 1983.

A principal policy issue is the extent to which China's large reserves and its comfortable debt and debt service position provide scope for a further acceleration of imports. The authorities noted that, although reserves were large, a part (about one third of the total) corresponded to the borrowing of the Bank of China. They stated that accumulation of reserves had not been the result of a deliberate policy and should be regarded as a temporary phenomenon. Reserves would decline in due course as a consequence of the Government's policy of accelerating imports. This acceleration would depend on absorptive capacity, and, in particular, on the completion of feasibility studies for some large, import-intensive investment projects. The authorities indicated that further import growth would also be supported by an active but prudent borrowing policy. They considered a debt service ratio of about 15 percent as the maximum permissible.

The staff team agreed with the authorities' policy of expanding imports in line with the growth of absorptive capacity. However, they also pointed out that larger imports could bring significant benefits in terms of reduced domestic shortages and a more rapid improvement in productivity through imported technology. In this context, they discussed with the authorities alternative medium-term balance of payments scenarios. A basic scenario shows that China's reserves could be kept above the minimum level the authorities consider adequate, at least up to 1989, even if imports were to grow much faster than exports. This scenario assumes a 15 percent annual growth in imports and a 9 percent growth in exports, which would represent a modest gain in market share (Appendix Table 7). Also, even assuming a 15 percent annual increase in gross disbursements of foreign borrowing, the debt service ratio would still be under 7 percent in 1990. Alternative scenarios show that a slower growth in exports or a faster growth in imports would, of course, cause reserves to drop at a somewhat earlier date. However, no realistic scenario appears to pose a problem for China's foreign reserves or debt servicing over the medium-term.

The authorities stated that the exchange rate system had remained unchanged since the last consultation, and that the Renminbi (RMB) remained pegged to the same basket of internationally-traded currencies. Reflecting the sharp appreciation of the U.S. dollar, the nominal effective exchange rate for the RMB depreciated by 8.7 percent between November 1983 (when China's exchange rate policy was last reviewed by the Executive Board) and July 1984; the RMB depreciated by 13.3 percent vis-a-vis the U.S. dollar from Y 1.99 to Y 2.29 during this period, and to Y 2.60 as of September 18. As China's rate of recorded inflation was moderate relative to inflation in its trading partner countries, the RMB depreciated by 10.4 percent in real effective terms between November 1983 and July 1984 (Chart 4). Foreign trade and trade-related transactions, representing more than 90 percent of all current transactions,

continue to be conducted at the internal settlement rate. This rate was introduced in January 1981, in light of the decentralization of foreign trade, and has been kept at Y 2.8 = US\$1 since that time; the margin implicit in that rate has narrowed from the original 80 percent to about 8 percent.

The authorities stressed that the internal settlement rate was still only a temporary arrangement which was implemented on an experimental basis and that they were keeping exchange rate developments under close review. They stated that a study of the adequacy of the exchange rate system is being conducted, taking into account domestic and foreign relative prices and domestic cost-price developments. This study, however, is complicated by China's distorted price structure. The staff team expressed the view that an appropriate exchange system should be an integral part of the reformed price system.

China maintains a 10 percent tax on profit remittances by joint ventures. As part of the scheme recently announced for promotion of foreign direct investment in certain designated areas in 14 coastal cities, the removal of this tax is foreseen for investment in such areas.

The authorities stated that the policy to reduce reliance on bilateral payments agreements remains unchanged. No agreements with Fund members have come up for renewal since the last consultation.

