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10:00 a.m., November 7, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	M. K. Bush
	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	
H. Fujino	T. Yamashita
	B. Goos
J. E. Ismael	
	L. Leonard
A. Kafka	C. Robalino
	A. S. Jayawardena
	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	
P. Perez	
J. J. Polak	
A. R. G. Prowse	A. V. Romuáldez
G. Salehkhou	
J. Tvedt	A. Lindø
	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Asian Department: Tun Thin, Director; P. R. Narvekar, Deputy Director; H. Neiss, Deputy Director; K. A. Al-Eyd, L. H. De Wulf, M. J. Fetherston, K. Saito, S. Takagi. Central Banking Department: L. M. Koenig, Deputy Director; P. Duvaux. European Department: R. P. Hicks. Exchange and Trade Relations Department: M. Allen, E. H. Brau. External Relations Department: Zhang Z. Legal Department: Ph. Lachman. Research Department: W. C. Hood, Economic Counsellor and Director. Western Hemisphere Department: G. Jauregui. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, S. M. Hassan, G. E. L. Nguyen, P. Péterfalvy, M. Z. M. Qureshi, A. Steinberg, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, I. Angeloni, Chen J., L. E. J. M. Coene, J. de la Herrán, G. Ercel, V. Govindarajan, N. Haque, G. D. Hodgson, A. K. Juusela, H. Kobayashi, K. Murakami, E. Olsen, J. Reddy, D. J. Robinson, C. A. Salinas, Shao Z., S. Sornyanyontr, L. Tornetta, Wang C. Y., B. D. White.

1. PEOPLE'S REPUBLIC OF CHINA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the People's Republic of China, together with a proposed decision concluding the 1984 Article XIV consultation (SM/84/221, 10/3/84; and Sup. 1, 11/1/84). They also had before them a report on recent economic developments in China (SM/84/229, 10/24/84; Cor. 1, 11/6/84; and Cor. 2, 11/7/84), together with the full text of the October 1984 decision of the Central Committee of the Communist Party of China on the reform of the economic structure (EBD/84/277, 10/29/84; and Cor. 1, 11/5/84).

Mr. Zhang made the following statement:

The economic trends of 1983 have continued into 1984, and favorable developments in many sectors have been consolidated and strengthened. The most important recent achievements have been the sustained rapid growth in agricultural and industrial output, the improvement in the living standard of the population, the success in carrying out key capital construction projects and in controlling the level of investment, the expansion of domestic and foreign trade, and, in the fiscal field, the satisfactory fulfillment of budgetary revenue plans. Nevertheless, certain structural weaknesses and limitations continued to hinder greater achievements. Energy and transportation still constitute critical constraints upon the overall rate of growth, economic performance and efficiency have improved only slowly, and the composition of industrial output has not adapted with sufficient speed to the changing patterns of domestic and foreign demand. In particular, the supply of both producer and consumer goods to rural areas has failed to keep up with demand resulting from the rapid growth in agricultural production.

The significance of these recent achievements and difficulties can only be properly assessed in the context of the program of reforms that China embarked upon in 1979. The measures so far implemented under the program have already brought about important changes in the functioning of the economy. As I emphasized in my statement to the Board on the occasion of the 1983 Article IV consultation (EBM/83/157, 11/21/83), the reform program should be regarded as an integrated project aimed at a comprehensive remodeling of the existing system to meet the new situations confronting the economy along with the achievement of a more advanced stage of socialist development. Such a fundamental reform of the system necessarily involves a gradual implementation, and the introduction step by step and on a trial basis, of concrete solutions to specific problems as they arise. On the basis of experience over the previous three years, the Government has been extending and deepening the scope of reform measures since early 1983, culminating in the formal adoption of a decision on reform of the economic structure on October 20, 1984.

It should be pointed out that the Government considers it only realistic to aim at implementing this program over a five-year year period.

On the reform of the rural economy, during 1984 the Government has implemented further measures, strengthening and extending to the entire rural economy the system of contractual responsibility and free disposal of output after fulfillment of contracts, which has been mainly responsible for the current expansion of agricultural output and income. These measures have included lengthening the period of contract, easing conditions for hiring rural labor, and promoting the division of labor and specialization in agricultural-related services, trade, and certain small-industry activities. The stimulating impact of these measures is now being felt throughout the rural sector.

Having achieved such a favorable outcome from reform in the rural economy, the Government considered that the time was ripe for it to extend the reform to the urban economy. The October 1984 decision consolidates the earlier specific reform measures and constitutes a systematic and comprehensive blueprint for the remodeling of the urban economy. It would be useful here to recall the reasons for the comprehensive reform. The system of planned production in existence for the last three decades has enabled the economy to develop a modern industrial base and has promoted a very rapid expansion of output. However, as the problems of generalized shortage of supply have been overcome, the disadvantages of the inflexibility and overcentralization of the present system and its failure to promote initiative and efficiency at the enterprise level have become increasingly apparent. The authorities have therefore recognized a need to provide stronger economic incentives to stimulate greater initiative in management and improvements in productivity, and also the necessity to secure greater allocative efficiency and responsiveness by expanding the role of the market within the socialist system. These changes represent a modification, not an abandonment, of the system of production for the pursuit of socialist goals under state ownership of the basic means of production. They are being introduced as a means of strengthening the performance of a socialist economy. Though greater emphasis is to be placed on allocative efficiency, the allocation of resources between different uses is not to be determined predominantly by market forces as in the private market economies. The system after reform will continue to be a planned economy in which control is exercised by the authorities over investment, the production and allocation of basic products, and the distribution of income.

In the provisions of the October 1984 decision, the most important changes relate to the form of planning and method of implementing plans, the organization and management of enterprises, the price and wage systems, and the policy of opening up

the economy to the outside world. Before discussing these changes, I would draw attention to one of the key features of this decision: the provision made to ensure the separation of political and economic authority. The intention is that government departments at all levels should delegate power to the enterprises. Thus, the decision provides for the establishment of certain legal rights and obligations of enterprises to protect them against ad hoc interference and to assure managers that they will not be subjected to interference in the day-to-day operations of the enterprises.

The scope of mandatory planning involving centralized control by directives to managers and production quotas for output has been gradually narrowed during the past few years. The virtual elimination of directives to management, except over a narrow range of crucially important production, is now foreseen, allowing greater scope for independent decision making by enterprise managers under the influence of market forces of demand and supply and strengthened economic incentives. Thus, instead of comprising a detailed set of production quotas to be fulfilled by enterprises, the central plan will become, in the main, an indicative macroeconomic planning document setting forth the desired broad allocation of resources as between investment, consumption, and foreign trade. The authorities will guide the enterprises in fulfilling the objectives of the plan by indirect measures of credit control, taxation, and price policy. The changes in the character of the planning system will lead eventually to a very considerable increase in the influence of market forces in determining both the composition of output for sale and the relative level of prices.

Furthermore, the change is associated with a threefold division of activities according to the degree of centralized control. First, a limited number of state-owned enterprises, which produce goods and services of critical importance to the national economy and the well-being of the population, will remain subject to production directives and central allocation of output (i.e., under mandatory planning). The small number of goods includes energy, rolled steel, nonferrous metals, timber, cement, electric capital equipment, synthetic fibers, newsprint, chemical fertilizers, and basic materials for the chemical industry. Targets will be set for agricultural commodities such as cereals, cotton, edible oil, tobacco, jute, pigs, and some aquatic products. Second, in the main, the production of state-owned enterprises will no longer be subject to directives, and their managements will be free to decide the composition and scale of output to meet market demands. Third, independent cooperative or individual enterprises will be permitted to produce for the market entirely free of central control. They can also lease small state-owned enterprises or run them on a contractual basis.

Mandatory planning will continue to play a key role in the allocation of investible resources, determining the scale and distribution of fixed investment by state-owned enterprises and capital projects financed by budgetary appropriations, or by foreign capital arranged by the state, as well as those included in the state credit plan. The other fields where mandatory planning will continue to be applied include the processing and allocation of daily necessities, and the total values of imports and exports, as well as those specific import and export commodities in the state foreign trade plan.

The shift to a more flexible system of planning requires the development of alternative broader forms of control, especially general fiscal and monetary instruments that will allow greater scope for the play of market forces. In fact, certain important changes in this direction have already been introduced, notably the establishment of the People's Bank of China in 1983 as the central bank responsible for carrying out a deliberate monetary policy. The main objectives of monetary policy include the following: to control the expansion of currency issue and credit for anti-inflationary purposes; to provide necessary credits for industrial enterprises and agricultural households to carry out structural adjustments and new investments; and to conduct an active interest rate policy designed to influence the rate of investment and savings.

Among fiscal measures, a reform that is extremely important in several respects is the substitution of tax calculated as a proportion of profits in place of the automatic transfer of profits to the government budget. That change has now been extended to all state-owned enterprises. The possibility of varying the tax rate gives the authorities scope to influence the operations of the enterprises. The authorities are hopeful that the change to a tax on profit will provide enterprises with an important incentive to improve efficiency and secure reductions in cost and also to measure their cost-effectiveness. Furthermore, the authorities have recently adopted many new taxes with the aim of establishing a comprehensive tax system for all industrial and commercial enterprises.

The decision to ensure greater autonomy of the enterprises in order to promote improvements in efficiency, higher productivity, and a more effective response to changing demands involves very great changes both in the organization and management of enterprises and in the system of distribution and trade. When the reform program is fully implemented, the great majority of state enterprises will be free to determine their own policies with respect to production, sales, prices, labor management, and investment within the guidelines laid down in the overall plan for the economy and subject to control exercised by the central

authorities through fiscal and credit measures and over certain basic resources. Another important measure in this connection is the substitution of tax for delivery of profits by the enterprises, as already described.

Moreover, those measures will be accompanied by basic changes in the internal structure and decision-making process. The system of an independent enterprise director or manager, who will have the sole and overall responsibility for the production, operation, and management of his enterprise, will be reinstituted. He will have the authority to determine the personnel policy, to assign specific jobs to workers, and to introduce incentive payments schemes. His authority can be further strengthened when the contractual responsibility system is adopted at all levels within the enterprise.

The Government is concerned to ensure that the excessively egalitarian wage structure is corrected and that wages will be differentiated according to levels of skill, training, seniority, and effort involved. It is the intention that wages should reflect the individual's contributions as well as the performance and profitability of the enterprises, so as to promote higher productivity and give the work force an interest in the efficiency of the enterprise and its success in meeting market demands.

The greater autonomy of the enterprises emphasizes a major reshaping of distribution and trade. The customary procedure of unified purchases and supply prescribed by administrative decisions will need to be replaced by the development of markets in various products and of direct transactions between enterprises. It is envisaged that the change will encourage an expansion of interregional and intersectoral transactions and will tend to reduce the excessive tendency of enterprises, sectors, and regions to aim at self-sufficiency under the existing system.

A systematic and comprehensive price reform is regarded by the Government as an essential element of the general reform program, but it is also recognized that price reform can only be implemented gradually. The basic objective of the reform is that price relationships should reflect both relative costs and the supply and demand situation. Certain price reform measures have already been implemented over the past few years. Prices of an increasing number of goods, such as foodstuffs, have been allowed to float within the prescribed limits, or in certain cases to rise to the level that consumers are prepared to pay. Enterprises have been permitted to sell surplus production after the state quota is met at freely determined market prices. The price at which goods are transferred between enterprises has been set at more economically justified levels. The calculation of prices for capital goods to be used in estimating costs has been initiated.

In addition to these specific measures, whose application can be extended in the coming months, preparations are now under way for a pragmatic and feasible program of price reform. It will take into account the rate of growth of production, the impact of price changes on the state budget, and the need to increase gradually the real income of the population.

