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Minutes of Executive Board Meeting 83/157

10:00 a.m., November 21, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	
	M. Teijeiro
R. D. Erb	
M. Finaish	T. Alhaimus
	T. Yamashita
J. E. Ismael	
	L. Leonard
A. Kafka	
	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	A. A. Agah, Temporary
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
	A. Clark
Zhang Z.	

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present:
Asian Department: H. Neiss, Deputy Director; L. H. De Wulf, F. Le Gall, K. Saito, D. A. Scott, Wang X. European Department: L. A. Whittome, Counsellor and Director; P. C. Hole. Exchange and Trade Relations Department: M. Allen, M. Guitian. IMF Institute: Zhang Z., Participant. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman. Research Department: W. C. Hood, Economic Counsellor and Director; D. J. Goldsbrough, M. Goldstein, C.-Y. Lin. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: J. R. N. Almeida, C. J. Batliwalla, L. Ionescu, H.-S. Lee, Y. Okubo, I. R. Panday, D. I. S. Shaw. Assistants to Executive Directors: J. Bulloch, L. E. J. Coene, M. Eran, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, N. U. Haque, J. M. Jones, H. Kobayashi, M. Rasyid, J. Reddy, Shao Z., S. Sornyanyontr, C. Y. Wang.

1. CHINA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with China (SM/83/213, 10/25/83). They also had before them a report on recent economic developments in China (SM/83/221, 11/3/83).

Mr. Zhang made the following statement:

My authorities found the consultation discussion with the staff very useful and appreciate its well-prepared report. They agree with the general thrust of the staff's analysis and appraisal. In the following I will concentrate on three topics: the current economic situation; the general features of the economic reform; and some policy issues.

Current economic situation

Since the last consultation, in 1982, China has continued to carry out the policy of "readjusting, restructuring, consolidating, and improving the national economy." The Plan for 1982 was successfully implemented and the overall results were better than originally anticipated. Thus, the year 1982 witnessed a further lessening of instability in several sectors of the economy and the elimination of serious imbalances. These gains were accompanied by a significant improvement in the methods of planning and management of the economy and by the setting up of new organizations and mechanisms; these changes contributed substantially to a more effective economic policy.

These favorable trends continued during the first ten months of 1983. According to data just published, total industrial output increased by 10.5 percent over the same period of 1982; the rates of increase in heavy and light industry were 12.9 percent and 8.1 percent, respectively. In agriculture, total grain output for 1983 surpassed the record level of 1982 by more than 3 percent, and the planned targets for major industrial crops have been exceeded.

The planned production targets for individual industries were also generally fulfilled or overfulfilled. In the heavy industry sector the most notable cases were in energy production and transport. The increase in output for the various branches of energy production, for instance, ranged from 3.6 percent to 7.4 percent in the first ten months of 1983, compared with the same period of 1982. Many important light industries also showed steady increases in output, particularly synthetic chemical fibers, bicycles, television sets, and some manufactured food items. As a result, the supply situation as a whole was improved. The volume of retail sales was 10.5 percent higher during the first ten months of 1983 than in the same period in 1982.

In the field of capital construction many key projects were completed according to the Plan and, consequently, there was an overall improvement in the structure of investment. At the same time, the Government was able to bring under control, as planned, the rising trends in state capital construction at both the central and provincial levels. During the first nine months of 1983 there was a large reduction in the number of new projects financed from extrabudgetary funds.

The true significance of the achievements on the production front can only be grasped when they are seen and appraised in the context of the ongoing readjustment policy, which was initiated at the beginning of 1979. The main objectives of this policy are to reduce the serious sectoral imbalances and to raise the overall performance of the economy through better planning and implementation and improvement in economic mechanisms. During 1979-83 the effects of this policy were particularly noticeable in the following four aspects. First, the rates of increase in the output of agriculture and light industry were accelerated and that of heavy industry much reduced. Consequently, there is now a better sectoral balance of branches of national production. This shift is clearly indicated by the fact that the relative shares of agriculture, light industry, and heavy industry in total output, which were, respectively, 27.8 percent, 31.1 percent, and 41.1 percent in 1978, became 33.6 percent, 33.4 percent, and 33.0 percent in 1982. Second, the drastic curtailment in investment brought about a decline in the ratio of investment to GNP from 36.5 percent in 1978 to 29 percent in 1982, and this has led to a less disproportionate relationship between investment and consumption in national expenditure. Third, as a result of these changes, there has been a steady increase in the production and supply of consumption goods sufficient to meet the rising demand of both the urban and rural population. This has made it possible to contain the inflationary pressures and to keep retail prices stable. The index of the general retail prices for the first nine months of 1983 stood at 101.1 percent, taking the same period of 1982 as 100. Fourth, together with the recovery and expansion of production, there have been widespread efforts to improve the efficiency of management and production of the enterprises, which has already yielded visible results in many cases. There has been a general increase in labor productivity and a reduction in cost in many industrial branches, as well as an overall improvement in the quality, varieties, and composition of goods produced.

Despite the favorable results achieved over the past several years, one should not overlook some structural difficulties in the national economy resulting from past developments that still remain to be resolved. For instance, on the production front some essential raw materials are in short supply, energy production still does not keep pace with the continuously rising

domestic and export demand, and the inadequate transport and infrastructure still constitute a serious bottleneck. At the enterprise level, efficiency remains relatively low, though greatly improved, and consistent efforts to apply technological innovation and to secure improvements in technology are lacking. On the macroeconomic level, the decision to curb the growth of the extrabudgetary investment expenditures, particularly at the provincial and local levels, has not been fully implemented. Inflationary pressures have abated appreciably in recent years, but they persist, as there is still an exccess of liquidity in the hands of consumers.

General features of the economic reform program

The readjustment policy is intended essentially to prepare the economy for undertaking some basic, longer-term changes in the economic structure and the functioning of the planning system. With the economy progressing on a firmer and sounder basis during the past several years, the Government embarked upon a reform program in 1982. The program as it has evolved up to now has three characteristics. First, it does not represent a definitive program of comprehensive changes, but is rather a preliminary and preparatory approach to the problems at hand. Second, it aims at gradual systemic remolding, involving the introduction, step-by-step and on a trial basis, of concrete solutions to the functioning problems of the economic system. Third, it has reintroduced and continues to expand certain methods of management relating to the managerial system in the enterprises, economic accounting, and financial controls, which had been abandoned or disrupted during the decade before 1978.

It has become clear in recent years that the functioning of the present economic system is impeded by overcentralized management, under which the enterprises have little authority for decision making, and the market mechanism has a minor role to play. From the point of view of the economy as a whole, changes are therefore needed in order to provide more competition, greater specialization and improved cooperation in production among the enterprises, to enable the enterprises to deal directly with each other for their supplies, to establish a more direct linkage between efficiency and rewards, and to promote an increase in recourse to foreign trade and capital. The guiding principle of the reform remains a continuing reliance on central planning as the dominant factor in the economy, but supplemented by market elements. It is expected that by introducing new regulations, mechanisms, and organizations, planning in the future will become more efficient as an instrument for a coherent and balanced economic development in China. It should be emphasized that the planned economy, public ownership, and remuneration according to one's

contribution to work will remain the three basic features of China's socialist economy, and that the economic reform does not entail changes in the fundamental sociopolitical objectives of the country.

To be more specific, the reform progam up to now includes the following main elements:

Because the effectiveness of planning itself had been impeded by overcentralization, the system of planning is being altered, by making it less detailed and more longer-term oriented, and henceforth the plan implementation will rely increasingly more upon economic than administrative control procedures. It is now intended that production of enterprises will be subject to directive planning, indicative planning, or will be market-determined, depending upon the importance of an enterprise to the national economy and on special conditions or various industries.

One of the central problems of the industrial sector has been how to give enterprises the autonomy and power to make their own decisions in management and production. The profit retention scheme introduced in 1979, gave the enterprises free choice over the use of their retained profits, and was the first step in this direction. The scope of this decision was greatly enlarged in June 1983, when the new system of tax on the profits of the enterprises was adopted to replace the previous practice of transferring the profit to the budget.

Another aspect of the industrial reform has been to improve the efficiency of the management and production of the enterprises. Since the beginning of 1982, the Government has been implementing an enterprise consolidation program, which is expected to cover all enterprises by 1985. This program includes: selection of enterprises' managers on the basis of merit; improving the organization of labor and the internal production process; enforcing labor discipline; and developing a system to strengthen the responsibility for production. Furthermore, enterprises have been required to apply the system of economic accounting, so that they will be solely responsible for the profit and loss of their operation.

From the point of view of the economy as a whole, the efficiency of industrial production will depend also on the specialization of individual enterprises and on the level of technology applied. Efforts have been intensified to develop specialization of production through cooperation between various industrial ministries and between different localities. In March this year, the Government started the technical innovation program for existing enterprises, and it intends to carry out a large-scale technical transformation during the next two Five-Year Plans. For this purpose imports of foreign technology and capital will continue to expand over the coming years.

In agriculture, the principal reform has been the institution of the production responsibility system, based upon contracts with the peasant household, under which remuneration is linked to output. The government procurement prices for grains, industrial crops, and other sideline products have been raised substantially. As a result of the steady increase in agricultural production during the past several years, it has become possible for peasant households to expand the scope of division of labor and specialization in farming, as well as to combine farming with other activities, such as processing, retail trade, and local transportation. It has been estimated that almost one out of ten households is engaging in these activities at the present time.

In some areas of economic activity, where the state enterprises were not able to contribute actively and effectively in the past, the Government has decided to expand the role of collectively owned enterprises as well as that of self-employed persons. Measures have been taken to encourage these operations in such areas such as handicrafts, local transportation, small-scale construction work, retail trade, and essential consumer services in both urban and rural areas. The setting up of open markets during recent years is a notable example.

Some policy issues

In association with the various reform measures, the role of financial and fiscal policies as a means of macroeconomic control has been greatly increased. In the monetary field, the recent reorganization of the People's Bank of China to exercise exclusively the functions of the central bank by shedding the functions in the fields of industrial and commercial banking, has been an important step toward this end. The functions of the People's Bank of China as the central bank will concentrate on formulating overall monetary policy, managing the flow of credit funds in accordance with the State Credit Plan, and maintaining the stability of the currency. Furthermore, in order to give full play to the important role of China's banking system in macroeconomic management, the People's Bank of China will now be assisted in its task by four Specialized Banks responsible for banking activities in foreign trade, in industry and commerce, in agriculture, and in capital investment.

As to fiscal policy, the immediate tasks are, on the one hand, to promote coordinated development of the economy and establish effective control over the growth of extrabudgetary investment, and on the other to improve the efficiency of the operations of he state enterprises through fiscal measures. Furthermore, steps are being taken to increase taxes and other revenues, as well as to improve tax administration. The level of subsidies will be controlled and their reduction will be

effected gradually, so as to soften the impact on the incomes of urban inhabitants. It is expected that subsidies on a number of essential commodities will be retained.

Regarding wage and price policies, various measures have been introduced, on a trial basis, to improve wage payments and to rationalize the process of price determination; and a comprehensive reform program in these areas is being studied. The objectives of the reform will be ultimately to link wage payments directly to work, and to fix prices in relation to production costs.