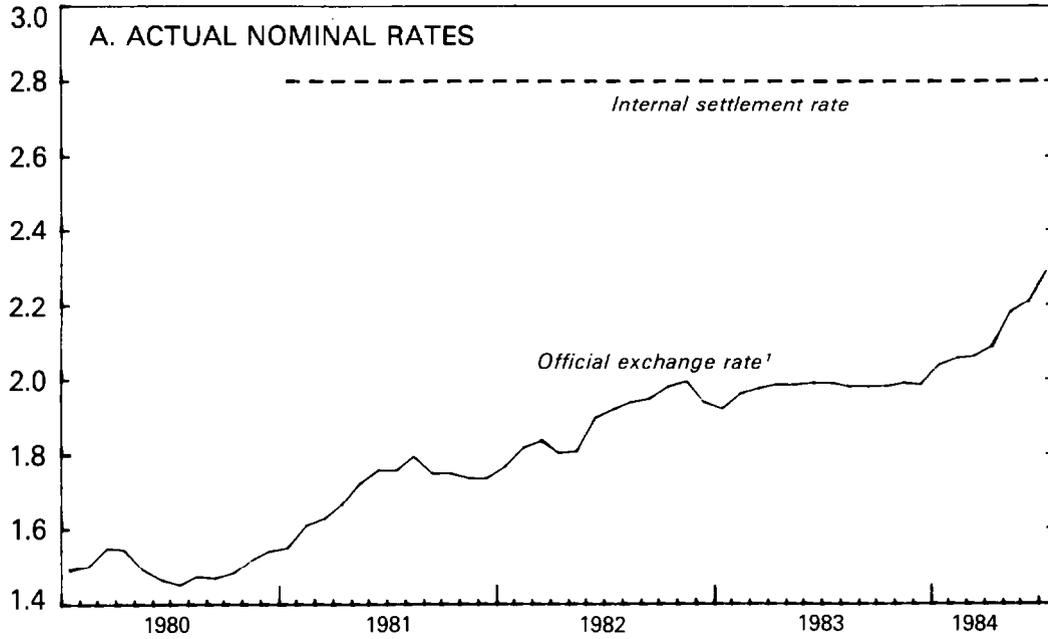
V. Staff Appraisal

The manner in which the Chinese authorities have steered the economy in recent years deserves admiration. While preserving the basic socialist orientation of the economy, with its emphasis on public ownership and concern for the distribution of income, the authorities have set in train a series of changes that have lent a new dynamism to the economy. This is most evident in agriculture, the sector which is crucial to the performance of the economy and the well being of the people. The buoyancy of aggregate supplies has kept shortages from becoming excessive and has contributed to the continuing strength of the balance of payments. Some of the basic problems of the economy remain, of course, while the successes have posed new challenges, such as the need to provide larger supplies of both consumer and investment goods to satisfy the stronger demand emanating from the agricultural sector and the need to create new employment opportunities for the manpower rendered surplus on the farms. These problems and challenges continue to be faced in a pragmatic fashion.

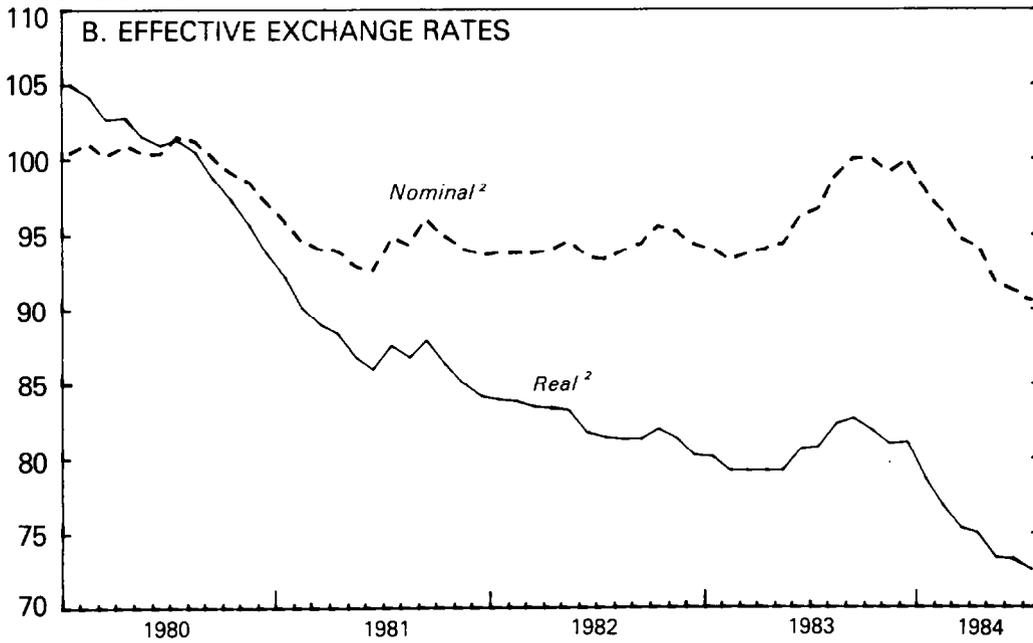
The progress made in the last few years as well as the forthrightness with which weaknesses in the system are identified and addressed gives hope for the future. Nevertheless, on any broad reckoning, the fundamental task of substantially raising the present low per capita income remains formidable. Recent rates of economic growth have been

CHART 4 CHINA EXCHANGE RATES, 1980-84

Yuan per U.S. dollar



Index: 1980 = 100



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

¹Higher figures indicate more depreciated rates.