It should, however, be pointed out that the need for major changes in the price system poses perhaps the most difficult problem facing the Government over the medium term. Price stability is recognized as an important social goal in itself, and subsidies holding down particular prices cannot be readily eliminated without affecting the sense of equity of the population. Furthermore, while the price reform will entail both price increases and price reductions, there is some concern that granting greater autonomy to enterprises to set prices may result in a general upward movement of prices. Indeed, in announcing the intended price reform, the Government has emphasized that it is absolutely impermissible for any unit or person to boost prices at will by taking advantage of the reform.

The Government will attempt to ensure that the increase in prices of raw materials and semimanufactures does not result in price increases of final goods. The increase in cost should be offset by economy in the use of such materials and, to a relatively smaller extent, by tax reductions and exemptions. In the case of agricultural products and other goods that are now sold at prices below those paid to the producers by state purchasing agencies, the Government intends to compensate for price increases through wage increases made possible by improvements in productivity.

Opening up the economy to the outside world continues to be the main long-term objective of China's foreign economic policy. Under the impetus of the reforms, there will be a further strengthening of economic operations in the Special Economic Zones and an extension of the opening of coastal cities on the one hand, and expansion and fuller utilization of foreign financial resources and technical know-how on the other. China will continue to pursue an active but prudent foreign borrowing policy. Various measures have been taken to promote foreign investment, which may take the form of joint ventures, cooperative management, or direct investment. One aspect of the decentralization of decision making described earlier is that enterprises may now take the initiative in seeking cooperation with foreign enterprises in production and investment.

To conclude, for the past 35 years China's economic development has been carried out within the framework of public ownership of the means of production and central planning. The record

shows that public ownership and central planning have made substantial and solidly based economic progress possible. While that point is indisputable, the stage has been reached where highly centralized planning is not sufficiently flexible, where new organizational structures and institutions are necessary to assist the pace of economic development, and where some prevailing practices have become a hindrance to the expansion and modernization of the economy. The comprehensive reform program, initiated in 1979 and now broadened for implementation in coming years, is intended to modify the system and remedy that situation. It is foreseen that public ownership of the basic means of production and a more flexible planning system, making greater use of market mechanisms, will enable the economy to realize its vast potential. The blend of plan and market, centralized and decentralized decisions, state control and grass-roots initiative, will accelerate the pace of socialist economic development in China.

Mr. Fujino observed that China's economic reform, initiated in 1979, continued to move forward. To achieve a speedy improvement in living standards and reduce poverty, the authorities had taken a number of steps to invigorate the domestic economy--through decentralized management and an improved incentive structure--and to open the economy to the outside world. Significant progress had already been made, particularly in the agricultural area, where the average annual rate of growth of 7.5 percent between 1979 and 1983 was a remarkable achievement. With the spread of the production responsibility system, the output of most grain and nonfood crops had reached record levels, making it possible to eliminate rationing of many products and to reduce agricultural imports substantially. Production in light and heavy industry had also grown rapidly, reflecting strong demand for consumer and producer goods and measures to increase the autonomy of enterprises.

The recent decision on reform of the economic structure adopted by the Central Committee of the Communist Party was welcome, Mr. Fujino continued. It clearly identified the underlying weaknesses of the economy and confirmed the strong determination of the authorities to follow the direction already undertaken in restructuring the economy. In particular, the decision clearly stated that invigorating the enterprises was fundamental and that they should be made relatively independent economic entities. Despite those developments, a number of weaknesses and inefficiencies remained to be tackled, notably the relative price structure, which, in many cases, did not properly reflect demand and supply conditions. Furthermore, there was a good deal of room for improved efficiency in enterprise management.

In a planned economy such as China's, Mr. Fujino commented, it was difficult to assess the appropriateness of macroeconomic policy in the usual manner because an imbalance at the macroeconomic level might not always lead to visibly widespread inflation or external deficits; frequently, it might appear only in the form of commodity shortages and

excessive price increases on certain items. The current shortages of some industrial goods, energy, and construction materials were largely attributable to the structural problems of the economy rather than to excess aggregate demand. However, if the authorities were to carry out the price reforms without causing inflation to accelerate, they would need to maintain prudent financial policies.

Fiscal policy had been fairly cautious in recent years, Mr. Fujino considered. Price subsidies, which had inevitably grown rapidly during the process of price reform, amounted to about one fifth of total expenditures. That increased burden was being counterbalanced by large cuts in investment and by increased revenues in an effort to reduce the budget deficit. The reduction in subsidies and the authorities' intention to reduce their scope gradually were welcome. Because of the improved performance of the enterprise sector, the revenue target for 1984 was likely to be exceeded, which, according to the authorities, would facilitate a corresponding increase in expenditure. It would be useful to know why the excess revenue was not being used to reduce the deficit further.

In the monetary area, Mr. Fujino continued, considerable change was taking place in the banking system, and the Fund should watch developments carefully in order to evaluate properly the system's functioning. The recent high growth in liquidity in the household and enterprise sectors would have to be assessed in light of the change in the system and the reforms currently taking place in the economy. However, he shared the concern of the staff and supported its cautious assessment of the liquidity situation.

The basic policy stance, aimed at opening the economy to the outside world, was also welcome, Mr. Fujino remarked. Foreign trade had been expanding rapidly, and measures had been taken to attract foreign direct investment, including the recent opening to such investment of 14 coastal cities in addition to the existing Special Economic Zones. The policy should give strong impetus to China's economic growth in the coming years. He emphasized the importance of following up those measures in order to consolidate the gains already achieved. The authorities had taken a cautious attitude to the use of the international capital market and commercial bank lending. While that approach was understandable, the limited availability of concessional funds suggested that more positive approaches would be warranted as the need for foreign financing increased. The present high level of reserves, which was projected to reach about $20 billion by the end of 1984, equivalent to 11 months' imports, should be regarded as temporary, as the authorities had stated. Given the need for technical transformation of antiquated industries, the authorities could take advantage of the positive reserve position to expand imports. Reserves were expected to be run down as some large-scale projects got under way, a prudent and pragmatic approach.

As to the scope for further economic reform, the most important and difficult task would be the readjustment of the price structure, Mr. Fujino said. The price adjustments introduced since 1983, including those for

textiles and some consumer goods, were commendable. However, as stated in the recent decision of the Central Committee: "The prices of many commodities reflect neither their value nor the relation of supply to demand." In its report on recent economic developments (SM/84/229), the staff showed that there remained widely differing profit margins among enterprises. Subsidies had formed a large share of total fiscal expenditures in recent years, and the tax system was complicated because it was being used to cope with the variations in enterprise profitability.

Perhaps the problem of the price structure was most conspicuous in the energy sector, Mr. Fujino suggested. Despite the authorities' emphasis on increasing energy production, energy shortages, coupled with transportation bottlenecks, remained among the key supply constraints on economic growth; for example, the profit margin of the coal industry, the major energy source, was extremely small and there were wide differences in the prices of transactions. As the recent Central Committee decision rightly said: "Pricing is a most effective means of regulation, and rational prices constitute an important condition for ensuring a dynamic yet not chaotic economy." However, the difficulties involved in the reform of the price system were completely understandable: there would inevitably be a large redistribution of income, a matter of particular concern in any socialist economy, and possibly an acceleration of inflation. The authorities would have to formulate carefully a feasible plan of how to deal with those problems. The reform might not be completed in a short period; nevertheless, he agreed with the staff that the present generally favorable economic situation provided a good opportunity to embark on the task.

Mr. Leonard said that it was useful to try to distinguish between two aspects of the complex process of economic change described by the staff and Mr. Zhang: the restructuring of the organizational, institutional, and physical means of production and distribution in the economy; and the macroeconomic environment in which the restructuring was taking place. In macroeconomic management, the orthodox and cautious approach of the authorities had served them well. Recorded inflation was low, the balance of payments was strong, reserves were the equivalent of almost one year's imports, fiscal deficits were less than 2 percent of GDP, and growth was rapid. The authorities were, therefore, well placed to tackle the structural problems that had yet to be overcome: low per capita income, goods shortages, production bottlenecks, and deficiencies in the pattern of supply. In dealing with those tasks, the authorities had shown an open-mindedness, creativity, and pragmatism that had often been thought to be the hallmarks of capitalism and that he would not have expected from their conservative record of demand management.

The staff and Mr. Zhang referred to the success that had been achieved in the agricultural sectors through the system of contractual responsibility and free disposal of output after the fulfillment of contracts, Mr. Leonard continued. Extremely rapid increases in the production of agricultural goods--notably cotton, wheat, and oil-bearing crops--had taken place over the previous five years. China was currently able to feed its enormous

population; indeed, a recent press report had noted that it was even a net exporter of cereal grains, a remarkable and admirable development in a country that had suffered regularly from widespread famine. It was, therefore, logical for the Chinese authorities to extend the reforms that had been so successful in agriculture to the industrial and urban economy. The authorities were also taking advantage of the present favorable conjuncture of rapid growth, low inflation, and external balance to effect the structural changes that they believed were necessary.

In that context, the reforms announced on October 20, 1984 were enlightened, practical, and well directed, Mr. Leonard commented. While maintaining the essential socialist orientation of the economy, particularly as it pertained to the production of certain basic goods and to the distribution of income and output, the authorities had recognized the economically efficient role of market forces in generating economic growth and allocating resources. Therefore, he fully supported their commitment to fostering competition among enterprises while accepting the closure of unprofitable units that might result, to allowing the development of a significant private sector, and to the encouragement of greater autonomy for state enterprises in the management of their affairs. Those measures were potentially powerful mechanisms of economic adaptation, and he hoped that in time they would prove to be as effective and advantageous for China as they had been for other countries.

The management of change was of special importance in a number of areas of the economy, Mr. Leonard considered. First, there was the issue of pricing policy and the danger of inflation. The reported inflation rate for 1983 and 1984--2 percent each year--was extremely low, but there was reason to believe that it understated actual inflationary pressures to a considerable degree. Those pressures, which had existed for some time in the disguised form of queues, import shortages, subsidies to enterprises, and widely varying profit margins among firms, might be relieved once price reform had advanced sufficiently. In such circumstances, admonitions by the Government that it was impermissible for any unit or person to boost prices at will by taking advantage of the reform were unlikely to be sufficient to contain price rises and would have to be supplemented by other means.

Fortunately, fiscal policy was not a source of inflationary pressure in the economy, Mr. Leonard went on; however, he urged the authorities to give close attention to monetary policy and to the dangers inherent in the current strong increases in liquidity. He accepted that a higher rate of liquidity expansion than in the past might be permissible in view of the rapid growth of productivity, the monetization of rural areas, and the resulting decline in the velocity of circulation. Nevertheless, considerable caution should be exercised in the conduct of monetary policy, as advocated by the staff. The separation of the central banking functions of the People's Bank of China from the commercial banking function at the beginning of 1984 had been a positive institutional measure. However, it would need to be accompanied by a shift in the focus of policy from its traditional target of currency in circulation to broader measures of

liquidity. In addition, a more flexible interest rate policy should be adopted, particularly in respect of central bank credit to commercial banks. Finally, he encouraged the authorities to make increased use of treasury bonds as a means of further limiting fiscal reliance on bank financing and of soaking up high levels of liquidity in the enterprise and agricultural sectors.

A second issue was the need to promote more direct contact between the domestic and international markets, Mr. Leonard said. A good opportunity for doing so was emerging at present as a result of the conjunction of domestic price liberalization with the decrease in the margin between the official exchange rate and the internal settlement rate. Given that the margin between the two rates was only about 8 percent at present, it should not be difficult to eliminate it altogether while making progress in integrating the economy with the world trading system.