The foreign exchange reserves have been increasing over the past several years. However, the projections for 1983 made by the staff seem to have been overestimated, judging from the trend of the current account surplus for the first seven months of 1983. Furthermore, according to statistics just published by Customs, the value of imports and exports increased by 13.3 percent and 6.3 percent, respectively, during the first nine months of 1983, compared with the corresponding period of 1982; and consequently there was a fall in the trade surplus from $1.88 billion to $1.08 billion between these two periods. On the basis of these facts, the continuous large increase in the reserves should be treated only as a temporary phenomenon, both because the level of imports has been deliberately reduced during the current process of economic adjustment, and there have been cases of nonfulfillment of import plans, owing to economic and physical factors, such as delays in placing orders in overseas markets, inadequate harbor facilities, and so forth. Furthermore, it should be pointed out that the figures for official reserves include the working balances of the overseas branches of the Bank of China--an operational revolving fund that cannot be disposed of by the state--as well as the unspent balance of foreign borrowings; all these figures are normally excluded from the total official reserves of other countries. Therefore, the significance of the large and increasing foreign reserves should not be exaggerated, particularly since it is expected that, as soon as the current readjustment process is completed, the demand for imports of capital equipment and other essential materials and goods will be drastically increased. In fact, plans are being drawn up to increase imports to be used for exploration of energy, transport and harbor construction, and new foreign technology for technical renovation in the enterprises.

Lastly, the policy of opening up the economy to the outside world will be maintained. We expect that the economic and trade relations between China and the rest of the world will be further strengthened and developed. As pointed out before, we put particular emphasis on imports of foreign technology. Programs to import 3,000 advanced technological items are drafted for 1983-85, and some items are being negotiated. Moreover, at present, China

is still at an early stage of development. We also need imports of foreign capital and direct foreign investment. In fact, various legislative measures have been adopted to encourage foreign investment. China will remain a net capital-importing country for some time to come, but we shall follow a prudent borrowing policy.

Mr. Yamashita commented that the authorities had been largely successful in restoring overall stability to the economy. They were to be commended for the decisive adjustment measures, which had reduced demand pressures and strengthened the external position. Recently, however, there had been signs of increasing demand pressure caused by larger than planned investment and by an acceleration in the growth of the supply of money. Although the pressure had not yet been reflected in increased domestic prices, the authorities had appropriately decided to maintain cautious demand management policies.

Commenting on investment policy, Mr. Yamashita said that economic reforms stressing the decentralization of decision making had increased the amount of financial resources at the disposal of enterprises and local governments. The rapid increase in extrabudgetary investment by enterprises had been the main cause of the excess investment over the planned level, and the authorities' efforts to increase the control over such investment were welcome. However, he agreed with the staff that heavy reliance on administrative measures, although perhaps necessary in the circumstances, would undermine the medium-term objective of decentralization, and that further improvement of the fiscal and monetary policy instruments would be a better way to complement the decentralization policy. Mr. Zhang's statement that henceforth the authorities intended to rely increasingly on economic measures, rather than administrative procedures, was reassuring. In recent months, heavy industrial activity had again grown more rapidly than light industrial activity, and he wondered whether that development was consistent with the Government's priorities.

As a result of the economic reform measures introduced since 1978, Mr. Yamashita noted, the share of central government expenditure in GDP had steadily declined, although extrabudgetary expenditures had rapidly increased. Fiscal policy had generally been prudently managed and the deficit had been kept under control, but the authorities were still concerned about the weakness of the public finances. Revenues depended importantly on state enterprise profitability, which had stagnated, as many enterprises had been running losses; and the industrial sector in particular had suffered from excess inventories of some commodities and from shortages of others. In that connection, it was important to note that the price structure had remained essentially unchanged since the early 1950s and did not fully reflect productivity developments in the various sectors. The present price structure, together with the relatively low indirect taxes, enabled relatively inefficient enterprises to continue operating, and the recent replacement of the profit remittance system by

a profits tax seemed to be a step in the right direction. Changes in the price structure were called for, and the study by the State Price Bureau should be useful. On the expenditure side, the rate of growth of subsidies had fallen in recent months after a long period of rapid growth. There had been no major increases in procurement prices in recent months, a move that, by reducing the burden on state finances, could help to encourage investment in key budgetfinanced projects. The authorities' intention to reduce the burden of subsidies by narrowing the gap between retail and procurement prices was welcome.

The growth of currency in circulation in 1983 was expected to exceed the plan target, Mr. Yamashita observed, partly because of the unexpectedly large wage bill. Had the currency expansion contributed to the rapid rate of growth in aggregate demand? There was a clear need for the authorities to continue monitoring the expansion of the currency supply.

The recent major reform of the banking system was welcome, Mr. Yamashita commented. It was too soon to assess all the implications of the reform, but he hoped that the separation of the central and commercial banking functions would make it easier for the central bank to control effectively the overall supply of liquidity through various macroeconomic instruments.

Despite the international recession, Mr. Yamashita said, exports had grown steadily, and exports of machinery and equipment had risen at a remarkable rate. Imports, however, had stagnated as a result of the implementation of the stabilization program. While noting Mr. Zhang's observation that the trade surplus was a temporary phenomenon, he agreed with the staff that, given China's present strong financial position, there might well be some scope for expanding imports through a more liberal import policy, thereby helping to alleviate domestic shortages and to increase the productivity of domestic industry. The authorities were actively studying the question of the appropriate exchange rate system for China, and he generally shared the staff's views on the matter. Finally, he had no difficulty in accepting the proposed decision.

Mr. Polak remarked that the present consultation with China, unlike previous ones, had not suffered from a lack of data. The data on the important variables, such as industrial production and retail sales, were fairly current--through October 1983--and the main economic developments had been clearly painted in broad strokes. The staff reports did not contain the great detail characteristic of some previous reports on other countries. Nevertheless, they provided a clear picture of the major elements of success, but also contained some unmistakable signs of strain.

Among the successes, Mr. Polak noted, real national income had continued to grow at a highly satisfactory rate--with real growth in 1982 significantly exceeding the target--as a result of the major adjustment program. The balance of payments had swung into a surplus that was perhaps excessively large, although Mr. Zhang had explained that it was temporary, and that China expected to return to its natural position of

a net importer of capital. The overall development of exports had also been highly satisfactory, and the share of manufactured exports other than textiles had risen from 29 percent of total exports in 1979 to 38 percent in 1982, while the share of machinery and equipment had increased from 3 percent to 15 percent. In statistical terms, the main contribution to the trade surplus had come from a decline in the value of imports, but the volume of imports had risen by 5 percent, and the authorities had also succeeded in increasing the quantity, variety and quality of consumption goods.

The strain in the economy, Mr. Polak continued, was reflected in the Government's inability to control the pressure for a larger volume of investment, excluding investment that was financed through both the budget and extrabudgetary expenditures. Investment by state enterprises was clearly out of control. The strong urge to invest was not easily contained by the centrally planned economy and tended to direct resources away from top-priority projects. The surge in investment had involved large wage payments which, in turn, had increased the volume of currency in circulation and had caused some excess demand for consumption goods that was not reflected in the statistics, which were apparently limited to an index of controlled prices.

The best corrective mechanisms to deal with the existing tensions in the economy were not self-evident, Mr. Polak remarked. The authorities had stated that they were relying on a combination of economic and administrative measures together with moral suasion. The necessary changes in the economic system that Mr. Zhang had described in paragraphs 7 and 8 of his opening statement had been defined rather weakly; they were either preliminary, or were to be introduced gradually, on a trial basis. The direction of the changes in the system were clear in only two respects. First, the authorities intended to restore accounting and financial controls that had been lacking over the previous several years; second, they planned to continue the trend of decentralization.

It was difficult, Mr. Polak said, and perhaps impossible, for an outsider to judge how well the administrative and other noneconomic guidance measures worked in China, and he wished to comment only on the economic measures. The authorities would of course decide for themselves the extent to which they thought it would be necessary to depend on economic measures, but correct prices would certainly play an essential role. There was no point in giving the profit motive a larger role in the decision making in enterprises unless the profits resulted from proper cost accounting based on proper prices.

He fully agreed with the staff that profitability was not a useful standard unless it reflected real conditions, Mr. Polak went on. Profitability that reflected nothing but the quirks of the price system was not a useful guideline for decision making; that principle was valid for internal prices and wages as well as for the prices of imported commodities. According to the staff report, the studies designed to examine proper prices in China were to deal separately with the prices of international

commodities and the prices of domestic commodities. In fact, the question of proper prices was essentially independent of the origin of the items concerned. Moreover, the staff discussion on page 17 gave the impression that the studies on prices were to be long and drawn out, as the substance of the matter was to be dealt with only after certain theoretical problems concerning the role of prices had been solved.

The need to identify proper prices should be seen as an urgent one; it had become of immediate relevance once the authorities had decided to give profits a larger role than hitherto and to increase the decentralization of decision making, Mr. Polak continued. Proper economic criteria were needed in part to permit the banks to play an appropriate role in the decisions on investment. The staff paper gave the impression that the banks had not played their assigned role and had reluctantly made funds available to customers badly wanting to invest. The banks were supposed to make investment decisions "on the basis of macroeconomic criteria," but the precise meaning of that objective was unclear. Were bank officers supposed to apply macroeconomic rules in deciding whether one particular procedure or another was appropriate? If the banks were to function properly, suitable financial constraints on their activities would have to be introduced.

The staff had noted, Mr. Polak remarked, that the authorities' method of analyzing monetary matters was different from that of other countries. In China, attention was focused primarily on currency in circulation, a reasonable practice, as currency in circulation was a large proportion of the total money supply. However, the attention of the authorities seemed to be focused entirely on flows, including increases in currency in circulation as a result of wage payments, and the absorption of currency by consumer goods and private savings. It might well be true that in a fully planned economy it was possible to control all those flows, so that the size of stocks need not be a cause for concern. But as the decentralization process continued, the flow analysis would become inadequate and the authorities would have to pay attention to the monetary origin of the currency in circulation, namely, credit creation. The staff had concluded that credit creation in China was not a matter that received great attention. However, in the light of the decentralization, the economics of Western countries, which paid critical attention to credit creation, would make a genuine contribution to dealing with the problems of finance in the Chinese economy, and particularly the problem of excess demand that was clearly reflected on the investment side and also, although less clearly, on the consumption side. That was an additional reason why the recent separation of the central banking functions from the commercial banking functions was welcome. He hoped that it would give the People's Bank of China the time and the staff to consider the monetary approach that would be appropriate for the increasingly decentralized Chinese economy. Finally, he agreed with the staff's comments on the desirability of unifying the exchange rate.

Mr. Leonard stated that in managing the economy the authorities were attempting to reconcile at least three different sets of principles--each backed by a particular orthodoxy--that permitted ample room for conflict among them. The skill, commitment, and pragmatism that the authorities had shown were commendable, and in setting the objectives for the economy they were obviously guided by classical principles of balanced macroeconomic management. Most observers of the Chinese economy were interested primarily in the authorities' readiness to draw on market principles in their efforts to achieve their objectives. Mr. Zhang's opening statement clearly showed that the authorities were fully aware of the implications of the experiment in which they were engaged.