²Higher figures indicate more appreciated rates.



consistent with the authorities' goal of quadrupling output during the period 1980-2000. However, there is still a long way to go and the achievement of the target will require perseverance with the present broad direction of policies which is aimed at promoting greater efficiency of the economic system. Effectively raising living standards will require in addition an appropriate slowing of population growth, an aspect of policy that is as important as it is complex and delicate.

Focusing now on areas of direct concern to the surveillance process, the staff considers that three broad questions deserve special attention: (1) the present state of the macroeconomic balance and whether or not a slowing down of monetary expansion from its current tempo would be appropriate; if so, how it could be brought about; (2) whether or not given the present large foreign exchange reserves and low external debt and debt service burden, imports should be further accelerated; and, (3) the scope and speed of further reform of the economic system.

(1) On the first issue, it is difficult to assess with confidence the state of the macroeconomic balance and the appropriateness of the present rate of monetary expansion. The recorded rate of price inflation is not by itself an adequate indicator. Systematic information about shortages and bottlenecks, and about changes in their severity, is difficult to come by. Moreover, in an economy like China's, shortages are endemic and may not necessarily represent aggregate excess demand pressures arising from financial developments. On the other hand, the various structural changes taking place in the economy--and especially the increased monetization of rural areas--probably require a faster growth of currency circulation than in the past.

All the same, it does appear that the strong demand for investment and consumer goods continues to press hard against supplies. Although staple foodstuffs are in abundant supply and the scope of rationing has declined, shortages of better quality consumer products as well as energy, construction materials, and some industrial raw materials remain prevalent. While fiscal policy has been fairly cautious in recent years, with overall deficits held below 2 percent of GDP, moderately rapid growth in credit to enterprises and other units, together with a sharp expansion in net foreign assets, has contributed to high rates of growth in liquidity. Not only currency in circulation, but also sight and time deposits of households have grown rapidly. Enterprises also are quite liquid, even after the imposition of new taxes on their retained funds. The authorities have introduced some measures intended to slow the use of enterprise liquidity for investment purposes. Nevertheless, the risk remains that the already tight supply situation would be exacerbated if the recent rates of liquidity expansion continue.

In these circumstances, it might be better to err on the side of caution, and implement some further measures to contain the rapid growth in overall liquidity. A somewhat more restrictive credit policy, aided by an increase in the rate charged on the People's Bank's lending to the specialized banks, and greater reliance on Treasury bonds to finance the budget deficit, would be helpful. In addition, the relatively cautious fiscal policies of recent years should be continued. The recent establishment of the People's Bank as a central bank has laid a foundation for improved future credit policy and development of the necessary monetary instruments.

(2) More than one view can be held about the appropriateness of China's present high level of foreign exchange reserves and the likely future addition to it, and of the small volume of external debt. On the one hand, it is possible to argue that given the immense development needs of the economy, China should substantially accelerate imports by drawing down reserves and/or borrowing abroad more aggressively. On the other hand, the authorities emphasize that the recent increase in foreign exchange reserves is not the result of deliberate policy but of a number of temporary factors. They argue that reserves are likely to be drawn down quite quickly once a number of large-scale projects now being prepared get under way. They also stress their intention to pursue an active but still prudent borrowing policy. At the same time, however, they emphasize their determination not to rush into importing at rates in excess of domestic absorptive capacity and to take the time necessary to carefully prepare their investment projects. In the staff view, this latter emphasis and the implied desire to carefully manage foreign exchange resources is appropriate. Having said this, however, the staff also believes that the present level of reserves could support some expansion of imports in the short term designed to renovate existing industrial plant and equipment and upgrade technology, alleviate shortages in crucial sectors, or to support trade liberalization measures or a substantial price reform. The staff also considers appropriate the policy of attracting direct foreign investment as a channel for importing foreign savings, technology, and managerial skills.

(3) The authorities have so far demonstrated a notable ability to implement reforms of the economic system in a pragmatic fashion, and have stated that the reform process will continue. While the staff cannot make confident judgments as to the pace of future reforms that would be most appropriate to China's situation--an issue that is as political as it is economic--it can point to a number of key areas where early action could bring substantial benefits.