China's external trading and borrowing relations constituted another important issue that the authorities had approached prudently, Mr. Leonard commented. At the present juncture any other attitude could lead to a misdirection of imports and a frittering away of reserves with little economic gain to show for it. Moreover, it had yet to be shown that a more liberal import policy was fully compatible with the authorities' intention of retaining a high degree of centralized control over the production of the range of goods and services deemed to be of critical importance to the national economy and the well-being of the population. However, if the Government's price reforms were applied widely and effectively, the efficient absorption of imports within a sound overall balance of payments position could be greatly encouraged. Furthermore, as the staff's medium-term projections indicated, a faster rate of growth in imports was possible without a serious deterioration in China's financial position. Consequently, room existed for modest increases in imports as a means of helping to ease sectoral shortages and bottlenecks. He also welcomed the more open attitude toward foreign direct investment, which was a nondebt-creating flow that would improve the rate of technology absorption in the Chinese economy.

Finally, the considerable improvement in the scope and quality of China's economic and financial statistics in the past year was welcome, Mr. Leonard remarked. The continuation of that trend would greatly assist the authorities in assessing the effects of their new policies on the economy and in devising necessary corrections.

Mr. Schneider said that he shared the staff's admiration of economic developments in China in recent years. That huge country, with its ancient civilization and traditions, had again demonstrated to the world that it was able to revive itself and that its experience could be an example to a number of other countries. The Fund should closely follow developments in China and observe how the Chinese leadership was trying to tackle, shrewdly and carefully, the country's complex and difficult

problems stemming from its size, population, level of economic development, and social orientation. The rest of the world could only profit from intensified participation by a major country in the international scene.

In describing China's economic reforms, the staff correctly stated that China remained a socialist, centrally planned country, Mr. Schneider noted. Nevertheless, the staff appeared to try to link the socialist nature of a centrally planned economy to the presence or absence of mandatory planning or to the role of market forces in the economy. In that respect, not only developments in China but also reforms in other socialist countries provided evidence that the staff was not quite on the right track. The concept of a planned economy did not necessarily determine the methods of planning, which could be entirely mandatory, as was the case in most socialist countries, or could be indicative, as in Hungary or Yugoslavia, where no obligatory targets were prescribed for the economic units. Therefore, China would not lose any of its socialist characteristics by applying less obligatory targets and by relying more on market forces. The point deserved emphasis in order to avoid misconceptions about socialist countries in Executive Board discussions. Of course, the experience of other socialist countries had also shown that the two approaches to economic planning in a socialist economy could not coexist over an extended period of time. Either the obligatory targeting would have to be abolished altogether, or, contrary to the intention of the policymakers, more and more obligatory targets would be established for the economy.

The implications of the economic reform in China for the world were much broader than envisaged by the staff, Mr. Schneider continued. For a long time, it had been thought that socialist countries at a low level of economic development could not and should not rely on market forces at all, and that the central plans were fully capable of handling directly every aspect of the operations of the economic units with efficient results. According to that school of thought, reliance on market elements could only be considered at a higher level of development. However, at any level of development, distorted prices, a lack of differentiation in salaries, arbitrary investment decisions, and the absence of direct links between the external and domestic markets would lead to inefficient economic structures that would be politically and socially difficult, sometimes even painful, to abolish. The Chinese authorities had recognized that reality by introducing their reforms at an early stage of development.

Experience could be gained from the Chinese reforms, Mr. Schneider suggested. It had become obvious to the Chinese policymakers that reform measures had to be comprehensive and mutually consistent. The authorities had recognized very early that the reforms implemented in agriculture would have to be followed by reforms in other areas of the economy; it had also become clear that the price system could not be reformed while the salary system was left intact. Similarly, an efficient investment system could not be set up without either an adequate banking system or a capital market.

The nature of the methods used in the management of the national economy was one of the basic issues confronting Chinese policymakers, Mr. Schneider commented. In other socialist countries that had implemented a major reform along the lines that China was currently following, the first and most important step had been to abolish the obligatory surrender of agricultural products to the state procuring agencies in rural areas. Market forces usually provided sufficient incentive to increase and maintain production at the desired level. However, in SM/84/221, it was not clear what was meant by a "State mandatory plan" covering "the procurement of a proportion of output of foodgrains, vegetable oils, and cotton." If the reference implied the obligatory surrender of those products to the state procuring agencies, perhaps Mr. Zhang or the staff could explain why that method was necessary, given the otherwise excellent results of Chinese agriculture after the introduction of market incentives. Was the plan considered a temporary measure to remain in force until the other aspects of the reform were implemented?

Similarly, Mr. Schneider went on, it would be useful to know more about which elements of previous mandatory targets for economic units, including the administrative regulation of transactions between enterprises, would remain in force and for how long. Experience in other socialist countries seemed to show that, as long as the system of economic management operated with obligatory targets, the economic units tended to fulfill those targets only in a mechanical fashion, without questioning their rationale, while holding the higher authorities responsible for creating the conditions to achieve the targets. In such circumstances they did not seek better results or attempt to work more efficiently and to economize on factor inputs.

He generally agreed with the view that the transition to a reliable liberalized price system should be gradual, Mr. Schneider stated, although too much gradualism could diminish the expected result and lead to measures that were out of step with the other elements of the economic reform process. Leaving aside that possibility, he joined the staff in stressing "the advantages of early action on a more comprehensive reform and of linking domestic prices for traded goods to their international prices."

The Chinese authorities recognized the comprehensive nature of the reform process as far as the financial intermediation system was concerned, Mr. Schneider continued. He welcomed the measures that had already been introduced in that respect or that were being contemplated for the years ahead. Of course, reform was not an easy process and China was playing a pioneering role among the centrally planned economies. The separation of the central banking and commercial banking functions of the People's Bank of China appeared to be a good start. However, further steps ought to be taken to create a countrywide system of commercial banks and a capital market equipped with the necessary instruments. Perhaps the process was already further advanced in China than indicated in the staff report; it would be useful to have further information on how the banking system was working and what the immediate plans were for further reform of the system of financial intermediation. He agreed with the staff that the changes

in the pattern of savings had also "greatly increased the importance of providing adequate financial intermediation, and underscores the importance of the reforms of the banking system." The reform of the financial intermediation system had to go hand in hand with the reform of investment procedures and with the redefinition of the role of the budget.

A significant aspect of China's economic reform was the opening up of the economy, Mr. Schneider said, a matter of importance not only to China but also to the rest of the world. A market of China's size and its skilled labor force would make an important contribution to the development of international economic relations. China's unique situation placed it in a position to implement economic reform while maintaining large international reserves and an excellent standing in the international financial markets. That exceptionally favorable position could speed up the reform process, create the circumstances required for the modernization of the national economy, and develop the necessary conditions for an increased level of competition in the domestic markets. In that regard, Chinese policymakers should not hesitate to consider the future of the renminbi in the context of a unified exchange rate as well as to review the domestic and international management of the currency. Finally, he congratulated the authorities for the cautious policies that they had been following and for the fundamental resolutions that they had made for the years ahead. The results of the reform process and its contribution to the world economy would be of great interest.

Mr. Finaish remarked that the recent decision of the Central Committee of the Communist Party of China carried forward in a significant way the process of institutional change geared toward a more open and modernized Chinese economy. The picture presented by the staff--commendable economic performance characterized by rapid economic growth over the past five years, low rates of inflation, and increasing reserves--was refreshing in a period of low growth and severe financial difficulties in the global economy. The staff had, therefore, appropriately commended the manner in which economic policy had been conducted in China in recent years.

The staff's projections for 1984 gave encouraging indications that the momentum of growth initiated in the late 1970s was expected to be maintained, Mr. Finaish continued. In agriculture, where, as a result of substantial reform, significant productivity gains had been realized and rural incomes had risen by 50 percent in the five years to 1983, growth was expected to slow in 1984, although not by much. Industrial growth was expected to remain strong and was likely to be spread evenly over heavy and light industry. As a result of recent efforts aimed at enhancing efficiency, the use of inputs had become more economical and labor productivity had improved. However, as noted in the Central Committee's decision, the authorities remained aware of the need to do more in the area of enterprise efficiency.

The policy set out in 1981 to contain the budget deficit to less than 1.5 percent of GDP had subsequently been successful in all but one year, Mr. Finaish remarked. Growth in expenditures had been restrained

considerably, while tax revenues had increased by about 50 percent in the past three years. Those trends were expected to continue in 1984, during the first half of which there had already been buoyant revenue performance. The authorities had also succeeded in slowing the growth in extrabudgetary investment, an issue that had been of some concern to the Executive Board at the time of the 1983 Article IV consultation (EBM/83/157, 11/21/83). As for the future, it appeared that further fiscal gains could be expected following the completion of the recently initiated tax reform efforts and the implementation of the Central Committee's decision to rationalize prices and to lessen the costs to the Government of subsidies.

While welcoming the recent institutional changes aimed at a more effective and decentralized banking system, Mr. Finaish went on, he noted that the staff was concerned that liquidity growth in recent years had been on the high side. Although inflationary pressures did not appear to have developed, partly because of an increase in the demand for money arising out of the recent institutional changes, a more cautious credit policy might be needed in the future, especially in view of the past growth in liquidity. Increasing the share of bond financing in the financing of the budget deficit deserved consideration.

There was weight to the authorities' argument that China's reserve position, which was currently regarded as more than comfortable, should be viewed in a dynamic sense and in a longer-term perspective, Mr. Finaish considered. In light of China's development needs, the country would remain a net importer for some time. Therefore, the authorities' view that the recent buildup of reserves should be regarded as largely temporary, appeared valid. Furthermore, the course being pursued, namely, to increase imports only to levels that could be efficiently absorbed, was appropriate.

The staff called for an increase in import levels and a drawdown of reserves, and at the same time appeared to advocate an aggressive borrowing policy, Mr. Finaish observed. On the latter point, it should be noted that savings rates in China exceeded 30 percent of GDP, permitting the country an enviable degree of reliance on domestic sources of finance; moreover, the projected growth in domestic output might be high enough to allow for continuing large savings after accommodating significant increases in consumption. Furthermore, reserves were high, and import requirements, although they continued to grow, could be subject to a restraining influence as a result of the recent shift in emphasis away from heavy industry. In light of such considerations, any reasonably targeted levels of consumption and investment might, for the most part, be attainable through domestic savings and normal capital inflows without recourse to aggressive foreign borrowing. Therefore, unless the domestic savings rate were to fall substantially or imports were to accelerate sharply--perhaps as a result of an upward shift in the propensities to consume and to import following the opening of the economy to a wider range of consumer goods and importables--the case for an aggressive borrowing policy appeared unclear. In addition, such an aggressive policy, once in place, might validate itself by inducing the conditions favoring it; in other words, by reducing the country's

reliance on its traditionally strong domestic savings effort, it could cause excessive growth in imports. He invited the staff to comment.

With regard to normal capital inflows, Mr. Finaish went on, the staff listed in Annex VI of SM/84/229 several measures taken in recent years to attract foreign direct investment. The information in Table 53 suggested that the response had been favorable. It would be useful if the staff could provide further information on the current status of the Special Economic Zones being set up to attract foreign investment. In the longer run, the contribution of foreign investment projects in those zones would depend on the extent to which they were integrated with the rest of the economy through backward and forward linkages rather than kept isolated, a situation that could lead to a dualistic productive structure.