The authorities had achieved considerable success in recent years, Mr. Leonard continued. They had made substantial adjustments in the economy and encouraged notable improvements in general economic conditions, and particularly in the external sector. In 1982, output had increased by 7 percent, compared with the target of 4.5 percent, despite the tight domestic restraint. That achievement had been made possible in part by the improvement in agricultural output resulting from incentives in the form of higher producer prices, the decentralization of decision making, and favorable weather conditions. Industrial production had also risen, although at some cost. In addition, the balance of payments had improved dramatically, and exports had increased substantially, despite the difficult international environment. He agreed with the staff that the various gains were impressive.

Centralized decision making in a planned economy had undoubted value in containing adverse economic trends, Mr. Leonard commented, but could have important implications for economic efficiency in the medium term. The adjustment effort in 1981 and 1982 had clearly been effective, as was evidenced by the positive rate of economic growth. Nevertheless, the existing structural difficulties in the Chinese economy seemed to have sprung at least in part from the earlier reform and could seriously limit future growth if they were not dealt with. An important structural weakness was the rapid growth in extrabudgetary investment. The investment overruns had caused total investment to exceed significantly the planned level, led to shortages of imported inputs, and spread financial resources over an excessively large number of projects. The escalation of project costs and the lengthening of the construction periods had reduced the potential profitability of the projects. In addition, there was some risk that shortages in the economy could intensify, undermining regular production activities. Curtailing overall investment was not the solution to the problem. Indeed, more, rather than less, investment was required to pave the way for future growth, and the staff had made specific reference to required investment in energy, the supply of essential raw materials, transport, and other infrastructure facilities; investment in research and the application of new technologies was also needed. The quality, structure, and balance of investment should be looked at carefully.

A critical question in the investment area, Mr. Leonard continued, was whether the new economic mechanisms being introduced by the authorities would be able to achieve the proper allocation of resources. The reforms in the banking system and in the allocation of credit had become effective on October 1, 1983, and it was much too soon to assess all the implications, although the authorities' objective of having credit policy play a more active role than hitherto in economic management was certainly welcome. The decision to match credit requirements to output demand was commendable and should help to smooth out the fluctuations in inventory accumulation that had taken place in the past, when credit had been issued automatically to the various plants.

The authorities should act to improve the fiscal situation, Mr. Leonard considered. Merely reducing the volume of investment was not a genuine solution, and the staff had usefully concluded that the subsidies should be contained and that additional revenue should be raised. A more rational pricing system than the present one would make a contribution to increasing the efficiency of tax collection, and the authorities had wisely decided to expand the role of market mechanisms in the economy. Because of its huge size, the Chinese economy would certainly benefit from decentralized activities based on market-oriented prices. He agreed with the staff that the present price structure was hampering the efficient allocation of resources, and that prices should be permitted to reflect, inter alia, underlying scarcity values. If the authorities wished to alleviate the adverse effects of prices on the distribution of income, they could best do so by fiscal means, rather than by controlling the prices of individual items. More market-oriented pricing, together with appropriate demand management, would also provide both a useful means of controlling investment and a rationing system for resources that would help channel them into the most profitable sectors. The authorities' preferred combination of economic tools and moral suasion might well have a role to play, but, as the staff had suggested, it might undermine the decentralization process. The authorities would undoubtedly benefit from price information obtained through the external sector.

He supported the authorities' efforts to develop the external sector in a competitive manner, Mr. Leonard went on. The economy would certainly benefit, and trade in particular would continue to expand, if external prices were linked to a rational trade and exchange regime. Since the internal price structure had serious deficiencies, it would be prudent for the authorities to take as much advantage as possible of the information contained in international prices in their effort to improve the operation of the domestic economy.

The dual exchange rate should be unified, Mr. Leonard considered, and domestic prices should reflect international prices through an appropriately valued exchange rate. In that connection, the study being undertaken by the State Price Bureau was a positive development, and he regretted that it was not to be completed in the immediate future. The authorities understandably felt that price reforms would take time but, given the strains on domestic resources and the importance of achieving greater integration with the world economy, unnecessary delays should be avoided.

He sympathized with the staff, Mr. Leonard remarked, who felt that there would be little benefit in a further buildup of reserves. Reserves could be used to avoid shortages, thereby relieving the strains in the economy. At the same time, the authorities believed that the promotion of imports should be approached with caution.

He agreed with the staff, Mr. Leonard stated, that further progress should be made in eliminating the bilateral payments arrangement. The present exchange rate system was only minimally effective. On the other hand, China's early repurchases and inclusion in the Designation Plan and Operational Budget were welcome.

In the past, Mr. Leonard recalled, the staff had apparently been hampered somewhat by the lack of adequate data on the Chinese economy. The increased contacts between the Fund and the authorities over the previous year were encouraging, and he was pleased that the staff had been able to formulate the analytical models in the areas of savings and foreign trade contained in Annexes II and III of SM/83/221. The authorities were to be commended on the increase in the volume of statistics available to the Fund and should be encouraged to work closely with the staff to fill any remaining information gaps. Finally, he generally agreed with the staff appraisal and fully supported the proposed decision.

Mr. de Groote remarked that the measures recently introduced by the authorities clearly showed that a general search for new ways of overcoming economic backwardness could, if conducted with due caution, be rewarding in terms of increased income, and could have positive results even in the short run. Those facts were of great significance for the advice that the Fund would give to other developing countries. At the same time, the sound development of the Chinese economy, whose potential in terms of human resources was substantial, was an important factor in the world economy. China's increasing participation in the international division of labor could positively affect the economies of many countries.

The success of the Chinese economy in recent years was obviously attributable to the cautious implementation of major economic programs aimed at establishing a realistic economic policy based on the introduction of market instruments in the context of a socialist economy, Mr. de Groote commented. The authorities had realized that, even at the present stage of development, their economic plans could not be achieved solely by means of directives; they also had to rely on initiatives taken by economic units that were becoming, albeit gradually, increasingly independent, and on the power of market forces. In that respect, the recent experience of China, like that of Hungary, had international implications, as it demonstrated that socialist economic systems and the use of market-economy instruments were not mutually incompatible. Several months previously, when the Executive Board had discussed another socialist country, an Executive Director had mentioned that that country would have to find a compromise between socialism and the use of market-economy instruments. In his own view, however, no such compromise was necessary. China's increasing use of market-economy instruments had not detracted

in any way from the socialist character of its system, which did not permit private ownership of productive resources and which organized resource allocation according to certain basic directives.

The staff report, Mr. de Groote continued, clearly showed the weakness typical of an economy that was moving from a highly centralized management system to a decentralized one--namely, the lack of policy instruments to influence adequately the new decision-making process. There was bound to be some uncertainty during the transition period, and such a situation was clearly one in which the Fund could play a useful role by providing resources if a balance of payments need arose and by giving advice to the authorities during staff missions and consultation discussions in the Executive Board. At present, however, the Chinese authorities had no need of financial support, as they had responded to the uncertainties of the transition period by adopting prudent policies.

He sympathized with the authorities, who were reluctant to accept the Fund's recommendation to expand imports at the present stage, Mr. de Groote said. The medium-term balance of payments scenario suggested that imports might reach entirely excessive levels if they were broadly liberalized before underlying market mechanisms could be further developed. The authorities should be urged to introduce as soon as possible new policy instruments that would permit the monitoring of economic developments to be accomplished by other than administrative means, which, as the staff had noted, could run counter to the process of decentralization.

Before such policies could be effective, however, two additional features would have to be introduced into the Chinese economy, Mr. de Groote continued. First, the market incentives would have to be made to reflect the relative scarcities of resources, so that efficient choices could be made. Mr. Polak had convincingly made the case for grounding the profit incentives in a realistic price system. Second, a process of financial intermediation must be established to give capital-surplus enterprises investment alternatives besides reinvestment in the enterprises themselves. The splitting up of the People's Bank of China was an important step in the right direction, but further steps would be necessary to organize a sound financial system providing adequate liquidity wherever it was needed. Otherwise, enterprises might hesitate to invest their surpluses and financial assets to avoid being locked in when other investment opportunities arose.

The role of the exchange rate should be gradually expanded, Mr. de Groote considered, to provide a better link between domestic and international prices. He hoped that the Fund could establish a fruitful dialogue with the authorities on that issue. Choosing a suitable exchange rate might help to reduce the present comprehensive import controls, provided that the other measures that he had mentioned were introduced first. China's development required a huge volume of imports; a much higher level of exports than at present might therefore be needed.

The required transformation of the Chinese economy could only be made gradually, Mr. de Groote said. For some time, China's economy had been guided by rigid and unrealistic expectations and the changes presently being made had been thought to be anathema. Hence, it was important to recognize that in the coming period the economy would have to be approached with great caution. Still, China might be able to speed up the transformation process by sharing in the experience gained by some other countries.

The lack of success in controlling investment in heavy industry was understandable in an economy in which such industry had for decades been the motor of economic development, thereby gathering an enormous momentum of political and social support that had permitted it to circumvent government guidelines, Mr. de Groote commented. To enable market forces to become more effective in such a system, negative incentives should perhaps be introduced to penalize the nonimplementation of general policy guidelines, so that the entities responsible for mismanagement and for the nonimplementation of directives would effectively have to bear the appropriate economic and professional sanctions. That approach was the most effective way of breaking resistance to the move away from heavy industrial development that was a prerequisite for further successful steps on the long road toward a higher income level.

Mr. Grosche considered that the authorities were to be commended for having restored overall economic and financial stability while maintaining growth and improving living standards. The adjustment efforts since 1981--and particularly the cuts in credit, investment, and currency expansion--had resulted in large balance of payments surpluses that had exceeded the estimates at the time of the previous consultation with China.

He had been struck, Mr. Grosche went on, by the discrepancy between the strong external reserve position and the need for an increase in imports of investment goods. A larger number of investments with a significant technical content could make better use of China's growth potential. The authorities and Mr. Zhang had stressed the exceptional and temporary nature of the present strength of the external balance, and had noted that the level of imports had been deliberately reduced as a part of the adjustment effort. Some of the external surplus seemed to have been caused by factors that were temporary in nature, indeed, and the further opening up of the economy to foreign firms for direct investment would probably encourage imports. However, the external surplus would probably continue to be sizable if the structural weaknesses that had hampered the financing of key projects and a larger influx of investment goods were not dealt with. Project financing by the Central Government had expanded at a moderate pace, but extrabudgetary investment by enterprises and by provincial and local governments had increased sharply, thereby straining the resources of the economy and delaying the construction of key projects. At present, newly introduced controls on provincial and enterprise investment should increase the investment potential of the central authorities, particularly in the energy and transportation sectors, which had been characterized by bottlenecks. Those administrative steps were basically welcome, but they might undermine some of the progress that had been made in giving local governments more autonomy.