The most important action would be a readjustment of the price structure, which does not yet provide the information needed to make correct allocation decisions, especially in a more decentralized system. Also, despite recent increases in the prices of some subsidized items, budgetary expenditures on subsidies remain large. Without significant price adjustments, the current reforms will not yield their

full potential and the task of macroeconomic management will be complicated. The authorities agree with this view, but are not yet ready to implement a comprehensive price reform. For the time being, they intend to correct some of the largest relative price distortions, and to rely on tax devices to offset some of the large variations in profitability across industries; the resulting tax system is complex. The staff would suggest that, in light of the present favorable economic situation, price reform be given greater priority and that domestic prices be brought more in line with those prevailing internationally. Also, for a reformed price system to continue to operate efficiently it will have to ensure that not only production costs but also demand pressures are reflected in relative prices. The authorities' concern to avoid adverse distribution effects that might result from substantial price increases on subsidized commodities, even if accompanied by a compensating wage increase, is understandable. Such adverse effects could be minimized by selective measures designed to compensate the most affected groups, while avoiding large wage increases that would overcompensate most workers.

The staff believes that an important complement to the price reform would be an exchange system that provides an effective link between international prices and those faced by domestic producers and consumers. The official exchange rate for the RMB is linked to a basket of internationally traded currencies. The RMB depreciated by 10.4 percent in real effective terms between November 1983, when the Executive Board last discussed China's exchange rate policy, and July 1984. In addition, China maintains a more depreciated internal settlement rate, which applies to all foreign trade and related transactions. This rate has remained unchanged at Y 2.8 = US\$1 since it was introduced in January 1981, but the margin between it and the official rate has narrowed substantially. With some enterprises now allowed to export and import directly at world market prices, rather than through foreign trade corporations, the internal settlement rate affects the domestic price of a growing share of foreign trade transactions. However, final prices received by most export producers and paid by most import users still do not reflect this rate, but are based instead on domestic prices. The authorities stressed that the present exchange system was still temporary and that they are presently evaluating the experience gained from it with a view to establishing a system that corresponds to China's needs. The staff believes that early action in this area is desirable.

The existence of the internal settlement rate, as well as the tax on remitted profits of joint ventures, in force since 1980, constitute multiple currency practices subject to approval under Article VIII. China's strong external position makes such practices unnecessary and the staff does not recommend their approval by the Executive Board.

In conclusion, the staff would make a brief comment on the international implications of recent developments in China and its progressive opening up to the world economy. China's more open external

policies have so far not had a large overall impact because China still accounts for only a small share of total world trade. However, the effects of greater import demand and increased export competition have already been significant in the markets for particular goods. This is only to be expected. In the longer term, of course, both China and the rest of the world, operating together in a multilateral trading system, can only benefit from the increased specialization and greater use of advanced technology resulting from China's increasing integration with the world economy.

The scope and quality of China's economic and financial statistics have improved considerably since the last consultation, in particular in the area of balance of payments. The staff has benefited from this improvement, as it has permitted a much better understanding of the economy. However, as indicated in Annex IV, information gaps remain, especially in respect of the coverage and detail of budgetary and monetary data, as well as external debt and foreign trade price indices. The staff continues to work with the authorities in improving data, including those for the Fund's statistical publications.

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

VI. Proposed Decision

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

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Section 3, in concluding the 1984 Article XIV consultation with China, in the light of the 1984 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
2. China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The Fund notes with satisfaction the intention of the authorities to eliminate the remaining bilateral payments arrangements with Fund members. The maintenance by China, in addition to the official rate, of an internal settlement rate for trade transactions and an exchange tax on remitted profits of joint ventures, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The exchange restrictions, multiple currency practices and bilateral payments arrangements that relate to this decision are described in SM/84/221 (10/3/84) and in SM/.../84 (10/.../84).

Table 2. China: National Income and Output, 1980-84

	1980	1981	1982	1983	1984 Estimate
(In percent change at constant 1980 prices)					
National income	6.4	4.8	8.3	9.1	8.0
Gross agricultural output	3.9	6.6	11.0	9.5	6.0
Gross industrial output	8.7	4.1	7.7	10.5	10.0
Light industry	18.4	14.1	5.7	8.7	10.0
Heavy industry	1.4	-4.7	9.9	12.4	10.0
(In millions of tons, unless otherwise specified)					
Grain	320.6	325.0	353.4	387.3	404.0
Cotton	2.7	3.0	3.6	4.6	5.0
Oil bearing crop	7.7	10.2	11.8	10.6	10.6
Coal	620.0	622.0	666.0	715.0	720.0
Crude oil	106.0	101.2	102.1	106.1	110.0
Steel	37.1	35.6	37.2	40.0	...
Cotton yarn	2.9	3.1	3.4	3.3	...
Cotton cloth (bn. meters)	13.5	14.3	15.4	14.9	...