In the recent decision of the Central Committee, regarded as the most important since December 1978 when the incentive system for the peasantry had been adopted, the authorities had sought to extend China's economic transformation by doing for industry what had been done for agriculture, Mr. Finaish said. At the macroeconomic level an important issue had been made clearer, namely, the appropriate degree and form of central planning to be maintained in China. The change involved a move from mandatory planning toward a more flexible approach that would allow a much larger role for independent decision making at the enterprise level. As a corollary, the authorities recognized that more emphasis would be needed on indirect policy instruments or, in the words of the Committee's decision, "economic levers" for the overall direction of the economy. It was appropriate, therefore, that fiscal and monetary policies were expected to play a greater role.

At the microeconomic level, Mr. Finaish continued, the authorities were resolved to move at an appropriate pace toward a market-oriented wage and price system. The achievement of such a system was viewed as fundamental to the success of the current reform efforts. In recent discussions of that aspect of the Central Committee's decision, analysts had pointed to the possibility of a buildup of inflationary pressures in China as a result of the proposed rationalization of the price system. To the extent that prices had been suppressed below levels that market forces might otherwise have determined, it was possible that short-run increases in the rate of inflation would result. However, if monetary accommodation was resisted, needed adjustments in relative prices could be made without causing inflation on a sustained basis. Thus, the reform of the price system would need to be supported by an appropriate monetary policy. On the question of the pace at which prices might be adjusted, the authorities' wish to avoid sharp adjustments because of their concern for possible adverse distributional effects was understandable.

Development of high-level managerial and technical skills was being given special attention by the authorities, Mr. Finaish noted. They had distanced themselves from earlier notions of "absolute equalitarianism" and were allowing wages to reflect differences in the nature and quality of work. However, it had to be recognized that, in view of the time

required to develop human resources and despite the provision of adequate incentives, necessary managerial talent and other skills for the many tasks identified might remain in short supply for some time. He invited Mr. Zhang or the staff to indicate what measures were being taken in the Chinese system of education to back up the adopted system of incentives in order to produce the needed skills at the required pace.

As the envisaged reform took hold and efficiency gains were realized, with enterprises becoming leaner and more cost efficient, Mr. Finaish commented, a reduction in the employment levels of existing enterprises could not be ruled out. Moreover, as the staff noted, labor surpluses had already appeared in rural areas as a result of the recent reform and were likely to increase in the period ahead as efforts at modernization intensified. It was questionable whether the faster growth arising from the envisaged increases in efficiency would be enough to absorb those labor surpluses and to maintain the low levels of unemployment of recent years.

Among the more striking features of recent Chinese economic experience had been the ability of policymaking to adapt to changing economic circumstances in an economy as large and as diversified as China's, Mr. Finaish suggested. The staff's phrase--"pragmatic experimentation"--was an apt description of a policy that, as Mr. Zhang had also noted, was attempting to experiment, with pragmatism and due gradualism, with different methods of resource allocation and distribution while maintaining the underlying system of socialist ownership of the main factors of production. In a similar vein, while opening up the economy, the authorities intended to pursue a prudent, selective approach by importing and borrowing from abroad only those goods and ideas that the economy needed and could effectively utilize in its own special context. Although the path ahead was fraught with many uncertainties, and many problems continued to remain unsolved, the earnest and carefully designed efforts that the authorities had taken provided grounds to expect continued progress.

Mr. de Maulde said that the 1984 Article IV consultation with China was being conducted in the context of a continued high rate of economic growth in conjunction with price stability and a positive external balance. The advice normally offered by the Executive Board was unwarranted in China's case because the country was clearly doing better than any other important country; its economic policymakers were highly sophisticated; and the nature of its system of political and social control meant that economic policy instruments had different implications and led to different results than in Western economies.

With regard to the process of stabilization of the internal economy, the staff expressed concern about the current rate of monetary expansion, which it considered a weakness and a danger for the future, and about the link between excess liquidity and the improvement of rural incomes, Mr. de Maulde continued. What did the authorities intend to do in that respect? Was there a sufficient network of savings institutions to collect the funds in question and to recycle them toward investment? What kind of

interest rate policy would be appropriate in that context? As for fiscal policy, it was difficult to criticize the budget deficit, because it had been held well below 2 percent of GDP. The new economic measures should result in a reduction of both public receipts and expenditures. On the receipt side, enterprises would retain a share of their profits instead of turning over all of them to the state; on the expenditure side, subsidization should, apparently, decrease. How did the authorities intend to synchronize both developments and what would be the resulting overall balance of public finances in the period ahead? If a larger deficit were envisaged, what role did the authorities intend to give to the development of new financing instruments, including the bond issues suggested by the staff?

The issue of subsidization was connected with the general question of the price and incentive system, Mr. de Maulde stated. He had been impressed by Mr. Zhang's remarks concerning the wide role to be given to managers of enterprises and the fundamental change involved in the establishment of the "separation of political and economic authority." However, it was unclear whether the managers would receive and respond to real market signals. While the central allocation of output would be restricted to a small number of goods, those goods--inter alia, energy, cereals, steel, and nonferrous metals--appeared to represent a significant part of GDP. Thus, for some time, the managers of Chinese enterprises would not be working in a proper market economy but would be undergoing a kind of training process in somewhat artificial conditions. He invited the staff or Mr. Zhang to comment. In addition, a fundamental problem in a country as populous as China was that the available labor force would be increased not only by the natural growth of population, but through improvements in agricultural productivity. Current policy consisted of the creation of light industries in rural areas rather than allowing the large migration to the urban areas of the labor force formerly employed in agriculture. Would such centers of light industry be efficient and would their products be competitive?

In the external sector, Mr. de Maulde went on, the authorities appeared to be reluctant to use the room for maneuver that they had created through their internal and external management. He fully appreciated the importance of the policy of opening up the economy to the rest of the world and the tremendous changes it entailed for certain coastal cities. Nevertheless, given the enormous need for modernization and development, it seemed that the authorities were being too cautious in concentrating their search for foreign credits on multilateral concessional sources. Important opportunities existed for investments that, through foreign exchange earnings, would be self-reimbursing and could well be financed by loans at market rates. They would contribute decisively to improvements in overall productivity and to removing some of the bottlenecks that plagued industrial development.

At present, China accounted for only 1 percent of world trade, Mr. de Maulde observed, and was situated in a region in which a number of countries--developed and developing--had met with considerable success in

recent years in the expansion of their exports. How did the Chinese authorities and research institutes envisage the expansion of China's external trade in the medium term? What comparative advantages was China considered to have? On what kind of exports did the authorities intend to concentrate? Which markets was it logical for them to pursue? China's trade policy for the medium term could provide an interesting research topic for the next Article IV consultation; work being undertaken by the World Bank in that respect could prove useful.

Mr. Clark remarked that he agreed with Mr. de Maulde that caution was warranted in commenting on the Chinese economy because of its size and diversity; because it was difficult for a distant observer to grasp adequately the way in which policy actions were transmitted through the economy; and because of the current significant changes in the structure of the economy. While the staff had provided helpful background information, the recent statement of the Central Committee was particularly interesting.

The staff indicated that the Chinese economy had continued to perform well, Mr. Clark continued. Real GDP had been rising faster--about 9 percent a year--than in almost any other country, and China had expanded its involvement in the international trading and financial systems while maintaining a strong external position. An essential element in China's economic success had been reform of the agricultural sector through a combination of increased procurement prices and greater autonomy for individual farmers. The results could be seen in the 50 percent increase in rural per capita income and the substantial improvement in yields, some of which were at present, according to a recent article in The Economist, among the highest in the world.

Nevertheless, as the authorities recognized, weaknesses remained, Mr. Clark commented. Perhaps most important, there continued to be serious problems in the structure of prices; the industrial sector was unbalanced; and the energy and transport sectors continued to cause bottlenecks. Against that background, the recent decision of the Central Committee to extend the reform process to the urban sector was welcome. In that decision the authorities stated that "reform of the price system is the key to reform of the entire economic structure." The decision included proposals to reduce the scope of mandatory planning, to increase enterprise autonomy and to encourage competition, and to relate wages more closely to individual performance, all of which would be an essential complement to price reform. Perhaps Mr. Zhang could provide further information on the timetable envisaged for the various reforms.

The failure to raise consumer prices in line with procurement prices had resulted in a heavy burden of subsidies on the budget, a policy that was not sustainable in the long run, Mr. Clark stated. Although the authorities' concerns about the effect of subsidy reductions on income distribution were understandable, particularly since subsidies were at present equivalent to one third of urban wages, the current high level of increases in per capita income presented an opportunity to make significant

progress on that front. In the energy sector, despite significant administrative efforts to promote energy savings, consumption remained high in China relative to other developing countries, exacerbating what was already an important constraint on economic growth. At least part of the problem appeared to be the low prices of a number of energy products, particularly coal and fuel oil. He welcomed, therefore, the emphasis in the recent Central Committee's decision on raising the prices of certain mineral products and raw materials; in combination with the measures to increase enterprises' interest in profits, that approach should lead to significant improvements in energy conservation.

The staff correctly pointed to the need to contain the growth of liquidity, Mr. Clark said, a measure that would be important if inflationary pressures resulting from price reform and subsidy reductions were to be restrained. However, the term structure of interest rates was somewhat puzzling as it appeared to be sharply upward sloping for savers but downward sloping for borrowers. He invited the staff or Mr. Zhang to comment.

Given the continuous strong growth in reserves since 1980, Mr. Clark commented, he agreed with the staff that some expansion in imports might be desirable to alleviate domestic shortages and to reduce supply constraints to growth. Despite the recent depreciation of the official exchange rate, China continued to maintain a dual exchange rate, which seemed unnecessary in view of the strong current account position. He encouraged the authorities to take measures to allow the exchange rate and world prices to have a more direct effect on domestic exporting enterprises and import users. He welcomed the authorities' pragmatic, although limited, approach to foreign direct investment. The Special Economic Zones offered potentially favorable terms to investors, and the removal of tax on profit remittances from those zones would have beneficial effects. However, the complex legal system, together with the length of time needed to finalize contracts with foreign firms, remained potential disincentives to investors. In that context, the introduction of the new patent law in April 1985 should be a useful step forward. Annex VI to SM/84/229, setting out the incentives for foreign direct investment, had been a useful innovation; he hoped that it would be repeated in reports on other countries.

Substantial differences between the urban and rural savings ratios were apparent from the information in Table 7 of that document, Mr. Clark noted. Mr. Zhang had suggested that they might be partly the result of supply shortages for consumer goods. He invited Mr. Zhang to comment on what other factors might be involved and on how the two ratios were expected to move in the future. Finally, given that China was at present the third largest recipient of World Bank finance, it would be helpful to have the kind of assessment of objectives and results of World Bank operations that had been requested for other member countries.

Mr. Ismael stated that developments in China in the past few years had been impressive, especially in light of the relatively difficult world economic environment. The achievements were particularly commendable in

two areas: first, the high rate of real growth in the economy based on strong increases in both agricultural and industrial production, and second, the strong performance of the external sector. With regard to agricultural production, The Wall Street Journal had recently reported that China had a foodgrain surplus at present and that it was exporting grain to other countries. The good agricultural performance was attributable to higher government purchasing prices for grain, the successful policy of allowing families to operate private plots, and good weather. In addition to achieving a rapid rate of growth of real GDP, the authorities had succeeded in controlling the rate of population growth, which was at present among the lowest in the developing countries. As a result, China was in a position to achieve a rapid growth in per capita income and living standards. In the external sector, exports had performed well and balance of payments surpluses had been recorded. The favorable balance of payments developments had obviated the need for commercial borrowings, allowing China to make early repayment of some of its loans and to keep its debt service obligations at a low level.