The Government still faced difficult policy decisions, Mr. Grosche continued. The unwelcome results of some of the economic reform measures, such as the loss of control over resources for investment purposes, might be seen as calling for a sharp change in the reform effort, rather than for continuing along the unknown and somewhat risky road of decentralization. However, the authorities themselves obviously did not share that view, and he was pleased that they intended to continue the reform process and to apply economic instruments more forcefully than hitherto. For instance, in order to direct a greater volume of funds into key investment projects, they intended to issue treasury bonds, apply a new 10 percent tax on extrabudgetary funds, and apply credit ceilings to local banks. However, even more effective instruments of indirect guidance were needed to decentralize decision making, which would be improved if the price system was made a more accurate guide to resource availability. Presumably, it would be difficult to make such a dramatic change as basing the whole Chinese economic system on market conditions. However, the authorities should be encouraged to avoid being excessively cautious about gradually freeing the economy from the fixed prices that had accumulated over several decades. The study by the State Price Bureau of the possible reform of domestic prices was welcome, and he shared the staff's hope that the study would provide a good opportunity for a comprehensive reform of the country's price system.

He was pleased to learn from Mr. Zhang's opening statement, Mr. Grosche said, that the authorities intended to increase their use of market-related instruments in their planning effort. They should refrain from the temptation to solve temporary problems by returning to a system in which central planning covered all aspects of economic activity. Another important, and perhaps less difficult, step toward improving the allocation of domestic resources would be a strengthening of the central government finances. While the fiscal deficit had been effectively controlled, the declining share of investment expenditure in overall expenditure and the rising share of subsidies were a cause for concern. The low profitability of state enterprises was worrying, as they made an important contribution to revenues. However, reforms had been undertaken: the ineffective system of remittances was to be replaced by a new system of profit taxation designed to encourage enterprises to increase their profitability. The new system should perhaps be applied on a larger scale than was now contemplated.

The recent separation of the central banking functions of the People's Bank of China from its commercial banking activities was welcome, Mr. Grosche remarked. That change might eventually contribute to a more active credit policy by the central bank.

He agreed with the staff and previous speakers that China's interests would probably best be served by an exchange rate system that was based on a unified and realistic exchange rate, Mr. Grosche indicated. Given the country's strong external position, the present multiple currency practices were unnecessary. In addition, the continued separation of domestic and external prices was likely to send the wrong signals to the

designers of the economic plan and to foreign trade managers; the prices of imported foreign inputs could be set at inappropriate levels, and incentives from foreign markets for producing units in China might not be felt. Any reform would have to include changes in relative prices. He was pleased that the authorities were reviewing the appropriateness of the internal settlement rate, as well as the exchange rate arrangements in general. The proposed decision was acceptable.

Mr. Erb remarked that, although the staff reports were informative, it had been difficult for him to assess fully economic developments in China. The staff had painted a picture of an economy that was dynamic and growing but subject to a number of strains and crosscurrents. In particular, in recent years the functioning of the country's economic system had been undermined by overcentralized management that had given individual enterprises little authority to make decisions. That fact should be seen in the context of the Government's decision, in response to the unexpectedly rapid growth in investment expenditures, to increase reliance on administrative measures and moral suasion. The State Planning Commission, the Ministry of Finance, the People's Bank of China, and the Capital Construction Bank all felt the need to send teams into the field to scrutinize investment projects and to halt those not meeting certain criteria.

As previous speakers had stressed, Mr. Erb recalled, a crucial element of the reform process was the examination of the role that prices should play in the economic system, whether it was a highly centralized system or a somewhat less centralized one. Thought was being given to the role that prices could play in providing the appropriate signals for investment and expenditure decisions, and the studies of the domestic pricing system and the exchange rate should be integrated. Increasing reliance should be placed on the exchange rate and international prices as vehicles for building a system of domestic prices that would enable the authorities to have more control than hitherto over the investment decisions being made in China. As Mr. Polak had stressed, the steps that the Government was taking to modify the overall fiscal and monetary management of the economy would depend importantly on there being a system of prices that adequately reflected underlying macroeconomic trends. He, like Mr. Polak, had noted that the lack of an increase in reported inflation despite the strong growth of currency in circulation and credit was due to the price control system. It was difficult to assess the effectiveness of overall monetary control in the absence of underlying prices, but it appeared that demand pressures were building up, and that the development of an adequate pricing system would make an important contribution by providing correct signals on the overall performance of the economy and by improving the efficiency of resource allocation.

He agreed that great caution was required by the authorities in expanding exports, Mr. Erb said. In addition, given the uncertainties about the existing distribution of resources in the economy, and particularly whether the resources were being channeled to the most productive

sectors, it would be a mistake to reduce sharply China's strong reserve position and to undertake a more aggressive external borrowing program. However, it was unclear to him why the authorities were placing particularly great emphasis on high technology imports and investment. In the light of China's large work force and low per capita income, imports and investment should be directed toward the sectors that could make the greatest contribution to employment and productivity.

Mr. de Maulde considered that the authorities were to be commended for the remarkable results in 1983, which had reinforced the vigorous growth of 1982. The external position had remained strong, and the latest economic data indicated that agricultural production in 1983 would exceed the bumper crop of 1982 by 3 percent, industrial production would grow by 10.5 percent--twice the planned level--the trade balance would again record a large surplus, and overall financial balance and price stability would be maintained. In recent years, few countries had been able to achieve simultaneously such a wide array of achievements.

The staff report was complimentary, and rightly so, Mr. de Maulde remarked. However, it did not deal explicitly with the potential for improving productivity in China. The staff and Mr. Zhang had mentioned that there was a strong willingness and need to intensify the use of modern technology; apparently, the prospects for the continued development of the economy would be diminished in the absence of such technology. But little had been said about the steps that decision makers were taking to prepare the various sectors of the economy for the introduction of new technology. The staff had provided an interesting description of the evolution of the management of enterprises and the introduction of various mechanisms to assist central planning. However, he was not fully convinced that the reforms were sufficient at the present stage to prevent all risk of underutilization or misuse of imported inputs. He wondered whether the authorities were considering moving beyond the present set of reforms in order to encourage the most efficient allocation of resources, including capital goods.

In its report the staff had clearly indicated that the exchange rate, one of the most important prices, could play a more significant role in the economy, Mr. de Maulde commented, and in his opening statement Mr. Zhang had implied that in some cases prices would be allowed to exert a direct influence on the production decisions of certain firms. But Mr. Zhang had also said that the cases would be limited to enterprises that were not considered of primary importance for the national economy. In addition, there was no indication in the staff report that the authorities might be willing to move away from the present exchange rate regime. Further comment on the price mechanism in China would be helpful.

One of the main policy questions, Mr. de Maulde remarked, was whether the strong reserve position should be seen as temporary. A country like China, with a narrow capital base and immense physical needs, might naturally be expected to run a current account deficit financed by sizable foreign borrowing. Should the authorities be encouraged to move away from

their established practice of prudent financial management? There was clearly room for an increase in imports, especially of capital goods, but recent experience suggested that foreign borrowing should supplement domestic savings rather than substitute for them. A proper balance between borrowing and domestic savings was difficult to achieve, but the performance of the Chinese economy suggested that it would continue to achieve a level of domestic savings commensurate with its modernization and growth objectives.

Mr. Kafka recalled that during the previous discussion on China a number of Executive Directors had been somewhat skeptical about the short-term prospects for the economy because of the expected adverse effects on growth of the abrupt adjustment in investment in 1981. Those effects had not materialized, in part because the authorities had shown a remarkable degree of flexibility after the strong adjustments of 1981 and had been *able to increase investment to a higher level than had been forecast in* the long-term plan. He was pleased that China had shown the needed degree of flexibility.

The staff had concluded, Mr. Kafka noted, that in the period 1976-82 export growth had been due mainly to the diversion of a larger share of available exportable goods to overseas markets, rather than to an increase in the rate of growth of domestic production. China's plans to open the economy were interesting. Exports as a share of GDP had increased from 5 percent in 1972 to 8.6 percent in 1982, a remarkable achievement. The Chinese experience raised some interesting issues. The external debt policy had remained very cautious, although during the previous discussion several speakers had stressed the high marginal social productivity in China of additional investment, and he wondered whether additional medium-term or long-term borrowing would not have been useful. Did the authorities feel that there was a high risk factor in borrowing abroad, or was the marginal social productivity lower than suggested in the past?

The total volume of subsidies had increased in 1982 compared with 1981, Mr. Kafka observed, despite the widespread feeling that the growth of subsidies should be limited. As for the question of credit, the present policy seemed to be to allow bank branches to increase loans if they could attract deposits in excess of the initial targets. That approach seemed to constitute a less than optimal kind of credit regulation, and the recent reform of the banking system was welcome. He hoped that the authorities would display the same kind of ingenuity in continuing the reform of the banking system that they had shown in the interest rate area, where both deposit and loan rates had been substantially increased in 1983, thereby directly contributing to the increase in deposits and overall financial savings. The ease with which credits had been obtained had undoubtedly been responsible for the continued high level of inventories.

The authorities were to be commended on the reforms that they had introduced, Mr. Kafka considered. The actions had been decisive, and the new monetary and fiscal instruments had been used cautiously. The

new market tools, the opening up of the economy, and the reduction in the bilateral agreements showed that the general attitudes of the authorities were on the right track, and that the economy had responded adequately and without undermining economic growth.

Mr. Senior remarked that the implementation of the stabilization and adjustment policies since 1979 had resulted in an impressive performance of the economy in the previous two years. Economic and financial stability had been achieved and a rapid rate of economic growth had been recorded, thereby broadening and strengthening the economic base. The considerable fiscal and monetary restraint had reduced demand pressures, which, in turn, had caused a rapid improvement in the external position, permitting the authorities to make an early repayment of certain external loans while doubling the country's holdings of international reserves. Given the world economic environment, the growth performance of the economy had been impressive. In addition, real national income had increased by 5 percent in 1981 and 7 percent in 1982, mainly as a result of the strong growth of agricultural output. Those achievements were a reflection of the effectiveness of the implementation of the stabilization and industrial policies and constituted an important step in the implementation of the overall strategy for restructuring and modernizing the economy. The adjustment efforts of 1982 and 1983 had placed the economy on a sounder basis for achieving sustained rates of stable growth in coming years.

Despite the substantial improvement in the overall performance of the economy, Mr. Senior continued, the authorities recognized that to consolidate and strengthen the gains, more lasting solutions to the problems still facing the economy were needed. In the fiscal area, most of the reduction in the overall public sector deficit, from 3.5 percent of GDP in 1980 to 1.3 percent in 1981 and 1.4 percent in 1982, had resulted from the control of investment expenditure. Hence, most of the burden of budget cuts had fallen, perhaps unduly, on public investment, while the authorities had been less successful in controlling current items and extrabudgetary investment. Recognizing that a better balance between budgetary and nonbudgetary investment was needed, the authorities had decided to make active use of additional means to control extrabudgetary investment. In the future, less extrabudgetary resources would be available, a new 10 percent tax on funds out of the budget would be introduced, and stricter credit ceilings and other controls were to be enforced. At the same time, greater reliance was to be placed on incentives for increasing the profitability of the state enterprises, which had stagnated in 1982. The more active use of taxation and the elimination of automatic subsidies to unprofitable enterprises would undoubtedly help to correct the fiscal imbalance while increasing the overall competitiveness of the economic system.