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

Table 3. China: Investment and Savings, 1980-84

	1980	1981	1982	1983	1984 Estimate
	(In billions of yuan)				
Total investment	<u>138.5</u>	<u>133.9</u>	<u>146.7</u>	<u>166.9</u>	<u>185.0</u>
Fixed investment	<u>111.3</u>	<u>101.1</u>	<u>120.0</u>	<u>136.9</u>	<u>152.0</u>
Public fixed investment <u>1/</u>	74.6	66.8	84.5	95.2	104.0
Budget financed	38.2	28.7	31.0	38.7	45.0
Extrabudgetary	36.4	38.1	53.5	56.5	59.0
Other fixed investment <u>2/</u>	36.7	34.3	35.5	41.7	48.0
Stockbuilding and work-in-progress	27.2	32.8	26.7	30.0	33.0
Total savings	<u>132.7</u>	<u>132.6</u>	<u>156.3</u>	<u>174.7</u>	<u>193.0</u>
Balance on external trade in goods and services	<u>-5.8</u>	<u>-1.3</u>	<u>9.6</u>	<u>7.8</u>	<u>8.0</u>
	(In percent of GDP)				
Total investment	32.3	29.2	29.8	30.8	31.0
Total savings <u>3/</u>	30.9	28.9	31.7	32.3	32.4
Of which: Household financial savings <u>4/</u>	(4.5)	(3.6)	(4.3)	(5.8)	(...)
Current account surplus of the budget	(8.2)	(7.5)	(6.4)	(6.8)	(...)

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

1/ This item corresponds to the sum of "capital construction" and "renewal of equipment and technical transformation" in national data.

2/ Investment in collectively-owned units and by households.

3/ Because the production and expenditure sides of China's national accounts are estimated separately, there is a statistical discrepancy between the two that complicates estimation of the savings rate. Alternate estimates of savings could be 1-2 percentage points lower.

4/ Change in savings deposits and currency holdings plus subscription to Treasury bonds.

Table 4. China: Overall Budgetary Operations, 1980-84

(In billions of yuan)

	1980	1981	1982	1983		1984
				Budget	Outcome	Budget
Revenue	131.6	138.6	140.3	150.0	152.7	160.2
Tax revenue <u>1/</u>	57.2	63.0	70.0	79.0	87.0	89.0
Gross profit remittances	70.9	72.3	65.9	68.6	59.9 <u>2/</u>	65.3 <u>2/</u>
Other	3.5	3.3	4.4	2.4	5.8	5.9
Expenditure	146.2	143.9	146.8	157.5	161.7	168.9
Current	99.0	106.6	111.6	118.2	119.1	121.1
Subsidies <u>3/</u>	27.4	36.9	36.3	36.2	35.8	35.5
Other	71.6	69.7	75.3	82.0	83.3	85.6
Capital	47.2	37.3	35.2	39.3	42.6	47.8
Capital construction	41.9	33.1	30.9	36.2	38.3	44.2
Other	5.3	4.2	4.3	3.1	4.3	3.6
Surplus (+)/Deficit (-)	-14.6	-5.3	-6.5	-7.5	-9.0	-8.7
Financing	14.6	5.3	6.5	7.5	9.0	8.7
Domestic	12.4	2.1	6.7	6.5	7.9	6.4
Bank <u>4/</u>	12.4	-2.8	2.3	2.5	3.7	2.4
Nonbank <u>5/</u>	--	4.9	4.4	4.0	4.2	4.0
Foreign <u>6/</u>	2.2	3.2	-0.2	1.0	1.1	2.3
Gross borrowing	4.3	7.3	4.0	5.4	3.8	5.1
Less: amortization	-2.1	-4.1	-4.2	-4.4	-2.7	-2.8
				(As percent of GDP)		
Subsidies	6.4	8.0	7.4	6.7	6.6	6.0
Capital construction	9.8	7.2	6.3	6.7	7.1	7.4
Overall deficit	-3.4	-1.2	-1.3	-1.4	-1.7	-1.5
Bank-financed deficit	-2.9	0.6	-0.5	-0.5	-0.7	-0.4

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

1/ Includes new taxes on extrabudgetary revenues and investment introduced in 1983.