The staff candidly admitted that it was difficult to form a judgment on the appropriateness of the current rate of liquidity growth, Mr. Ismael continued, a position with which he agreed. Domestic credit expansion to the Government was not a major source of liquidity, given that the fiscal deficit was low--about 1.5 percent of GDP--and only a negligible proportion of it was financed from the banking system. Furthermore, the growth in liquidity was strongly influenced by positive factors such as the high savings ratio and the strong external performance, and there was no direct relationship between monetary growth and the evolution of prices and the balance of payments as there was in free enterprise economies. In the absence of evidence of deleterious effects of the current rate of monetary growth, the matter could be left to the good judgment of the authorities, who were in the best position to assess monetary developments and their consequences.

A degree of caution was also warranted on the question of whether, in view of the favorable external developments, imports should be accelerated, Mr. Ismael suggested. It was not clear whether the external improvement was temporary or permanent. China was in the process of preparing a number of capital-intensive projects and of accelerating the pace of industrialization, which was based heavily on foreign technology and imported capital goods. With the implementation of those projects, the external surplus was expected to be eliminated. Indeed, on the basis of present policies, the medium-term scenario presented in Appendix Table 7 of SM/84/221 pointed to the emergence of a substantial current account deficit and a sharp reduction in reserves during the second half of the 1980s. The authorities' cautious approach, which involved adequate project preparation, and their reluctance to import at a pace not justified by the absorptive capacity of the country were appropriate; there was no need for a deliberate policy change in that area.

The staff was again candid in stating that it was not in a position to pass judgment on the most appropriate pace of future reform of the

economic system, Mr. Ismael remarked. It was a matter where the authorities were best qualified to decide. He commended the authorities for their pragmatic approach in attempting to make their system of economic management more flexible and efficient. They would no doubt be carefully monitoring the impact of the reform measures and making necessary adjustment to speed up the pace of economic development in time.

On the multiple exchange rate, Mr. Ismael concluded, the substantial narrowing of the differential between the official exchange rate and the internal settlement rate was commendable. As a result, the distortions arising from the multiple rate system were minimal at present. He welcomed the authorities' recognition that the present exchange system was temporary, and he hoped that the necessary reforms in that respect could be brought about shortly.

Ms. Bush said that the current review of developments in the Chinese economy were particularly timely for two reasons. First, the rapid opening up of the economy meant that developments in China were having an increasingly important impact on the economies of other members of the Fund. It was striking that the size of the foreign sector in China was now similar to those of countries such as India and Brazil that had long been full partners in the world economic system; recent changes in the Chinese economy suggested that China was also on its way to becoming a fuller partner in that system.

Second, the reform of the Chinese economic system, aimed at introducing a greater degree of freedom for market forces to influence economic performance, had its counterpart in the economies of most Fund members, Ms. Bush continued. Thus, there might be useful lessons to be learned from the Chinese experience. Reform efforts similar to those being undertaken in China had taken different forms in different countries: in developing countries, a shift from a state-directed approach to more market-related development; in socialized economies, the modification of state planning; and in industrial economies, a movement away from accumulated rigidities. The central theme was that a system of relatively free markets for goods, services, and factors of production often functioned most efficiently and brought significant improvements in economic performance. While that proposition was particularly valid as an economy grew in size and in technical complexity, even the still low level of per capita income in China would ultimately be best affected by an economic system based more on incentives and market-related forces.

She generally agreed with the staff's favorable comments on the way in which the Chinese authorities had recently managed the difficult problem of transition toward greater use of market forces, Ms. Bush stated. The evident determination to proceed further in that direction, as embodied in the October 1984 decision of the Central Committee, was particularly encouraging. Previous reforms had resulted in more efficient functioning of the agricultural sector, increases in aggregate output, a lowering of recorded inflation, and the strengthening of the external position. However, success bred new problems: growing rural income would

have to be matched with larger supplies of consumer goods and housing; distribution systems would have to expand; labor shed in efficient sectors would have to be reabsorbed elsewhere; direct controls over investment would have to be replaced by indirect and more traditional macroeconomic means of influencing investment; and the growth of household and enterprise liquidity, in conjunction with decentralized investment, created a need for more sophisticated techniques of financial intermediation. In short, the phasedown of direct controls required that, if efficient resource allocation and reallocation were to occur, a system of more market-related price signals should be developed concurrently.

The staff and previous speakers had correctly emphasized the need for broad reform of the pricing system, Ms. Bush observed. Some progress had already been made. As Mr. Zhang had pointed out, wages were increasingly being linked to performance of the worker and of the firm, and the Government was seeking to bring about greater wage differentiation to reflect individual contributions. Steps had been taken, and more were contemplated, to increase the relative importance of floating and negotiated prices compared with fixed prices. Movements of domestic prices in response to exchange rate changes were somewhat more prevalent than hitherto. She understood the authorities' concern about possible undesirable income distribution effects from the comprehensive price reforms that would be introduced over the coming five years. However, the importance of those reforms called for a degree of boldness, coupled with pragmatic implementation. She supported the staff's recommendation that, in the meantime, steps should be taken promptly to begin to remove the major price distortions.

Commenting on the balance of payments, Ms. Bush said that she was impressed by the rapid growth of the foreign sector, by the sharp rise in exports, and by the increase in China's market share. Recent measures to facilitate foreign direct investment were important steps; they would certainly result in further improvements in the balance of payments and would allow the Chinese economy to take advantage of capital, management, and technology available from abroad. Such measures would also complement the authorities' cautious attitude to external debt. Furthermore, the potential impact on reserves of investment in large-scale projects could be diminished in the medium term by attracting additional foreign capital. She sympathized with the argument that China's international reserves and foreign debt position offered the possibility of an acceleration in imports to help renovate existing plant and equipment, reduce shortages, and update technology. However, any acceleration would have to be weighed against the importance to the development of the economy of the planned large-scale projects. In sum, considerable caution should be exercised if imports were accelerated.

The effects of the reforms already introduced highlighted the need for improvements in macroeconomic policy tools, Ms. Bush considered. In the fiscal area, the ratios of revenues and expenditures to GDP had been declining as decentralization of decision making within the Government and between the Government and the enterprises moved ahead. However, the

decentralization of investment decisions had not been accompanied by a fully developed array of policy tools for indirectly influencing investment. As a consequence, stopgap measures had had to be taken to influence the unexpected growth of extrabudgetary investment. Similarly, price rigidities had diverted the effort to reform the taxation of enterprises by requiring the use of a complex tax rate structure to offset corresponding distortions in relative profitability among enterprises. On the monetary side, she welcomed the relative shift from direct government financing and investment toward increased financing through the evolving banking system. She also welcomed the separation of central banking and commercial banking functions, greater flexibility in interest rates, and the growing monetization of the economy.

She agreed with the staff that an appropriate exchange rate system should be part of the overall pricing reform, Ms. Bush added. There had been a steady real effective depreciation of the currency since 1980 and the spread between the official rate and the internal settlement rate had been narrowing. She invited the staff to comment on the present state of China's international price competitiveness and on the need for further real exchange rate adjustment. How did the staff and Mr. Zhang evaluate the recent changes in the spread between the two rates? She welcomed the authorities' intention to eliminate the remaining bilateral payments arrangements with other Fund members.

Mr. Prowse commented that the Chinese authorities had achieved remarkable success in their economic management with respect to growth, the control of inflation, and the strong external position. He agreed generally with the staff's assessment, particularly with its remark that the fundamental task was to raise the present low per capita income of the Chinese population. There were two aspects to that issue: one, which had appropriately not been addressed at length by the staff, was the rate of population growth; however, if the authorities' objective of 1.2 percent population growth a year was achieved, the population aspect could be considered tolerable. The other aspect was increased economic growth, which involved not only structural adjustment but also macroeconomic stabilization policy. It would have been helpful if the staff could have addressed more explicitly the interrelationships between short-term macroeconomic policies and medium-term structural adjustments in the context of the fundamental objective of economic growth.

A substantial package of structural policies had been announced, Mr. Prowse observed. In that respect, it was important to distinguish between greater use of the price mechanism to allocate resources and changes in the ownership of resources. The latter question would have to be given greater attention in the future because it could have implications for the difficulties likely to be faced in extending the effective responsibility system from the rural areas into the urban and industrial areas. The position in the rural areas clearly allowed for ownership of resources, indeed for increases in ownership as a result of higher productivity and efficiency, a factor that underlay the great success in increasing agricultural production. Whether the system could be applied in the industrial

and urban areas was a critical issue, left unresolved by the staff. No doubt the authorities were addressing the question as part of the overall problem of mutual consistency among the various elements in the policy package. In that regard, it was difficult to overemphasize the need for early action in applying the new pricing and incentive system, not only in the domestic economy but also in the external sector. The authorities regarded the maintenance of the present exchange arrangements as temporary; he agreed with the staff 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." Given the strength of the external situation, he could support the staff's recommendation regarding China's present multiple currency practice.

The consistency of policies was important, Mr. Prowse remarked, and he agreed with many of the points made by Mr. Schneider regarding the broad political-economic context in which reform was being carried out. Mr. Zhang had stated that:

> Mandatory planning will continue to play a key role in the allocation of investible resources, determining the scale and distribution of fixed investment by state-owned enterprises and capital projects financed by budgetary appropriations, or by foreign capital arranged by the state, as well as those included in the state credit plan. The other fields where mandatory planning will continue to be applied include the processing and allocation of daily necessities and the total values of imports and exports, as well as those specific import and export commodities in the state foreign trade plan.

Mr. Zhang had also said that:

> ... the change [in the planning] is associated with a threefold division of activities according to the degree of centralized control. First, a limited number of state-owned enterprises, which produce goods and services of critical importance to the national economy...will remain subject to production directives and central allocation of output...[including such goods as] energy, rolled steel, nonferrous metals, timber, cement, electric capital equipment, synthetic fibers, newsprint, chemical fertilizers, and basic materials for the chemical industry. Targets will be set for agricultural commodities, such as cereals, cotton, edible oil, tobacco, jute, pigs, and some aquatic products.

It was not clear that such a mix of allocative mechanisms could be expected to produce optimal results. Of course, the reform was still in an early stage and was taking place in the context of changes in the broad political-economic structure of the country. The Fund could contribute to the authorities' search for solutions by emphasizing in the course of consultations

that there was a need for clarity of objectives, and for consistency among the various economic sectors and mechanisms being used to implement policy. Thus, the exchange system reflected inconsistent application of the price mechanism, as evidenced by the growth of subsidy costs. The increase in agricultural production had led to increased subsidies from the budget for grain, cotton, and edible oils, resulting in reductions in the financial capital available for important sectors such as energy and transportation. If the basic goal of raising living standards was to be realized, market influences would have to be allowed a much greater role than was apparently envisaged at present.

The expansion of imports represented an important potential means of raising productivity so as to meet some part of the unsatisfied demand in the economy, Mr. Prowse went on. The question of whether the present reserve situation was permanent or temporary was basically irrelevant; a country's reserve position evolved continuously, depending on the particular policy adopted. There were clearly large amounts of reserves available at present, indeed more than could be said to be necessary, and external debt was lower than appropriate for a developing, capital-poor country. Thus, the staff's projection that the current account surplus of $5.7 billion in 1982 would be turned into a deficit of only $3.5 billion in 1988 appeared too conservative. Such an outturn would not optimize China's opportunities to utilize international resources and savings. A more positive approach to the utilization of foreign savings and of existing reserves should, therefore, be adopted. In particular, the maintenance of reserves at the level of 11 months of imports seemed inappropriate.

The significance of the apparent increase in liquidity was not clear, Mr. Prowse considered. While the move toward a more market-oriented system with greater availability of consumer goods heightened the need for caution in credit policy, it was not a central issue. The problems created by shortages and bottlenecks arising from stronger economic growth were much more important, and they should be dealt with primarily through the restructuring of the price mechanism.