In the monetary and credit fields, Mr. Senior remarked, the recent separation of the central banking functions of the People's Bank of China from its commercial banking functions represented a major and far-reaching reform. Although it was too soon to assess fully the consequences of

the reform, the institutional framework required to implement more active monetary and credit policies was in place and would help to increase the control of overall liquidity. It might also help to improve the financial intermediation carried out by market elements, which constituted an important source of signals for general investment.

Externally, Mr. Senior continued, he agreed with the authorities that the significant improvement in the external position during the past two years, as reflected in the balance of payments surplus and the rise in international reserves, was temporary. Exports had continued to grow mainly because of the improvement in the terms of trade, and the stagnation of imports had been due largely to the effects of the stabilization program. The authorities had intended to increase imports in 1982, but bottlenecks in transportation and certain administrative difficulties had impaired import growth. To solve those problems, the authorities had continued to review regulations affecting imports and had expanded the communications and transportation sectors. Import recovery had already begun; there had recently been a rapid increase in imports of raw materials for the heavy industrial sector as a result of the stepping up of the implementation of some centrally financed investment projects. In any event, the process of gradually opening the economy, and the large import requirements, particularly of investment goods for key sectors, would require some use of foreign reserves and continued access to foreign financial institutions. The authorities were to be commended for their prudent policy on external borrowing. The new arrangements for closely monitoring the gradual increase in borrowing planned in the coming years would facilitate the continuation of a prudent foreign borrowing policy and would be consistent with the aim of strengthening financial and trade relations with the rest of the world.

During the past two years, Mr. Senior noted, the authorities had reduced the instability that had been evident earlier by correcting the disequilibria in major sectors. At the same time, the economy had moved onto a path of sustained growth. However, the process of readjustment and consolidation was still not finished. Significant reforms in the fiscal, monetary, and external fields had been implemented in recent years and further efforts in those and other areas, such as the pricing and exchange rate systems, were contemplated for the immediate future. The authorities' task of continuing the complex process of readjusting, restructuring, and modernizing the economy on the basis of the principle of supplementing the planned system with market elements was a formidable one, especially when the limitations imposed by the country's technical resources were taken into account. He hoped that the authorities would be able to make further progress toward achieving their goals, and he approved the proposed decision.

Mr. Finaish considered that a discussion on the economic performance of China should take into account two important characteristics of the country's economic management. The first was the fact that China's economy was essentially a planned one. The Fund had considerable experience in analyzing market economies, but relatively little experience

in assessing centrally planned ones. China's system of economic management had had considerable success in fighting poverty, starvation, and adverse natural forces. Growth rates over the previous three decades had averaged 6 percent a year, according to some sources, reflecting the high level of mobilization of both human and physical resources. The second general characteristic that should be noted was the political will and the policy flexibility that the authorities had displayed in adapting to the needs of economic progress. Their recent efforts to increase China's links with the international economy in order to increase the inflow of technology, and the accompanying relaxation of controls and decentralization of decision making, should be seen in that context. As previous speakers had stressed, developments in the Chinese economy had important international implications.

New measures had been introduced to increase incentives and productivity and to help maintain the high rates of economic growth during the period of adjustment and the restoration of financial stability, Mr. Finaish continued. The staff expected the high growth rates to be maintained in the foreseeable future.

Efforts to move toward a more open economy and to raise the growth rate of agricultural output had been largely successful, Mr. Finaish noted. According to some sources, the volume of foreign trade had more than tripled since 1977, and direct foreign investment, especially in joint ventures, had grown rapidly. Further gains in those directions were expected when special economic zones, with appropriate infrastructure development, were fully developed. In agriculture, measures had been taken to increase incentives and to encourage greater diversification, and although still at an early stage of application, they had already caused considerable growth in output. While the strengthening of such measures would in time help to increase output further, sustained growth would also depend on the progress made in modernizing technology, which, in turn, would require large and steady investment in human capital and technology infrastructure.

The outward-looking policies and concerted efforts to develop light consumer-oriented industries had resulted in strong export growth in the recent past, Mr. Finaish remarked. However, it was important to remember that the international market for light manufactures was very competitive, and that many of its competitors had a head start on China. The authorities had therefore correctly sought to improve further both product quality and managerial efficiency.

While the staff view that further liberalization was needed to boost import growth might be correct, Mr. Finaish continued, it was also possible that import demand would increase more rapidly once the current readjustment process was completed. The relatively slow growth of imports in the recent past was probably a reflection largely of the policy move toward the less capital-intensive, light industry sector. Moreover, many of the capital requirements of that sector were presumably met adequately by the output of existing heavy industry. As Mr. Zhang had noted, the

authorities intended to keep import growth commensurate with China's overall economic needs. In view of the prospective growth in imports, Mr. Zhang might well have been correct in concluding that the recent buildup of reserves was temporary in nature. In addition, as Mr. Zhang had suggested, the staff might have overestimated the growth of reserves.

The staff had described how the recent overshooting of planned levels of investment had strained domestic resource use and the government budget, and might possibly have contributed to the creation of bottlenecks and to a lengthening of gestation lags, Mr. Finaish observed. The authorities had wisely decided to cut government expenditure to offset the inadequate decreases in extrabudgetary investment outlays of the public and state enterprise sectors. However, the scope for further cuts might be limited if progress in building up China's infrastructure was to be maintained. Any movement from a centralized system to a more decentralized one, with a devolution of authority to enterprises, could not be entirely smooth; overshooting of investment targets and duplication of projects could easily be reflections of transitional problems associated with the process of decentralization, and the problems might well be solved with the benefit of experience. Economic management and productive efficiency were expected to improve considerably with the successful implementation of the recent managerial and administrative reforms.

Since the authorities intended to avoid excessively rigid central planning and to maintain the momentum of economic reform, Mr. Finaish continued, the staff suggestion for giving more weight to monetary and fiscal policies in macroeconomic management might be appropriate. However, considerable care should be taken in defining and developing such instruments. Any attempt to extrapolate directly the experience of market economies in a large, complex, and centrally planned economy like China's might be inadvisable.

China's energy was being mobilized to achieve economic modernization, Mr. Finaish remarked. The guiding principle of reform remained the continued reliance on central planning as the dominant force in the economy, but it was to be supplemented by market elements. The authorities would have to find and maintain the optimal level of decentralization. As the economic planner, Chen Yun, had described it, "the market economy is like a bird, and a planned economy the cage around it. If the cage is too small, the bird will have no freedom of maneuver. But the cage itself is absolutely necessary." Furthermore, much would have to be done to encourage local authorities and enterprise heads to manage their new responsibilities with the requisite skill and to spread modernization and its gains evenly, so that progress among the regions would be balanced.

The authorities would have to maintain a balance between the need to give enterprises and regions greater freedom of action and the need for continued central planning, Mr. Finaish went on. Such problems were compounded by the fact that modernization on a scale as vast as that required for China had no precedent. In a recent article on modernization in China, a sinologist described the transition in China in the following

words: "The face of China is changing. In physical looks as well as in ideology, it is a much more mundane, much less sloganeering, and in many ways, a less tidy place than in the heyday of Mao Tse-tung. Today, China does not delight purists of any type, whether capitalist or communist, but it is alive and kicking and there is forward momentum. The world can only watch and wish the Chinese people well." In the future, as in the past, all countries would learn a great deal from the Chinese experience.

Mr. Lovato said that he broadly agreed with the general thrust of the staff report and appraisal. There had basically been no change in the price index in 1982 and 1983, a remarkable development given the buoyant domestic demand and impressive output growth. Apparently that development was explained by the degree of policy stringency, the efficiency of the price control schemes, and the marked deceleration in the rate of growth of the currency aggregates. In China, shifts in demand were reflected in supplies of goods and service rather than in prices. In 1982-83, demand pressure had not resulted in price increases and had not spilled over into a trade imbalance. However, the staff had made no mention of longer queues at enterprises selling consumer goods, and it seemed likely that domestic output had responded favorably to the demand pressures.

At present, some domestic shortages were appearing, and capacity in certain crucial sectors was being strained, Mr. Lovato noted. It seemed reasonable to expect that those developments would be reflected in prices and import flows; he wondered whether the effects could easily be accommodated by the Chinese economic system, given its recent history of low inflation and strong reserves. There would probably be an upward pressure on prices following the behavior of the monetary aggregates in 1983. However, the mechanism by which movements in the monetary aggregates were translated into price developments was not fully clear to him. Since prices were controlled, an increase in cash balances of individuals might merely result in larger forced savings, at least in the short run, before consumers were offered a larger basket of goods through either an increase in, or a diversification of output.

Exports had continued to rise rapidly in volume terms, and export market growth had been substantial, despite the sizable appreciation of the currency, Mr. Lovato remarked. Was the good export performance a reflection of the present stage of the Chinese economy, which was a latecomer to international trade and had been stressing an outward-looking approach? Did the staff perceive a continued momentum of exports contributing to a further opening of the economy, or did the slight deceleration in export growth in 1982 indicate a need for appropriate supportive export measures? The authorities' interest in enhancing China's integration in the world economy was encouraging and, in that connection, the review of the dual exchange rate and other arrangements restricting international payments and links between domestic and world prices was welcome. The proposed decision should be approved.

Mr. Ramtoolah considered that the 1983 Article IV consultation with China was useful because it showed how China, one of the most important planned economies in the world, had adapted both its institutions and policies to changes in the international economic environment. In addition, other countries could learn from China's record of efficient economic management.

Agriculture, which had accounted for more than 30 percent of GDP in 1982, continued to perform well, Mr. Ramtoolah remarked. Gross output had increased by 11 percent in 1982--more than in any of the previous three years--as a result of the authorities' appropriate policies, particularly those designed to provide increased incentives to producers. Industrial output had also performed well in 1982, growing by 7.7 percent. The emphasis on increasing supply had clearly allowed the authorities to contain inflationary pressures.

During the previous discussion on China, Mr. Ramtoolah recalled, an Executive Director had appropriately raised the question of the significance of a budget deficit in China. Whatever its significance might be, the authorities had obviously made a substantial effort to contain the deficit. The increasing role of treasury bonds in financing the deficit was a positive development, given the increase in household savings, which had stood at 3.5 percent of national income in 1982, compared with 1 percent in 1979. The attempts to improve the efficiency of the operations of the state enterprises, to establish control over the growth of extrabudgetary investment, and to improve the tax administration were welcome.

The authorities seemed to understand the crucial importance of maintaining strict control over liquidity, Mr. Ramtoolah commented. The considerable attention they paid to the relationship between the growth of currency in circulation and the growth of consumer goods available in the market was an indication of their preoccupation with the liquidity situation. The growing importance of China's banking system in managing the economy at the macro level was a particularly welcome development.

The improvement in the external accounts had been remarkable, Mr. Ramtoolah said. The balance of payments were expected to move from a deficit equivalent to 1.1 percent of GDP in 1980 to a surplus of about 2.3 percent of GDP in 1983. Although the present external position was strong, the authorities' prudent stance on external trade was appropriate. As Mr. Zhang had noted, China's reserves had probably been overestimated; data on reserves could often be quite misleading. The authorities' policy of opening the Chinese economy to the outside world was commendable.