2/ Includes income tax on state enterprises.

3/ Price subsidies on living necessities and agricultural inputs, plus operating losses of state industrial enterprises.

4/ Gross borrowing less repayments to the People's Bank of China and use of deposits.

5/ Treasury bonds.

6/ Foreign borrowing by the Ministry of Finance through the Bank of China, including all official loans, deferred payments, energy credits, and buyers' credits.

Table 5. China: Monetary Survey, 1980-84

	1980	1981	1982	1983	1984 Estimate	1980	1981	1982	1983	1984 Estimate
	(In billions of yuan, end-year)					(Change in percent)				
Net foreign assets	-2.8	2.7	16.1	23.9	34.0	--	--	496	48	41
Domestic credit	253.3	287.0	320.5	366.4	415.9	27	13	12	14	13
Budget (net)	3.7	0.9	3.2	6.9	9.9	...	-76	256	116	43
Other <u>1/</u>	249.6	286.1	317.3	359.5	406.0	19	15	11	13	13
Currency and demand deposits	45.2	53.3	60.4	74.8	88.0	33	18	13	24	17
Currency	34.6	39.6	43.9	53.0	60.0	29	15	11	21	15
Individual sight deposits	10.6	13.7	16.5	21.8	28.0	49	29	20	32	27
Other deposits	147.9	177.9	205.3	242.2	289.0	32	20	15	18	19
Individual time deposits	32.1	41.1	53.7	69.8	89.0	41	28	31	30	27
Enterprise deposits	70.8	81.7	87.3	99.5	120.0	20	15	7	14	20
Other <u>2/</u>	45.0	55.0	64.3	72.9	80.0	49	22	17	13	10
Total liquidity	193.1	231.2	265.7	317.0	377.0	33	20	15	19	19
Other liabilities (net)	57.4	57.9	71.0	72.5	72.9	9	1	23	2	--

Sources: Consolidated balance sheets of the People's Bank of China, the Bank of China, and the Agricultural Bank of China; the balance sheets of the Rural Credit Cooperatives; and staff estimates; the operations of the People's Capital Construction Bank are not included; the reconciliation between this table and the data published in IMF, International Financial Statistics, is given in the Recent Economic Developments paper which will be issued shortly.

1/ Credit to industrial, commercial, and agricultural production units and households.

2/ Deposits of government units, organizations, the armed forces, and schools, budgetary deposits of local authorities and enterprises with the People's Capital Construction Bank earmarked for investment and redeposited with the People's Bank of China, and other deposits with the Rural Credit Cooperatives.

Table 6. China: Balance of Payments, 1980-84

(In millions of U.S. dollars)

	1980	1981	1982	1983	Staff Forecast 1984
Current account	<u>-3,281</u>	<u>1,349</u>	<u>5,667</u>	<u>4,457</u>	<u>4,170</u>
Exports, f.o.b.	18,492	22,027	22,476	22,223	24,220
Imports, f.o.b.	-22,049	-21,047	-17,113	-18,955	-21,170
Trade balance	-3,557	980	5,363	3,268	3,050
Services (net)	-294	-203	-167	678	590
(Credit)	(2,409)	(3,130)	(3,513)	(4,166)	(4,560)
(Debit)	(-2,703)	(-3,333)	(-3,680)	(-3,488)	(-3,970)
Net unrequited transfers	570	572	471	511	530
Net invisibles	276	369	304	1,189	1,120
Capital account (net)	<u>1,836</u>	<u>93</u>	<u>123</u>	<u>186</u>	<u>210</u>
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	--
Allocation of SDRs	146	142	--	--	--
Overall balance	<u>372</u>	<u>1,925</u>	<u>6,275</u>	<u>4,093</u>	<u>4,380</u>
Reserves and related items ^{1/}	<u>-372</u>	<u>-1,925</u>	<u>-6,275</u>	<u>-4,093</u>	<u>-4,380</u>
Gold ^{2/}	19	55	25	27)
Foreign exchange	-108	-2512	-6,361	-3,341)
Reserve position in Fund SDRs	-191	191	--	-176) -4,380
Use of Fund credit	--	524	--	-482	--

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

^{1/} (-) indicates increase.