Mr. Salehkhou said that economic conditions in China had continued to show impressive progress in the past few years. In line with the major shift in the focus of economic policy away from heavy industry toward higher living standards, and the concomitant fundamental economic reforms that had been initiated, the necessary groundwork had been prepared for uninterrupted development of the basic infrastructure and of the real economy. The industrial and agricultural sectors had grown rapidly in 1983. The gross value of industrial production had increased by 10.5 percent in real terms and the expansion had been well sustained in 1984. The major factors responsible for the upswing had been accelerated investment and a strong demand for agricultural inputs. Among major industrial goods, coal, tractors, motor vehicles, and chemical fibers had shown the most rapid improvement. There had also been emphasis on improving the profitability and efficiency of industries through such measures as restructuring of enterprises, reduction of administrative personnel, rationalization of production processes, and comprehensive cost-reducing measures.

In the agricultural sector, Mr. Salehkhou continued, the reforms of the past few years had led to favorable results. The rate of increase in gross agricultural output had doubled in recent years, compared with the average rate in the 1970s. Crop production had been a major beneficiary, but livestock, forestry, and fishery products had also expanded. Given that more than 70 percent of the population was engaged in agriculture, the production of food to feed the huge population and the authorities' achievements in agriculture became paramount. The important policy consideration was to find alternative rural employment for a large number of workers released from their former jobs as a result of agricultural reform measures. The authorities intended to expand rural and cottage industries so as to discourage urban migration. In that context, the staff suggested that the rapid increase in rural income made necessary greater availability of manufactured consumer goods, agricultural imports, and construction materials.

Investment policies had also shifted in emphasis, Mr. Salehkhou observed, with increased autonomy and decision-making authority being vested in state enterprises and local governments. Furthermore, tighter screening of investment projects and, through new policy instruments, greater reliance on economic forces gave the authorities the needed momentum to curb excessive investment. The new economic strategy was aimed at reducing the emphasis on the massive mobilization of capital; instead, the goal was to free investment resources so as to improve standards of living and to increase the availability of consumption goods. To compensate for the relative shortfall in investment, emphasis had shifted toward more intensive and efficient investment projects.

The staff remarked that monetary policy had been expansionary in 1983 when currency in circulation had increased twice as fast as in 1982, Mr. Salehkhou noted. However, given the increase in the demand for currency and greater retail purchases, together with increased monetization and financial autonomy of enterprises, a broad concept of liquidity should be adopted. In fact, the income velocity of money had fallen steadily--to 1.7 in 1983--underlining the continued expansion of total liquidity. In view of existing shortages, however, the increased liquidity had not immediately been translated into higher inflation. Nevertheless, the authorities were cognizant of the situation and had taken steps to control household liquidity and agricultural credit. Fiscal policy remained cautious and, according to 1984 budget estimates, the overall deficit would amount to about 1.5 percent of GDP and revenue and expenditure would be broadly in line with the growth of income. Price subsidies accounted for a major part of total budget expenditure; the Government was concerned about that burden and aimed to reduce it gradually.

The external sector was gradually being opened up to greater international contact, Mr. Salehkhou went on. Trade had grown steadily and the strong external surplus had continued in 1983 and the first half of 1984 notwithstanding a slower pace of exports and relatively higher imports. China's 1 percent share of world trade seemed small in light of the weight of the economy in the world, although, as the staff pointed

out, in some commodities, such as textiles, its share was much more significant. The gradual, cautious approach taken by the authorities in the face of the high volatility of international trade and the debt crisis of the developing countries was understandable. Nevertheless, they had taken additional measures to enhance international trade. In line with other reform measures, foreign trading corporations had been given greater autonomy of operation.

The authorities of the People's Republic of China had undertaken a series of courageous reform measures that had already started to bear fruit, Mr. Salehkhou stated. As Mr. Zhang had suggested, the underlying feature of the comprehensive rationalization measures--decentralization--was a further example of economic pragmatism. Indeed, the management of economic enterprises and other cost-conscious economic units on the basis of market and economic forces signified the realistic, commonsense reasoning behind every move involving the use of scarce resources. That approach represented a sensible acknowledgment that the eventual well-being of the state necessitated greater efficiency and maximum utilization of limited funds. The recent comprehensive reform measures, to the extent that they provided greater incentives and reflected relative scarcities and opportunity costs in the economy, were welcome. The Government was adopting a judicious attitude in undertaking a gradual, prudent approach to reform, not so much because implementation of greater decentralized market mechanisms necessarily entailed protracted or piecemeal adoption of the reform measures, but because the current imperfections that existed in open markets made it imperative to adopt a careful, preconceived strategy. Furthermore, the complex, far-reaching characteristics and vicissitudes of the economy of the People's Republic of China understandably required tailor-made solutions that, albeit based on the efficient employment of resources, were appropriate for such an economy. Inevitably, a long process of experimentation and learning was involved, as the authorities realized.

Mr. Polak commented that China had recently taken another major step toward the more rational use of its resources, attempting to pursue in the urban sector the successful transformation introduced about five years earlier in the agricultural sector. Most of the authorities' objectives and most of the measures introduced to achieve them could be readily understood within a framework of classical economics in which decision making was decentralized and prices guided the decisions to produce, and were, in turn, determined in such a way as to clear the market. While the changes in China's system were compatible with the continuing pursuit of socialist goals and with state ownership of the means of production, they required the devolution of decisions on the level and character of output to managers of enterprises, or in Mr. Zhang's words, "the separation of political and economic authority."

He had no difficulty with the view that the new system should be introduced gradually, Mr. Polak continued. The major capitalist countries also had state enterprises, for example, railroads and public utilities, that coexisted with privately run businesses. However, it appeared that

the area of centralist control in China might be large. In that context, Mr. Zhang referred to a limited number of enterprises and a small number of commodities but, as other speakers had observed, almost all major industrial commodities and many agricultural products appeared to be included in those categories. It would be useful to know what percentage of GDP was accounted for by the commodities remaining under centralized control. He questioned whether it could be said that "in the main" the production of state-owned enterprises would no longer be subject to directives, as so many of the major products remained subject to such directives. While the coexistence of controlled and uncontrolled parts of the economy was acceptable, it was more difficult to accept the continued coexistence of uneconomic and economic prices. For example, the prices of some commodities had been set about 30 years earlier, while other prices were determined in the short run by the market. Was the distinction between market prices and controlled prices broadly similar to the distinction between commodities where the control of production was decentralized and where it was centralized?

He agreed with Mr. Zhang that the need for major changes in the price system posed the most difficult problem facing the Government in the medium term, Mr. Polak said, and that price stability was in itself a worthy goal. Subsidies had been used to a large extent to make price stability possible. Both Mr. Zhang and the staff noted that price increases would become necessary as subsidies were abolished and would be compensated for by wage increases based on improvements in productivity, a situation that suggested that the workers would not receive the real benefits from the increases in productivity. It might be more reasonable to reduce subsidies while offsetting the effect on prices by corresponding reductions in the general sales tax. The subsidies amounted to y 35 billion, while the sales tax yielded y 59 billion. Such an approach could bring about a more rational price system without increasing the prices paid by consumers.

At the time of the 1983 Article IV consultation, Mr. Polak recalled, it had been said that the elimination of controlled prices would take place over a ten-year period. It now appeared that a five-year period was envisaged. Thus, enterprises would be receiving the wrong signals for a long time, which could lead to severe distortions in decision making, particularly with regard to investment. Perhaps the problem was more theoretical than real. It would be helpful if the staff could indicate the extent to which controlled prices in China differed from prices in international markets and how serious the losses might be from using such wrong prices in decision making. Were the authorities aware of the problem and would they be acting upon it, for example, by using in their investment plans appropriate shadow prices derived from the international market?

The staff correctly stressed the importance of monetary policy in dealing with excess demand, Mr. Polak remarked, although a tighter monetary policy could not deal with the problem of price distortions. The implementation of monetary policy was difficult because the Chinese economy was

undergoing rapid monetization and the income velocity of circulation was declining. Thus, a noninflationary increase in the money supply was warranted, which could be met through credit creation; however, it was difficult to know at what point inflationary pressures would begin to be felt. The staff also mentioned shortages and bottlenecks, which suggested that the cost of living index was not constructed in such a way as to catch incipient inflationary developments. Perhaps it could be improved through greater reliance on freely set prices. Furthermore, a quarterly cost of living index was too slow an indicator of possible inflationary risks; an index produced over a shorter period could provide a better guide to appropriate credit expansion.

China appeared to be one of the few countries that had pegged its currency to the U.S. dollar without suffering the adverse effects of the sharp rise in the dollar, Mr. Polak considered, no doubt reflecting China's excellent record on inflation. The large appreciation of the internal settlement rate had brought it close to the official rate, which was based on a currency basket; past arguments, never strong, in favor of a dual exchange rate no longer held, and the authorities should use the first opportunity to unify the rates.

Mr. Kafka noted that the Chinese economy had performed well in 1983 despite a number of constraints. The balance of payments was sound, subsidies had declined, inflation was almost negligible--although some once-for-all price adjustments would have to be made--growth was high and sustainable, and the differential between the internal settlement rate and the official exchange rate had narrowed, thereby opening up the economy further to economic relations with the rest of the world. Furthermore, the guidelines contained in the October decision of the Central Committee represented sound economic principles applied pragmatically.

The staff suggested that it was preferable to err on the side of caution and that, therefore, the growth of liquidity should be contained, Mr. Kafka continued. However, the staff's analysis did not seem to take into account the possibility that demand for money might have increased because of the growing monetization of a less developed economy experiencing high economic growth and because of the substitution of market prices for administrative controls. The Chinese economy was maturing financially, and the authorities were correctly keeping the development under close scrutiny. It might not be necessary to take further measures to contain liquidity at present. The information in Table 7 of SM/84/229 indicated that total profits were increasing while profits per unit of output were declining, possibly a healthy indication of increased efficiency. However, there did not appear to be any information on the rate of return on capital in the staff papers. He invited the staff to comment.

According to the staff, the current level of reserves, estimated to amount to about one year's imports by the end of 1984, was too high, Mr. Kafka observed, and a sharp increase in imports could be supported. The medium-term balance of payments outlook corroborated that assessment. Even if exports grew by 9 percent a year and imports increased by 15 percent

a year between 1984 and 1990, debt service would be at the comfortable level of 6.4 percent of exports of goods and services in 1990. However, reserves should not necessarily be used because their level was high and because the balance of payments perspective at present was sound. Reserves represented security against uncertainties, and the world economy would be in an uncertain state for the foreseeable future. Thus, although the financial yield on reserves was declining, and despite the fact that the marginal productivity of capital ought to be high in China, the security premium afforded by the holding of reserves could appear justifiably high to the Chinese authorities. Their attitude toward the additional use of foreign borrowing might also be correct, although they had substantial lines of unused credit. Nevertheless, it was odd that, taking reserves and disbursed credit together, China was at present a large capital exporter. Perhaps the staff could comment on the situation. Finally, the staff did not appear to have provided information on the educational level of the labor force, its degree of technical training, and the availability of management skills. Such information could be helpful in assessing the constraints facing the Chinese economy in the long run.

Mr. Abdallah said that the Chinese authorities should be commended for their successful management of the economy. The staff drew attention to an important development in the rural areas, namely, the emergence of a labor surplus of as much as one third of the labor force that had been engaged in agriculture. The question was of interest to all the countries in his constituency because they had been experiencing a similar phenomenon. As technological change took place in the rural areas or as the population continued to grow, the size of landholdings was increasing and a number of people working the land were becoming unemployed. The Chinese authorities were trying to deal with the situation through expansion of rural industry and through the encouragement of collective and small-scale private undertakings in the service, transportation, and construction sectors. It would be useful if the staff could continue to provide information in the course of future consultations on the success that the Chinese authorities achieved in that respect.