In sum, Mr. Ramtoolah concluded, the measures that the authorities had recently taken in response to the rapidly growing economic environment demonstrated their understanding of the importance of flexibility in the management of a huge economy. China's increasing and positive role in many African countries, and particularly those in his constituency, was welcome.

Mr. Ismael considered that the authorities were to be congratulated on their remarkable performance over the previous year and for the favorable prospects for the economy in the coming year, largely as a result of the reforms affecting output and productivity in all the important sectors. The decentralization of the economy was a step in the right direction and should be continued; the results, summarized in Table 1, were commendable.

Still, Mr. Ismael continued, a word of caution was called for. The monetary aggregates had been growing rapidly, and there was some danger of overheating of the economy, particularly as the progress toward liberalization of the economy had been uneven. Bottlenecks and shortages could arise if certain important sectors grew faster than others. That outcome was implied by the final paragraph on page 2 of SM/82/213, where the staff discussed the uneven growth of various industries. The authorities would have to be careful to prevent excessively rapid growth of credit and currency, and the improved living standards together with the lag in the output of consumer items could lead to price pressures. The authorities were to be commended for the very low rate of inflation despite the rapid rate of economic growth, and apparent excess demand.

In the circumstances, Mr. Ismael said, he fully agreed with the authorities' intention of maintaining cautious growth targets in their effort to balance consumption demand against investment demand while preserving overall stability. Finally, he welcomed the progress that the authorities had made in terminating bilateral payments arrangements and in reducing restrictions on current transactions, and he accepted the proposed decision.

Mr. Tvedt considered that the staff appraisal was well balanced, and that the proposed decision should be approved. The authorities had been very successful in implementing substantial adjustment measures over the previous two years. Following a period of growing internal and external imbalances, the authorities had acted resolutely and promptly to return the economy to a path of steady and balanced growth, and the economic indicators available thus far suggested that the economy had responded in an impressive way. Domestic prices had been stabilized at a low level, and China enjoyed a strong external position with a fairly comfortable level of reserves, even when adjusted in the way Mr. Zhang had suggested. At the same time, China had maintained relatively high growth rates and had improved the standard of living of its people by raising incomes and enlarging the supply of consumer goods, especially in rural areas.

However, Mr. Tvedt continued, as the staff had noted, strains on available resources had begun to emerge, and the demand for consumer and investment goods had tended to run ahead of domestic supply. While he fully agreed with the Chinese authorities that the process of integrating the Chinese economy into the world economy should proceed in a cautious and gradual way, he shared the staff view that there appeared to be scope for maneuver, including a more liberal import policy, in the domestic demand management. Imports in volume terms had been virtually unchanged

since 1980, while real national income had grown by more than 12 percent. In recent months, however, imports had picked up. Given the need for the physical and technological modernization of the economy, excessively strict adherence to import restrictions would hamper adequate growth in the medium term, something that would not be in the interest of either China or the world economy. Indeed, at the present stage of development of the Chinese economy, the authorities should aim at augmenting its resources by increasing imports.

As the Minister of Finance had mentioned in his statement at the 1983 Annual Meetings, Mr. Tvedt recalled, the Chinese authorities had consistently held the view that the economies of all countries were closely interrelated. The Minister had also said that China's present balance of payments surplus and the recent increase in foreign exchange reserves had been due mainly to the failure to fulfill the planned target for imports in the course of making adjustments to the economy; therefore, the surplus and growing trend of reserves were of a temporary nature, something that Mr. Zhang had confirmed in his opening statement.

He fully agreed with the staff, Mr. Tvedt said, that the dual exchange rate should be unified at an appropriate level in order to improve the link between domestic prices and those prevailing abroad. He also agreed with the staff that domestic prices should be allowed to reflect the underlying domestic demand and supply structure in order to ensure the efficient use of resources and to avoid the stockpiling of unsalable goods even as some other goods were subject to excess demand.

Given the huge size and complexity of its economy, a gradual and cautious approach should be taken to the introduction of reforms in China, Mr. Tvedt considered, but he hoped that the authorities would be able to comply soon with the Fund's rules. He looked forward to studying the outcome of the ongoing experiments on the reform of the wage and pricing policies in China.

Mr. Mtei commented that China's economy was one of the few in the world that had successfully weathered the global recession. The 6 percent rate of economic growth in the recent past was impressive compared with the performance of most countries, and there were indications that the high rate would continue in the coming period. The staff had concluded that the credit for the good performance should be given to the improved production incentives and to the organizational reforms that had been introduced by the authorities, together with the favorable weather conditions and the discipline that had been shown by the Chinese people.

There had been some difficulty in controlling expenditure at the provincial and local government levels, Mr. Mtei observed, and he hoped that the recently introduced measures, including stricter credit control and the mopping up of excess liquidity through the issue of treasury bonds, were an indication that the authorities intended to bring the situation under control. China's fiscal system seemed to be on a sound footing: the budget deficit had been equivalent to just 1.4 percent of

GDP in 1982 and was expected to remain close to that figure in 1983; and an effort was being made to eliminate the automatic subsidies to state enterprises, increase the profitability of the enterprises, and improve revenue collection.

In assessing China's recent economic performance, Mr. Mtei remarked, Executive Directors should bear in mind that the process of reform was still under way, and that it would be some time before its full impact was felt. The policy measures being implemented in the real sector gave reason for hope. For instance, the authorities' attempts to improve economic efficiency were particularly important, as productivity had apparently declined somewhat over the previous four years, and the consumption of production inputs, particularly energy, remained high by international standards. The authorities' efforts to increase incentives for producers, particularly in the agricultural sector, had already begun to pay dividends in the form of increased production. Given China's large population, a continuation of the effort to improve the agricultural sector would be important for the future development of the economy. Another noteworthy aspect of the Government's program was the emphasis on directing resources into productive areas, such as energy and transportation, in order to alleviate the shortages in those sectors that were thought to be major constraints on the future growth of the economy. He fully agreed with Mr. Zhang that the reforms did not entail changes in the fundamental sociopolitical objectives of the country. The reforms were a recognition that the system had been impeded by overcentralized decision making and management, and that less centralized management of investment and production would not necessarily conflict with the Government's socialist objectives.

In the monetary field, Mr. Mtei noted, the authorities intended to keep the growth of the money supply under control, with a view to preventing the emergence of inflationary pressures; the reform of the banking system, which was aimed at, inter alia, improving the control over liquidity in the economy, should help the authorities to achieve that objective. The rapid growth of household savings from 2.4 percent of total domestic savings in 1978 to 12.1 percent in 1982 was impressive and appeared to be closely linked to the increase in real incomes.

China's exports had continued to grow despite the international recession, Mr. Mtei observed. That development, together with the reduction in imports, had caused a further strengthening of the balance of payments. The country's international reserves, even after the adjustment suggested by Mr. Zhang, were at a relatively comfortable level. The staff had therefore concluded that, in view of the domestic shortages and the scope for raising productivity through the use of imported technology, China could usefully expand imports and he was pleased that the authorities were more or less in agreement with the staff. However, the authorities understandably wished to maintain a cautious approach in order to avoid saddling themselves with an unmanageable debt burden. At present, China's external debt was small and the debt service ratio--6.6 percent in 1982--was well within the limits that were normally considered to be

prudent. Finally, the authorities were to be commended for the financial assistance--largely concessional in nature--that they had given to other developing countries. The proposed decision was acceptable.

Mr. Prowse considered that the staff reports represented an impressive achievement in terms of data collection and collation on the part of both the Chinese authorities and the staff. The report included a list of the contacts between the Fund--through the IMF Institute--and the authorities, and between the World Bank and the authorities. The extensive contacts were welcome, and he hoped that they could be further developed.

The staff's helpful reports were in the usual format and made use of familiar references and benchmarks in analyzing the economy, Mr. Prowse said. Mr. Zhang's opening statement provided a good counterpart to them, and his description of the general features of the Government's economic program were essential for an understanding of the Chinese economy and the issues facing the authorities.

In his opening statement, Mr. Prowse commented, Mr. Zhang had stressed that central planning, public ownership, and remuneration according to one's contribution to work would remain the basic features of China's socialist economy, but that, under the reform effort, the central planning would be supplemented by certain market-oriented elements. The staff report focused on those supplementary features and therefore said relatively little about how the overall economic system could be made to operate more efficiently than hitherto, and he looked forward to hearing the answers to the questions that Mr. de Maulde had posed about the current operation of the economic system. However, he agreed with the thrust of the staff's assessment and accepted the proposed decision.

China was an unusually complex economy and was particularly interesting for two reasons, Mr. Prowse remarked, namely, its rapid rate of modernization, and the evolving nature of its structure. The Chinese economic system had clearly shown its capacity to operate effectively; there had been impressive economic growth with stability in recent years, and the external position of China was more favorable than that of most of the other countries that the Executive Board had recently examined. At the present stage, it was important to stress the need for an internally consistent follow-through to permit the supplementary market-oriented mechanisms to evolve smoothly, and it was in that need for consistency that problems might well arise. The recent separation of the central banking and commercial banking functions in China's central bank was welcome, but it implied the need for subsequent developments in the areas of the determination of interest rates, the ownership and control of financial capital, and the participation of private ownership in the financial market. Similarly, the policy of decentralization did not necessarily involve increased reliance on market mechanisms; it seemed to imply an increase in local autonomy at a time when the problems involved in achieving such autonomy had not been solved.

The considerable discussion on the problems of extrabudgetary expenditure and investment suggested that much attention would have to be paid to the management, responsibilities and powers of local governments, and particularly their responsibility for raising revenues, Mr. Prowse continued. The staff report had mentioned the decision providing local governments with more revenues, but it made no mention of an effort to permit those governments to increase revenues. He hoped that that and similar problems were being examined. To an increasing extent, the authorities' response to problems was to rely on market-oriented mechanisms, but it was important to bear in mind that the evolution of China's complex economy would necessarily be slow, and that interim problems, the solutions to which might be outside the Fund's expertise, might well arise. On the other hand, immediate attention should be paid to the policies governing prices and the external position.

Previous speakers had made useful comments on the role of prices in China, Mr. Prowse commented, and Mr. Yamashita had correctly drawn attention to the rigidity of the price structure, a feature that the Executive Board had underscored during its previous discussion on the country. There was an urgent need to tackle the problem of the pricing structure. The doubling of subsidies in a short period would normally attract attention in the analysis of a market economy, but in the case of China it was merely a symptom of the inappropriate nature of the present price structure and of the inability to reach the Government's objectives with rigid prices, rather than a problem in itself.

Externally, Mr. Prowse continued, the appreciation of the internal settlement rate seemed appropriate, and he endorsed the staff's general remarks on the exchange rate. The staff had made an impressive case for liberalizing the import policy. The level of reserves, which was equivalent to 23 months of imports, seemed more than enough to support such a policy, although Mr. Zhang's comments on the matter in his opening statement should be taken into account. On balance, the need for a more liberal import policy seemed to prevail, although it was useful to ask whether the volume of consumer goods in the recent past would have been increased if imports had been liberalized and, if so, how they would have been distributed and what the effects on the economy would have been.