^{2/} Difference between the U.S. dollar value initial stock at SDR 35 per fine ounce and the final stock at that price.

Table 7. China: A Medium Term Balance of Payments Scenario, 1982-90 ^{1/}

(In billions of U.S. dollars)

	<u>Assumed Change</u> Percent	<u>1982</u> Actual	<u>1983</u> Actual	<u>1984</u> Est.	<u>1985</u> Proj.	<u>1986</u> Proj.	<u>1987</u> Proj.	<u>1988</u> Proj.	<u>1989</u> Proj.	<u>1990</u> 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 ^{2/}	22.5	22.2	24.2	26.4	28.8	31.4	34.2	37.3	40.6
Imports, f.o.b.	15	-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	(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 ^{3/}	5.5 ^{4/}	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/} This table is not intended as a forecast of balance of payments developments. The assumed growth rates are chosen to illustrate a medium-term balance of payments scenario, and are not predicted values.

^{2/} 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.

^{3/} The rate was unusually high in 1982 because of advanced repayments of commercial debts; excluding such early repayments, the ratio was 6.6 percent.

^{4/} Excluding repurchase of Fund credits, the ratio was 3.7 percent.

China--Fund Relations
(As of September 30, 1984)

I. Membership status

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

A. Financial Relations

II. General Department

- a. Quota: SDR 2,390.90 million
- b. Total Fund holdings of currency: SDR 2.2 billion or 90.62 percent of quota
- c. Reserve tranche: SDR 224.0 million
- d. Current operational budget (September-November 1984):
Maximum use of SDR 93.4 million
- e. Lending to the Fund: None

III. Stand-by or Extended Arrangement and Special Facilities

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

IV. SDR Department

- a. Net cumulative allocation: SDR 236.8 million
- b. Holdings: SDR 404.7 million (170.9 percent of cumulative allocation)
- c. Current designation plan (September-November 1984):
SDR 7.9 million

V. Administered Accounts

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

VI. Overdue obligations to the Fund: None

B. Nonfinancial RelationsVII. Exchange Rate Arrangement

China's currency, the Renminbi, is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions. The representative rate is determined as the mid-point between the buying and selling rate of the Renminbi to the U.S. dollar. As of September 29, 1984, the representative rate for the Renminbi was Y 2.599 per U.S. dollar. China maintains an internal settlement rate of Y 2.8 per U.S. dollar for all trade and trade-related transactions. This constitutes an unapproved multiple exchange practice.

VIII. Last Article IV Consultation

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

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

IX. Technical Assistance

Since 1980, the IMF Institute has received 29 Chinese officials in its courses and seminars. Also, in late 1983, the Institute organized a three-week course in China (Xian) on "Banking and Monetary Policy."

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

X. Resident Representative/Advisor: None

Relations of China with the IBRD-IDA

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

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

	<u>Commitments</u>		<u>Disbursements</u>	
	IDA	IBRD	IDA	IBRD
	<u>(In millions of U.S. dollars)</u>			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.6	--
1983	150.4	463.1	24.6	0.6
1984	423.5	616.0	111.5	19.6

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

Economic Development
Institute:

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

Economic missions:

The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, "China: Recent Economic Trends and Policy Developments" (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984 an economic mission visited China focusing on long-term economic issues and options. A Fund staff member participated in this mission. It is presently planned to send a draft report to the Chinese authorities by December 1984, and to circulate the final report to the Executive Directors in early 1985.