Various measures undertaken in Africa had not been successful, mainly because the population had been increasing so rapidly, Mr. Abdallah continued. The problem was serious because people would migrate to the towns if they could not find jobs in the rural areas, but the towns were already overcrowded. Furthermore, the question of subsidies had to be considered in a different perspective. In poor developing countries there were no social security systems, and if people became unemployed and had no source of income, they had to rely on the extended family system, which was coming under increasing pressure, otherwise they starved. Subsidization was, therefore, a way of keeping some people alive, an aspect that tended to be forgotten when market-related factors were overemphasized. Thus, it should be borne in mind that many governments in developing countries sometimes had no alternative but to subsidize prices in order to save people from starvation.

Mr. Jayawardena recalled that at the time of the 1983 Article IV consultation with China his chair had held the view that, if the major structural reform aimed at stable growth then being put in motion by the authorities were pursued diligently, the medium-term prospects for China would be favorable. Those expectations had been fulfilled. The Chinese economy had shown remarkable resilience in its ability to undertake further reforms aimed at enhancing the influence of market forces. It was rare for an important developing country to achieve high output growth--about 9 percent a year for three successive years--at the present time of severe economic conditions all over the world. China's success was particularly remarkable because it followed the stabilization program initiated in 1981 and was accompanied by moderate inflation and a strong balance of payments. The fiscal deficit had been kept low and manageable and, perhaps most important, China had succeeded in limiting the growth of its population to little more than 1 percent in 1983, compared with 1.7 percent in 1980. By any international standards, the outcome represented a strong economic performance for which the authorities should be congratulated.

Events of considerable significance had taken place in China since the issuance of the staff report, requiring that the staff's appraisal should be viewed in the light of the economic reforms of October 20, 1984, which constituted an important milestone and blueprint for remodeling the Chinese economy on competitive lines, Mr. Jayawardena noted. As Mr. Zhang had observed, the reforms would have to be introduced on a "step-by-step and on a trial basis," because the authorities could not draw on many historical examples of the impact on long-term growth and price stability of liberalization within a socialist system; he commended the authorities for their pragmatism.

Several elements in the reform program deserved special attention, Mr. Jayawardena considered. First, the program emphasized urban sector development and rural industrialization following the recent improvements in the rural agricultural economy and farm incomes. Second, the scope of mandatory planning was being narrowed and that of indicative microeconomic planning was being broadened through credit, tax, and price policies rather than through direct allocative controls. Third, more active monetary and fiscal policies were to be pursued to allocate resources efficiently and to contain inflationary pressures. Fourth, greater autonomy was being granted to state enterprises in order to improve efficiency and productivity; wages would be differentiated to reflect productivity and profitability. Finally, the program envisaged pricing that reflected both relative costs of production and the relationship between market supply and demand.

The price reform was crucial to the success of the other reforms, Mr. Jayawardena commented. The staff's view understandably reflected the standard prescription: domestic prices for traded goods should be linked to their international prices, and adverse distributional effects flowing from price increases of subsidized goods should be taken care of through selective measures to compensate the groups most affected. Mr. Zhang had

stated that the price reform could only be implemented gradually and that subsidies could not be readily eliminated without affecting the sense of equity of the population. The situation represented a classic dilemma. After the Chinese revolution, the authorities had embarked on a highly centralized and directed development effort that had virtually eliminated famine, epidemics, and widespread poverty. There had been no other way to achieve those economic and social objectives. China had then found, like other centrally planned socialist economies, that incentives were needed in order to make further economic progress. Greater reliance on market prices in resource allocation in order to restore incentives was, therefore, implied. Such an approach entailed the liberalization of a controlled economy, the creation of a new ethos of management, and adjustment to a price system reflecting market forces more and the social objective of equity less.

On the one hand, Mr. Jayawardena went on, the authorities would now wish prices to reflect supply and demand so that resources could be efficiently allocated, which was fundamental if the liberalization of management was to yield results; otherwise, the new managers would not be able to respond effectively to supply and demand conditions in the market. On the other hand, too rapid an adjustment could negate the authorities' social and equity objectives. Indeed, while the authorities were well aware of the inefficiency of seeking equity via the price system, a quick transformation of the means of achieving those objectives from prices to other methods--for example, a tax expenditure approach--might entail a rapid escalation of prices, which could be destabilizing and perhaps weaken popular commitment to the reforms. Moreover, as Mr. Polak had said, price stability alone could be a laudable goal in any economy. The cautious, pragmatic approach of the authorities toward the transformation was admirable. The retention of certain key activities under state ownership and planned investment, with gradual liberalization of the price system, was the best strategy in the current context. Although the process could slow the realization of the economic benefit of the reform, the price might be worth paying for orderly adjustment.

With regard to monetary policy, the staff had indicated that the current rate of liquidity growth was high and causing concern and should, therefore, be reduced by raising the rate of lending by the People's Bank of China to the specialized banks and by selling more treasury bonds to the public, Mr. Jayawardena observed. The information in Annex IV of SM/84/229 suggested that money demand was highly income elastic in China. Given the growth rates of output and prices, and allowing for growing monetization of the economy and for excess demand pressure in commodity markets as a result of administered pricing, a growth of the money supply of about 19-20 percent a year did not appear excessive. Moreover, it was not clear that conventional money supply growth was as good an indicator as currency expansion in China where the role of fractional reserves was limited and where consumer lending was virtually nonexistent. He invited the staff or Mr. Zhang to comment on the question.

On the assumptions of a 15 percent annual increase in imports and a 9 percent annual growth of exports, the staff projected that the current account would turn negative, increasingly so after 1987, and that the overall balance of payments would behave similarly after 1988, Mr. Jayawardena noted. The deficits, however, could easily be met by the strong reserve growth up to 1987, so that even by the end of the decade, China would have a comfortable reserve position of three months' imports and an equally comfortable debt service ratio, with a high credit standing. However, it could also be argued on the basis of that scenario that China might face difficulties in the years after 1990 if the assumed trends continued into the next decade. Furthermore, the scenario would be quite different if the authorities wished to utilize their current reserves rapidly for the planned expansion of investment. Would the forthcoming seventh Five-Year Plan, for 1986-90, substantially alter the medium-term forecast? Would the continuing price reforms have a significant impact on the projected export-import scenario? Of course, it was difficult to forecast the development of an economy undergoing massive structural change; nevertheless, the Chinese economy was of great importance and the Fund should endeavor to improve continuously its long-term forecasts.

The authorities had managed the Chinese economy with pragmatism and prudence, Mr. Jayawardena added. They had been rewarded with good economic performance; but, if the momentum was to be sustained, China would have to restore incentives and liberalize the economy gradually. That exercise could not be done rapidly; it should be undertaken cautiously and with popular support. A gradual approach to reform had costs at the outset, but the price could be worth paying in order to achieve an orderly transition. The fiscal and monetary prudence exercised by the authorities deserved praise. The achievements in curtailing population growth were also remarkable and served as a lesson to other countries.

The Fund should not look at China's development from extreme ideological perspectives, namely, capitalist free market versus socialist state direction, Mr. Jayawardena concluded. No country in the world permitted markets to behave with full freedom, nor was there a country in which the economy was totally directed by the state. Economies consisted of differing mixtures of free markets and state intervention, and the traditional labels of "capitalist" or "socialist" often reflected political bias, not economic realities. It seemed that the only viable forms of economic and political organizations were "capitalist" economies moving toward control and regulation of economic activity and "socialist" economies moving toward liberalization of markets. Considered in that perspective, the direction that the Chinese authorities were taking was understandable and commendable.

Mr. Nebbia said that the Chinese economy had been experiencing profound, wide-ranging market-oriented reform in recent years, while remaining a socialist, centrally planned economy. In pursuit of the objective of increased output, the current emphasis was on more efficient use of resources rather than on massive resource mobilization. Incentives were playing a greater role, a certain amount of decentralization was

being implemented in the decision-making process, the economy was being made more open, and macroeconomic management had begun to rely on some market mechanisms, which had been gradually developed. Nevertheless, the major objectives within the overall economic framework remained those of a socialist economy, and thus the scope of mandatory planning, although decreasing, remained large and that of market forces, although growing, remained small.

On the whole, the reforms seemed to be bringing about more than satisfactory increases in output, Mr. Nebbia continued. Economic performance in recent years had been impressive, and the authorities should be commended for their achievements. Recent rates of economic growth had been consistent with the authorities' goal of quadrupling output during the period 1980-2000. In 1983, national income had risen by almost 9 percent in real terms and a similar result was expected for 1984. Agricultural output had increased by more than 9 percent in 1983, suggesting further substantial increases in 1984. Industrial production had also made significant progress in 1983, increasing by almost 11 percent, and expectations for 1984 were for similar growth. The share of investment in GDP had risen in both 1982 and 1983, while savings had also increased, to 32 percent of GDP in 1983. Those results had been achieved in the context of increased emphasis on improving living standards.

The 1983 budget deficit had accounted for 1.7 percent of GDP, Mr. Nebbia remarked, a figure substantially below the average of more than 4 percent in 1979 and 1980. In addition to the improved fiscal performance, revenues had been increased through the newly introduced tax on extrabudgetary receipts. The balance of payments had remained strong in 1983, with total gold and foreign exchange reserves increasing from $11.8 billion at the end of 1982 to $17.1 billion at the end of June 1984. That progress had been achieved despite the resumption of growth in imports, which had increased in value by 11 percent in 1983. Current account developments were also encouraging. There had been a surplus of $4.5 billion, equivalent to 1.6 percent of GDP in 1983, and the staff estimated that another sizable surplus could be expected in 1984. As a result, reserves would probably rise to about $20 billion by the end of 1984, reaching almost one year of current imports.

In light of recent developments, Mr. Nebbia commented, the prospects for the Chinese economy were largely favorable. Progress had been made in major sectors of the economy despite continuing important rigidities in a number of areas, the removal of which would clearly set the basis for further progress. In that respect, it was encouraging that the authorities were willing to extend the range of reforms from the rural to the urban economy so as to bring about more efficient allocation of resources and economic responsiveness by expanding the role of the market within the social system. The separation of political and economic authority, as Mr. Zhang had indicated, would provide the appropriate framework for increasing the effectiveness of the reforms on which China was embarked.

The authorities should be commended for the way in which they had been gradually narrowing the scope of mandatory planning and for their willingness to continue to reduce it in the years ahead, Mr. Nebbia stated. The influence of market forces in determining the relative level of prices and the composition of output would thereby be increased, which could lead to alleviation of the current supply shortages and to the stimulation of investment and production in key areas of the economy. The measures to ensure greater autonomy of enterprises should also promote improved efficiency, higher productivity, and a more effective response to changing demand--a crucial factor to be taken into account in view of the significant increase in disposable income implied by the overall growth of the economy.

The aim of increasing flexibility in relation to sales, the mobility of goods among regions, and international trade was notable, Mr. Nebbia said. Greater openness of the economy to the outside world was currently planned. However, to avoid the emergence of distortions in relative prices, comprehensive price reform to reflect relative costs and supply and demand within the economy would have to be implemented. He fully endorsed the authorities' view that the price reform should be undertaken with caution at the current early stage to avoid undue increases in prices, which at present did not necessarily reflect the opportunity costs of goods. In that regard, an appropriate exchange rate policy could provide the needed link between external and domestic prices and could, therefore, facilitate the task of internal price determination. Such a policy implied the elimination of the internal settlement rate mechanism, a step that could reasonably be taken in view of the sound external payments position currently enjoyed by China.