One of the main issues, Mr. Prowse considered, was the need for flexibility to respond not only to difficulties that arose, but also to opportunities. One of the opportunities that had not been perceived by the authorities was the availability of external savings. Continued accumulation of external reserves would not help the growth performance of the economy; nor would an excessively conservative borrowing policy. A country like China clearly should be an importer of capital and should run a current account deficit in the medium term. The present external surplus should be seen as a short-term response induced partly by the inflexibility of the planning system and its inability to take advantage of imports other than those for investment purposes.

The reaffirmation of the Government's policy of opening the Chinese economy to the outside world was welcome, Mr. Prowse said. However, further opening of the economy would involve much more flexibility than China had shown thus far. Finally, given China's record of growth and the achievement of short-term stabilization, there was every reason to feel confident about the progress that the economy would make in the coming period.

Mr. Malhotra remarked that he too had been impressed by the quality of the statistical information contained in the staff reports. Mr. Zhang's opening statement offered a number of insights into the evolution of the Chinese economy, and particularly the reforms that had been introduced on the basis of experience gained over the previous decade. The rate of growth of output in China had been remarkable, especially in the light of the simultaneous price stability. At the same time, the external position had evolved in a healthy fashion, as evidenced by the dramatic turnaround in the current account position and the rapid growth in reserves. Those achievements were all the more remarkable because they had occurred against the background of major policy changes designed to bring about a better balance between the various sectors of the economy, to increase agricultural output, to improve consumption while placing somewhat less emphasis on investment, to increase the external dimension of the economy by opening it to the outside world, and to improve incentives for producers while maintaining the basic characteristics of the economy, particularly central planning and the distribution of income according to work performed.

As Mr. Prowse had correctly stressed, Mr. Malhotra said, any analysis of the Chinese economy should start from the fact that the system had worked well, as demonstrated by the positive results that he had described. The usual market-oriented criteria for analyzing economic performance had to be applied to China with considerable qualifications. There were a number of lessons to be learned from a large centrally planned economy that had been remarkably successful in achieving high rates of output, in correcting imbalances between important sectors, and generally in making substantial improvements in both the domestic and external sectors.

The level of investment, Mr. Malhotra continued, had been higher than planned, mainly because of extrabudgetary expenditures. As he understood it, extrabudgetary expenditures included expenditures by local governments and by enterprises that were not fully supported by the budget. The staff reports did not clearly show how the increased investment had become feasible. Had it been made possible by credit from the banking sector? Did the public enterprises have ample liquidity resulting from large profits? The staff reports and Mr. Zhang's opening statement implied that prices were perhaps too low and did not reflect true costs, which suggested that enterprises might not have surpluses available for high levels of investment. Previous speakers had correctly stressed the need for a country like China to maintain a high and increasing level of investment. The staff had indicated that the infrastructure was under strain, and that new infrastructure investment was needed.

The authorities had to review the nature and the balance of investments in the various sectors, and their present efforts to review various programs and projects that involved large investments were appropriate. If local governments were receiving excessive credit from the banking sector, was that problem not tackled in the national credit plan? It was to be hoped that recent separation of the central banking and commercial banking functions of the People's Bank of China would improve credit management, and particularly credit allocation to various government units. The efforts to increase control over credit indicated that bank credit might have become a problem area. Profits of some enterprises were to be subjected to a tax, a move that suggested a certain level of profitability of the enterprises. However, that assumption was inconsistent with the conclusion that prices in China, including those of public enterprises, had been kept too low.

The central budget deficit had been kept under control, Mr. Malhotra observed, but budget constraints had perhaps adversely affected the growth of the infrastructure. Improvements in infrastructure would lead to improvements in the overall efficiency of investment. Though there had been a considerable growth of subsidies, it had not resulted in undue strain on the budget. An assessment of the subsidies should take into account the fact that they had lent some stability to the standard of living without straining the budget; the subsidies had not been inflationary. The authorities were reviewing the issue of subsidies and were not committed to maintaining them at a high level. Indeed, they had given priority to reducing subsidies for unprofitable enterprises as they felt that enterprises should not automatically be subsidized for their deficiencies or unprofitable functioning. Other subsidies, including consumer subsidies, were probably closely related to the achievement of social objectives. Although a reduction in the rate of growth of subsidies would be a welcome development, the issue of subsidies was a complex one and, as long as they were not straining the budget and contributing to inflation, a somewhat relaxed view of them was appropriate.

There seemed to be excess liquidity in the system, Mr. Malhotra remarked, and the recent changes in the banking system were therefore welcome. He hoped that greater attention would be paid not only to flows of money, but also to the overall money stock and its growth. Money stocks were likely to be of increasing importance in the future.

Commenting on the external sector, Mr. Malhotra said that the authorities were to be commended for the rapid rate of growth of exports despite an adverse international climate. He agreed with Mr. Zhang that the apparently high level of reserves needed to be viewed with certain qualifications, and that, given the diligent effort to pursue adjustment policies, the slowdown in imports was not surprising. However, in the light of the overall size of the economy and its requirements, he shared Mr. Zhang's view that the present bulge in reserves was not a healthy phenomenon. He agreed with the Chinese authorities that a prudent policy on borrowing was required.

China was a large producer and user of energy, Mr. Malhotra continued. Increased use of energy inputs had helped to increase the productivity of agriculture, and energy use in that sector was likely to remain high. However, in the economy as a whole, efficiency of energy use seemed to be an important issue.

The achievement of high growth rates together with stability in a country as large as China was a favorable sign for the world economy as a whole, Mr. Malhotra commented. The authorities had been reacting to developments as they occurred and had introduced appropriate and necessary corrective measures. The various changes in sectors and subsectors that Mr. Zhang had described in paragraph 5 of his opening statement were of great importance and had been undertaken in a prudent fashion, without altering the socialist nature of China's economy.

Mr. Teijeiro said that the proposed decisions were acceptable. The authorities had made commendable progress in the short run in increasing agricultural and industrial production and in improving the external position. Price developments might have been affected by the existence of controls, making the evolution of monetary policy difficult to judge. The authorities had taken the positive step of increasing their reliance on market prices in allocating resources. As previous speakers had noted, however, the ongoing transition process presented a major challenge.

The timing of the introduction of the reforms seemed to be an important matter, Mr. Teijeiro continued. The main issue was whether decentralization of decision making would improve efficiency in investment in he absence of a reconsideration of the system of relative prices, which should reflect domestic market forces and foreign trade opportunities. It was apparently assumed that the partial use of profits for reinvestment purposes would lead to appropriate results only if the profits had been derived from a correct price structure.

Mr. Agah commented that the authorities were to be commended for their industrious and prudent management of the largest and most complicated economy in the world. One of the lessons to be learned from China was that, no matter how large the economy, a strong program and favorable results were possible only if the authorities made a determined effort and maintained an efficient system of checks and balances. The positive results of the stabilization measures introduced some three years previously were clearly described in the staff reports. Unexpectedly favorable weather conditions and the introduction of certain reform measures, such as an increase in procurement prices and decentralization of decision making, had resulted in a substantial increase in agricultural output. The rise in industrial production had also been larger than had been expected. While the volume of imports in 1982 and the first half of 1983 had remained sluggish, export volume had accelerated and the terms of trade had improved substantially, contributing to a comfortable external current account surplus and an increase in reserves. Although the growth of investment, heavy industrial output, and consumption had caused considerable shortages of industrial inputs, construction materials,

and certain manufactured goods, the general economic trends seemed to be in the right direction. The shortcomings of the system had been appropriately addressed in the authorities' adjustment program.

Of the various policy issues, Mr. Agah remarked, the authorities had paid most attention to investment policy, partly because of the adverse effects of the rapidly growing extrabudgetary investment on the economy, and partly because of the effects of centrally controlled measures on the socioeconomic reform effort. The authorities would be well advised to scrutinize carefully the various investment projects and to halt those that did not meet certain criteria. The authorities' greatest concern in the fiscal policy area was the weakness of the central government finances. In the period 1979-81, subsidies had grown rapidly, taking up some of the state revenues, but in 1982 the growth of subsidies had fallen somewhat.

The system of profit remittances was to be replaced by a system of profit taxation, Mr. Agah noted, and the staff had usefully stated its views on the need for a more rational pricing system for China. Apparently the authorities' incentive-oriented system was to be temporary, and the special adjustment tax was eventually to be phased out. The major task of the monetary authorities was to keep under control the expansion of currency in circulation. The ratio of retail sales to currency in circulation had been falling in the period 1980-83. One of the most impressive achievements in the monetary area was the considerable growth of time deposits. He agreed with the staff that the implications of the reform of the banking system--particularly for supervision, the expansion of credit, and use of deposits--should be evaluated after the system had been functioning for some time.

The rapid shift of the balance of payments into surplus was a reflection of the authorities' cautious approach to the stabilization effort, Mr. Agah commented. Export volume had been continuously growing, and a number of foreign loans bearing market interest rates were being repaid ahead of schedule. He hoped that the strains caused by imbalances between the demand for investment and consumption on the one hand, and by domestic resource availability on the other, would be eliminated by the authorities' decision to focus their attention and activities on monetary and fiscal policies. Finally, the proposed decision was acceptable.

The staff representative from the Asian Department remarked that traditionally the main problem in the monetary area had been the need to maintain a balance between currency in circulation and the supply of available consumer goods; therefore, the People's Bank of China had carefully monitored all the inflows and reflows of currency and the level of currency in circulation. A rough guideline--equivalent to the concept of velocity--for the level of currency in circulation was the ratio of retail sales to the stock of currency outstanding; the historic norm was about seven. The problem in the first half of 1983, when the rate of expansion of currency in circulation had increased, was traceable to the strong investment boom, which had caused unplanned inflows of currency

through higher employment, large wage payments, and increased bonuses. On the other hand, the investment boom had tended to channel resources away from consumer goods industries and toward heavy industry, thereby slowing the flow of consumer goods to the market. The excess currency holdings had to some extent been absorbed by increased savings, which were actively promoted by the authorities through both moral suasion and high interest rates. Another portion of the excess currency had flowed into the free markets in the countryside and the cities that supplied agricultural goods, tools, handicrafts, and services. Those markets still evidenced some supply elasticity.

As the decentralization in the economy had continued, the staff representative went on, the authorities were paying increasing attention to other forms of liquidity. They felt that if excess demand was to be contained, credit creation by the banking system would have to be controlled, and they had therefore elaborated a credit plan in addition to the annual currency plan. However, it had proved difficult to implement the credit plan fully. The authorities had set overall targets for credit expansion in line with macroeconomic objectives, but it had been difficult to keep the credit issue of local banks in line with the targets. The new central banking law should increase the power of the central bank to control overall credit by giving it such instruments as the ability to impose minimum reserve requirements and to vary those requirements in accordance with overall credit development.

Many speakers had stressed the need for the early implementation of a price reform, the staff representative recalled. In its discussions with the authorities, the staff had emphasized the advantage of international prices as measures of opportunity costs, particularly as China further opened its economy to trade and foreign investment. The staff had also stressed the advantage of combining the price reform with exchange rate reform. The Chinese authorities had not excluded those possibilities, but they had emphasized that their preparations were still at an early stage. They did not expect a major price reform to be implemented during the period of the present five-year plan, which would end in 1985. However, partial price adjustments were being made on a continuing basis; for instance, various consumer goods prices had been adjusted in the early months of 1983. The references in the staff report to a rational price system were meant to suggest a price structure that more consistently reflected the relative scarcities facing the economy and that was sufficiently flexible over time to permit price adjustments to underlying changes in demand and supply.