CHINA

Basic Data

<u>Area</u>	3,748,800 sq. miles (9,597,000 sq. km.)			
<u>Population (end 1983):</u>	1,025 million			
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
<u>GDP (in billions of yuan, at current prices)</u>	429.5	458.7	493.7	541.1
<u>Population growth (in percent, mid-year)</u>	1.7	1.3	1.4	1.2
<u>GDP per capita (US\$)</u>	292	271	260	268
<u>Annual percentage changes</u>				
Real GDP	6.4	4.8	8.3	9.1
Real gross industrial output	8.7	4.1	7.7	10.5
Real gross agricultural output	3.9	6.6	11.0	9.5
Gross investment (current)	...	3.3	9.6	13.8
Budgetary revenue	4.2	5.3	1.2	8.8
Budgetary expenditure	-0.5	-1.6	2.0	10.1
Currency in circulation	29.1	14.5	10.9	20.7
Total liquidity	32.6	19.7	14.9	19.3
Domestic credit	26.8	13.5	11.9	14.3
Cost of living index	7.5	2.5	2.0	2.0
Agricultural procurement prices	7.1	5.9	2.2	4.4
Value of imports (balance of payments basis in U.S. dollars)	36.0	-4.5	-18.7	10.8
Value of exports (balance of payments basis in U.S. dollars)	35.4	19.1	2.0	-1.1
<u>Ratios to GDP (in percent)</u>				
Agricultural production	33.6	35.7	37.8	38.7
Industrial production	39.3	37.2	36.5	36.2
Total investment	32.3	29.2	29.8	30.8
Budgetary expenditure	34.0	31.4	29.7	29.9
Budgetary revenue	30.6	30.2	28.4	28.2
Budget deficit	3.4	1.2	1.3	1.7
Imports of goods and services (balance of payments basis)	8.8	9.3	8.0	8.2
Exports of goods and services (balance of payments basis)	7.4	9.6	10.0	9.6
Currency in circulation	8.1	8.6	8.9	9.8
Total liquidity	45.0	50.4	53.8	58.6
Domestic credit	59.0	62.6	64.9	67.7
<u>Balance of payments (US\$ mn.)</u>				
Exports, f.o.b.	18,492	22,027	22,476	22,223
Imports, f.o.b.	-22,049	-21,047	-17,113	-18,955
Trade balance	-3,557	980	5,363	3,268
Current account balance	-3,281	1,349	5,667	4,457
Capital account (net) ^{1/}	1,836	93	123	186
Overall balance	372	1,925	6,275	4,093
<u>International reserves (US\$ mn.)</u>				
(In months of imports)	1.7	3.2	8.3	9.8
<u>Debt service payments</u>				
(Percent of exports of goods and services)	5.8	8.6 ^{2/} 5.4 ^{3/}	10.9 ^{2/} 6.6 ^{3/}	5.5 ^{2/} 3.7 ^{3/}
<u>Official exchange rate</u>				
(Yuan per U.S. dollar, average during the year)	1.498	1.705	1.889	1.977

^{1/} Excluding errors and omissions.

^{2/} Includes early repayments/repurchases.

^{3/} Excludes early repayments/repurchases.

China - Statistical Issues1. Coverage, currentness, and reporting of data in IFS

	<u>Latest Data</u> <u>September 1984 IFS</u>	
Real Sector	- National Accounts	1983
	- Prices	Q2 1984
	- Production	1983
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Central Bank	n.a.
	- Deposit Money Banks	n.a.
	- Other Financial Institutions	n.a.
	- Monetary Survey	Q1 1984
External Sector	- Merchandise Trade: Values	May 1984
	- Merchandise Trade: Prices	n.a.
	- Balance of Payments	n.a.
	- International Reserves	May 1984
	- Exchange Rates	July 1984

During the past year, the reporting of data for inclusion in IFS has improved considerably; the present coverage of the data published, however, remains limited.

2. Outstanding statistical issuesa. Real sector

The data available for publication on National Accounts relate to one aggregate - National Income - and are on the Material Product System basis. Conversion of these data to a United Nations' System of National Accounts basis, and presentations on both bases would make data for China more suitable for the purpose of international comparisons.

During the Bureau of Statistics mission in March 1984, the authorities agreed to provide monthly data on industrial production and to commence reporting data on employment and earnings, for publication in IFS.

b. Government Finance

The Fund's proposals for improving the availability of government finance statistics were discussed during the recent Bureau of Statistics mission and, as a first step, the authorities agreed to respond to the GFS questionnaire.

c. Monetary Accounts

Data are highly aggregated and are provided on a quarterly basis for the Monetary Survey of IFS. The institutional coverage, detail, and frequency of these data could be improved to facilitate comparison with other countries.

d. Balance of Payments

The authorities have indicated that it is unlikely that balance of payments data would be published before 1986 and, until then, the data reported would be for the internal use of the Fund only. In view of China's importance in the world economy, the inclusion of balance of payments data for China in Fund publications would be desirable.

3. Data provided for the internal use of the Fund

The authorities have provided detailed data on the balance of payments and external debt, which are presented in the present report and in the accompanying Recent Economic Developments paper. They have also supplied the quarterly data on consumer price indices for 1983, which facilitated the calculation of a number of key variables in real terms. Conversion of National Income data to GDP are staff estimates based on information provided by the authorities.