Mr. Goos remarked that the courageous reform policies pursued by the authorities since 1979 were impressive, particularly the decision of October 20, 1984 to include the urban economy in a comprehensive reform program. Recent economic developments in many sectors, especially in agriculture, indicated that the continued decentralization and liberalization policies had been successful. Therefore, the authorities' intention to intensify and broaden their approach deserved the Fund's full support. Further strengthening of private initiative, the introduction of greater wage differentiation, more intense competition among enterprises, and less emphasis on price controls were essential to enhance efficiency of production and resource allocation and, thus, to speed up China's economic development. There was no doubt that China had vast economic potential; with appropriate policies, that potential could be realized much faster than in the past, to the benefit not only of China's population but of the world economy. Of course, fundamental reforms could not be implemented in a rush. Given their pragmatic approach in the past, it was not likely that the Chinese authorities would overlook the risks of an overly ambitious and too rapid reform process; on the contrary, in some areas there was scope for more forceful action.

The open manner in which the economic situation--including the deficiencies of an overly centralized planning system and the potential benefits of a more market-oriented framework--had been analyzed and assessed by the Chinese authorities and by Mr. Zhang, was impressive, Mr. Goos continued. He agreed with the staff that such forthrightness gave hope for the future. The crucial issues confronting the Chinese Government at present had been adequately covered by the staff, and while it was difficult to arrive at final conclusions on many of those issues, given the specific characteristics of the Chinese economy, he was in general agreement with the views and recommendations of the staff.

The staff correctly judged that a somewhat more restrictive credit policy, supplemented by various monetary policy measures, would be appropriate, Mr. Goos stated. Such an approach would not only help to correct the recent strong liquidity growth but would also contain future price pressures resulting from the increased autonomy to be granted to enterprises. It would certainly be less effective to try to counter such pressures by introducing additional administrative controls, particularly if the pressures reflected the emergence of further imbalances in supply and demand in the real economy. The recent shift in the pattern of savings, from the budget toward private households and enterprises, pointed to the need to build a functioning banking system.

The beneficial effects of the price reform measures would only be fully realized if supplemented by effective exchange rate arrangements, Mr. Goos stressed. He endorsed the staff's suggestion that the Fund should not approve the multiple currency practice at present, particularly in light of China's comfortable foreign exchange position and the relatively low level of foreign indebtedness. The margin between the official exchange rate and the internal settlement rate had narrowed considerably since the introduction of the latter rate in 1981. Was that narrowing an indication that the Chinese authorities were at present attaching less importance to the maintenance of multiple exchange rates and that they might plan to unify the two rates in the near future?

He also agreed with the staff that China's reserve position and its low debt service burden would permit a stronger expansion of imports, therefore further strengthening the impressive growth performance, Mr. Goos said. In that respect, the assumption underlying the medium-term balance of payments scenario of an annual growth rate of imports of about 15 percent was realistic. Such a growth rate would ease existing and newly emerging bottlenecks on the supply side and help to modernize productive capacity. It would also be in line with the authorities' highly commendable objective of pursuing prudent borrowing and investment policies. It would thus appear advisable to refrain from an unduly restrictive import policy stance.

Mr. Ramtoolah commented that the Chinese economy continued to perform in a remarkable manner. Real GDP was growing rapidly, reflecting the continued buoyancy of agricultural and industrial output. Investment and savings remained at high levels, and the overall fiscal deficit continued

to be low as a percentage of GDP. The external sector was in surplus, in both the current account and the overall balance. However, two policy areas deserved particular attention: first, the liquidity position and the evolution of prices, and second, the appropriateness of the exchange rate system.

It was not certain whether the cost of living index in China was an appropriate indicator of inflationary pressures in the economy, given that some prices were fixed directly by the state, Mr. Ramtoolah considered. However, prices that were set in response to market forces were increasing rapidly. In 1983, the prices of vegetables had increased by 12.7 percent, fruit by 14.7 percent, and aquatic products by 13.4 percent. Perhaps the situation reflected supply constraints resulting from various bottlenecks but, more important, it could also be the result of demand pressures. Therefore, the staff's word of caution with respect to the overall liquidity situation appeared justified. Household liquidity had risen by 27 percent in 1983, more than in the two previous years, while liquidity in the industrial sector, which was itself a possible influence on household liquidity, had also increased faster than the growth of economic activity. Prudence was, therefore, warranted. Perhaps the authorities should consider the staff's suggestion to increase bond issues accompanied by measures to enhance their attractiveness as a means of absorbing excess liquidity. Such a proposal would have the additional advantage of reducing recourse to bank financing of the budget deficit.

The Chinese economy was undergoing profound changes as a result of the ever-increasing importance of market forces in the determination of prices, Mr. Ramtoolah said. There was, therefore, a need for an exchange rate system that would provide what the staff referred to as an effective link between international and domestic prices. In the supplement to SM/84/221, the staff indicated that the margin between the official exchange rate and the lower internal settlement rate had declined from 80 percent in January 1981, when the latter had been instituted, to a mere 5 percent only a few days earlier. The closeness of the rates presented a good opportunity to bring about a unified exchange rate system.

His chair continued to believe, as it had at the time of the 1983 Article IV consultation with China, that the authorities' prudent approach with respect to imports was justified, Mr. Ramtoolah stated. China would soon have to embark on a major increase in imports following the implementation of the large-scale projects currently being prepared. Understandably, the country had to accumulate an appropriate level of reserves. The reform of the financial structure initiated in 1979, which in January 1984 had led the People's Bank of China to act exclusively as China's central bank, was welcome. He hoped that increasing use would be made of the more traditional instruments for the conduct of monetary policy. The continued emphasis on linking wages and bonus payments to individual economic performance in an enterprise was conducive to an overall increase in allocative efficiency. Finally, he thanked the Chinese authorities

for the inspiring role that they were playing in many of the African countries represented by his chair and for the financial and technical assistance that they were providing to those countries.

Mr. Tvedt remarked that developments in the Chinese economy in recent years had been impressive, particularly in the agricultural and industrial sectors. They had been accompanied by low price increases and a strong external position with a comfortable level of international reserves. The cautious stance of fiscal policy over the years was also impressive. On the other hand, monetary policy, judged by the traditional indicators, appeared to have been accommodating. However, as a number of speakers had pointed out, it was difficult to interpret the strong growth in liquidity, particularly because of the increased monetization of the economy. The developments in the monetary aggregates should, nevertheless, be monitored carefully, and necessary measures should be introduced without delay if internal or external imbalances emerged. In that respect, he welcomed the intention of the authorities to place greater reliance on treasury bonds to finance the budget deficit.

Despite the remarkable structural changes made thus far, further substantial improvement in the functioning of the Chinese economy was needed if the ambitious target of quadrupling output between 1980 and 2000 was to be achieved, Mr. Tvedt continued. At present, domestic resources were strained and domestic demand tended to run ahead of supply. While he agreed with the authorities that the opening of the Chinese economy should proceed gradually, he endorsed the staff's view that there was scope for a more liberal import regime. Given the need for technological modernization of the economy, a strict adherence to import restrictions could limit growth potential. At its present stage of development, China should, in fact, aim at augmenting its resources by running an import surplus.

The staff correctly pointed out that it was important to adopt an exchange system that improved the link between domestic and international prices, Mr. Tvedt commented. He also agreed with the staff that domestic prices should be allowed to reflect the underlying structure of demand and supply to promote the more efficient use of scarce resources, although he understood the Chinese authorities' concern about the impact of abrupt changes. However, the current high growth rates of production and income should permit speedy price adjustments without lowering real incomes in various sectors. Important structural changes had been made following the adoption of the program of reform in 1979, and he was confident that the authorities would successfully implement the decision on reform adopted in October 1984. It should be borne in mind, however, that the administrative and economic complexity of a nation as large as China called for a gradual, cautious approach.

Mr. Zecchini stated that China's economic performance in the past few years had been impressive; the Chinese authorities should be commended for the breadth of their economic achievements. The recent decision by the Central Committee indicated that the country was enhancing the process

of economic decentralization and that the authorities fully appreciated the role of guided market forces at the present stage of development. All the preconditions appeared to be in place for China to play a leading role in the world economy in the coming decades, both as a supplier and a market.

The problems facing China at present were related to the transition from the old to the new economic setting, Mr. Zecchini continued. Three aspects were of special importance: first, the conduct of monetary policy in an economy in which transactions, techniques, and habits were undergoing radical transformation; second, the problem of how cautious the authorities should be in the management of foreign exchange reserves and in increasing imports; and third, the more fundamental question of the ideal pace of economic reform so as to avoid disruption while rapidly bringing about the stimulus that free market forces could provide to domestic supply.

Although monetary growth had been high, Mr. Zecchini remarked, it should be recognized that a strong increase in money demand must also have occurred. The old notion of money as a "luxury good" made popular by Milton Friedman--that, at least at some stage in the development process, economies tended to have an elasticity of money demand with respect to income greater than one--well applied to China at present. In such circumstances, the monetary authorities should be accommodating, taking into account the decreasing trend in the income velocity of circulation. The situation did not necessarily imply the greater likelihood of future inflation. Much depended on whether larger cash balances were being demanded for transaction purposes or whether they were being kept idle by savers because of a lack of appropriate means of portfolio diversification. To prevent the latter development, which would indeed represent an inflationary threat, priority should be given to the gradual production of less liquid, more remunerative financial instruments that could also act as stores of value. That approach, in conjunction with the monetization of the economy, could not fail to strengthen the effectiveness of monetary policy in the medium term.

The appropriate degree of import expansion in light of the existing volume of reserves inevitably involved a value judgment, Mr. Zecchini considered. The Chinese authorities were right to stress the need for caution on the expectation of significant growth of imports in the medium term. The staff's projections showed clearly that China would not enjoy much longer the strong external position currently observed. For example, the ratio of reserves to annual imports, which was currently almost at unity, was expected to decrease rapidly through the remainder of the decade and to reach one fourth by 1990.

With regard to the general implementation of economic reforms, Mr. Zecchini said that he hesitated to make specific recommendations to the authorities on how fast they should proceed and would, therefore, suggest only possible priorities. Further wage differentiation in response to different levels of skills and of productivity should be

an essential part of the reform of the pricing system. Such a change was necessary in order to stimulate higher efficiency in the allocation of resources and in the processes of production. Similarly, it would be increasingly important to ensure that financial capital was allocated on the basis of cost-benefit considerations. In that regard, an incentive to greater use of the price mechanism--specifically, the interest rate--was being introduced into the economy to the extent that an increasing share of enterprises' external financing needs were met through loans rather than grants. Finally, taking into account China's external position and the recent drive toward reform of the price mechanism, the maintenance of an internal settlement rate distinct from an official rate no longer appeared justified.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/160 (11/5/84) and EBM/84/161 (11/7/84).

2. THE GAMBIA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with The Gambia to not later than November 26, 1984. (EBD/84/281, 11/2/84)

Decision No. 7834-(84/161), adopted
November 6, 1984

3. SENEGAL - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Senegal to not later than January 18, 1985. (EBD/84/280, 11/2/84)

Decision No. 7835-(84/161), adopted
November 6, 1984

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of Assistant to Executive Director as set forth in EBAP/84/235 (11/1/84).

Adopted November 5, 1984

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/75 are approved. (EBD/84/279, 10/31/84).

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/237 (11/2/84) is approved.

APPROVED: August 5, 1985

LEO VAN HOUTVEN
Secretary