Despite the prevailing excess demand, the staff representative continued, the price index had shown little change in recent months. The stability of consumer prices had been due in part to the strict enforcement of price controls. The good harvest had also helped to keep food prices down, even in the free market. There were shortages of some consumer goods, but most of the tensions created by the excess demand had been reflected in producer markets: shortages of energy, construction materials, and transportation facilities had caused delays in deliveries and

lengthened gestation periods for current investment projects. Investment resources were distributed on the basis of a combination of market mechanisms and central plans. Some quantitative rationing was undertaken by the central authorities, some through the regional industrial bureaus, and some was enforced by local government. However, there was also competition among enterprises for scarce resources, and the existing price regulations permitted deviations within limits from the prices fixed by the state.

The acceleration of investment in advanced technology, the staff representative explained, was a response to the need to modernize Chinese enterprises; the staff had not meant to suggest that the authorities sought the latest technology in all areas. To a large extent, equipment in Chinese industrial enterprises was outdated, and that was a major reason for the low productivity and the inefficient use of energy and other raw materials. There was a clear need to modernize and replace existing equipment, in many instances, to meet international standards for exports. The authorities had drawn up a program of modernization and had identified some 3,000 items that would have to be imported over the coming two years.

The acceleration of heavy industrial output in 1983 was a direct consequence of the investment boom, the staff representative continued. Industry had responded to the demand for inputs of investment goods. In addition, heavy industrial production had actually declined in 1982, and the recent acceleration had served partly to make up for the fall. Nevertheless, the authorities continued to give priority to light industry, and they certainly hoped that that sector would grow quickly. The preliminary data for the third quarter of 1983 showed that the gap between the growth rates of heavy and light industry was again being closed.

The excess extrabudgetary investment that was attributable to enterprises had been financed from retained profits, the staff representative commented. Most of the enterprises made profits and, under the reform, were permitted to retain a relatively large share of them. The retained profits could be supplemented by bank credit. Local and provincial governments could raise extra resources through taxes and fees and were free to dispose of them as they wished. They too could supplement their revenues by bank credit and foreign loans.

The authorities were endeavoring to improve productivity in three ways, the staff representative explained. First, they were using incentives, and, in particular, they were shifting incentives from the achievement of quantity targets toward the achievement of quality targets. The latter were measured in various ways, an important one being the marketability of a product, reflected in the buildup of inventories. When inventories piled up, disincentives were applied. Incentives were also directed toward savings in the use of inputs, as both raw material and energy inputs in industries had sometimes been excessive. Such inefficiencies had not been effectively combated under the previous system, when full attention was paid to the quantity of output. Some sanctions

were applied to enterprises that had incurred losses or that had not complied with plans to eliminate such losses in a specified period. In those cases, access to credit by the enterprises was restricted. Bonus payments by such enterprises were also blocked, and there were reports that managers of some inefficient enterprises were being replaced.

Organizational changes were the second way in which the authorities were attempting to improve productivity, the staff representative continued. Greater autonomy was being given to managers of enterprises in the making of decisions concerning the use of inputs and on output and marketing. The third means of increasing productivity was the authorities' plan to undertake a large-scale modernization of equipment in industrial plants.

The staff, like most Executive Directors, had stressed that the authorities' cautious foreign borrowing policy was appropriate, the staff representative stated. Because of the cautious nature of the policy and the relatively low level of foreign debt and debt service, the risk factor in China's present borrowing policy was low. The authorities were interested mainly in foreign loans with low interest rates and long maturities.

The question had been raised, the staff representative recalled, whether the favorable external performance could be expected to continue in the coming period. China had emphasized export production in the recent period, and a substantial potential for export expansion clearly existed. If export promotion was maintained and markets remained open, there was good reason to be optimistic about China's export growth over the medium term. The staff readily agreed that it might well have overestimated the balance of payments surplus. The balance of payments forecast usually included a large margin of error. If the most recent trends continued throughout the rest of 1983, the overall surplus could be some $2-3 billion less than the staff had estimated.

The staff did not have all the detailed data needed to give a precise indication of the appropriate level of the exchange rate, the staff representative from the Asian Department said. However, on purchasing power parity grounds, the internal settlement rate was closer to the equilibrium rate than was the present official rate.

Mr. Erb commented that the staff had frequently referred to the wish of the authorities to expand exports. Their objective was certainly a desirable one, especially if it involved removing measures that might restrain exports. However, to the extent that their export promotion involved special pricing subsidies or other special treatment of exporters, the growth potential of China's exports would be limited by the reaction to those measures by China's trading partners. The desire of the United States to import items from China would be limited to the extent that it was perceived that China's exchange rate was distorted or that pricing policies in effect subsidized exports. It was therefore important for the Chinese authorities to maintain an export policy that was consistent with the country's comparative advantage and to avoid special subsidies.

That was one of the reasons why he had emphasized the importance of establishing a rational pricing system; such a system would not give the impression that a special pricing subsidy was being used to promote exports.

Mr. Zhang remarked that many of the problems facing the Chinese economy were long-standing ones and had occurred as a result of rapid industrialization and social change. Hence, the adjustment and reform efforts could not be expected to be completed in a short time. At the same time, there was no ready-made model for the Chinese authorities to follow. They had achieved a number of their objectives, but some of the results had not been as successful as they had wished. China's reform had come a long way, and the authorities would continue to introduce on a trial basis measures that were suited to the specific conditions of the present stage of China's economic and social development. China's economy would continue to be a socialist one based on public ownership, central planning, and remuneration according to one's work.

His authorities generally agreed with the thrust of the staff report, Mr. Zhang commented. However, there had been no changes in the exchange rate policy since the 1982 Article IV consultation with China, and it seemed best for the second paragraph of the proposed decision to be the same as the second paragraph of the previous decision on China that the Executive Board had adopted.

The Executive Board accepted Mr. Zhang's proposal.

The Chairman made the following summing up:

Directors noted the impressive success of the adjustment program implemented by China over recent years. It had brought about a remarkably strong balance of payments position and had allowed the restoration of price stability. Even more commendable was the fact that this stabilization had been achieved while preserving a strong rate of growth, even though the world economic situation continued to be unfavorable. The substantial economic growth and the increases in the living standards of the population over recent years had been broadly based, including agriculture, a vitally important sector for the improvement of living standards.

Directors noted that, despite the price stability and the large balance of payments surplus, there were signs that demand pressures had recently intensified. These included various shortages, in particular of energy, construction materials, transportation facilities, and certain consumer goods. In these circumstances, they recommended the continued prudent demand management measures of the authorities. The pressures of demand on resources were being fueled by decentralized investment expenditures and unplanned bonus payments to workers, and Directors noted the additional steps taken to control these expenditures.

There were signs of ample liquidity in the economy, particularly in the enterprise sector, and the monetary aggregates, especially currency in circulation, had increased relatively rapidly. Directors generally believed that there was need for additional measures to contain this expansion.

Many Directors commented favorably on the substantial progress made toward strengthening China's public finances. In particular, they welcomed the stabilization of expenditures on subsidies. However, weaknesses in the revenue base continue, and measures were required to increase the efficiency of state enterprises and to raise their profitability.

Directors recalled that centrally financed investment expenditures had borne the brunt of the adjustment efforts of recent years, and said that it was now timely to shift the balance between decentralized and centralized investment in favor of the latter in order to allow urgently needed investment in infrastructure and energy projects to take place.

The measures taken by the Chinese authorities to reform their economic system are being followed with the greatest interest by Directors. They noted the success of measures to decentralize management and improve the incentive structure, particularly in agriculture. The reform of the economic system was not an easy task and has perhaps made macroeconomic management more complicated. Directors welcomed the authorities' determination not to return to an overcentralized system and to rely increasingly on economic and market-oriented criteria. In addition, there was a need to develop macroeconomic fiscal and monetary instruments to complement the decentralization of economic decision making. The recent changes in the system of enterprise taxation and the separation of the central and commercial banking functions of the People's Bank of China were welcomed and should be important steps to achieving this. Directors stressed the hope that the establishment of a separate central bank would soon lead to improved control over the monetary aggregates, and noted that the rapidly improving economic and financial data base should assist the authorities in their decision making in these fields.

Directors emphasized that the reform of the domestic pricing system, with a view to reflecting more realistically relative scarcities and supply and demand conditions, should be considered as an urgent matter to complement the other reform measures and to facilitate the taking of decisions in the more decentralized environment now emerging. In particular, correct pricing was considered important to ensure a proper functioning of the profit incentives and to provide the right macroeconomic signals to policymakers and decision makers.

The stabilization measures, in particular the cutback in centrally financed investment projects, had resulted in an exceptionally strong balance of payments position. Exports were weathering the recession in export markets with ease, and the improvement in the terms of trade, combined with a very cautious import policy, had further strengthened the trade balance. While commending the prudent borrowing policy of the Chinese authorities, several Directors felt that China, given its growth needs and potential, should not permanently run balance of payments surpluses. Indeed, the strong balance of payments had led to considerable reserve growth, which has given the authorities more leeway to pursue with determination their policy of opening up China's economy to the external world and to step up, albeit prudently, imports which could assist in raising the technological level of the Chinese economy and in supplementing domestic demand management.

The internal settlement price system for foreign trade transactions introduced by China in 1981 remains a temporary one, and the authorities are actively studying the introduction of a system which would fully correspond to China's evolving needs. Directors endorsed the views expressed on this point in the staff appraisal and welcomed the studies. Several Directors urged that these studies be conducted in close association with the study of the price system.

Directors noted Mr. Zhang's suggestion with regard to the description of the exchange system in the proposed decision. The staff has no objection to this proposal, which appears to be acceptable to Executive Directors.

The rapidly developing contacts between Chinese officials and various Fund departments and the IMF Institute, and the range of technical assistance provided through these contacts were warmly welcomed.

The next Article IV consultation with China will be held on the standard 12-month cycle.

The Executive Board then approved the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Section 3, in concluding the 1983 Article IV consultation with China, in the light of the 1983 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7559-(83/157), adopted
November 21, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/156 (11/16/83) and EBM/83/157 (11/21/83).

2. MADAGASCAR - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of the Malagasy Republic for technical assistance, the Executive Board approves the proposal set forth in EBD/83/288 (11/15/83).

Adopted November 18, 1983

3. WESTERN SAMOA - TECHNICAL ASSISTANCE

In response to a request from the Western Samoan authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/83/292 (11/18/83).

Adopted November 18, 1983

4. YEMEN ARAB REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the Yemeni authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/83/286 (11/10/83).

Adopted November 16, 1983

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 83/89 are approved. (EBD/83/287, 11/14/83).

Adopted November 18, 1983

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/279 (11/16/83), EBAP/83/281 (11/17/83) and travel by an Assistant to an Executive Director as set forth in EBAP/83/278 (11/15/83), is approved.

APPROVED: March 27, 1984

LEO VAN HOUTVEN
Secretary