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SM/84/229
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

November 6, 1984

To: Members of the Executive Board
From: The Secretary
Subject: People's Republic of China - Recent Economic Developments

The following corrections have been made in SM/84/229 (10/24/84):

Page 14, Other: Add 5/
line 11, "(As percent of GDP)": move to line 12.

Page 75, 2nd full para., penultimate line: for "\$330 billion,"
read "\$330 million,"

Page 84, line 7: for "\$83 billion" read "\$83 million"
line 8: for "\$56 billion" read "\$56 million"

Page 121: Delete footnote 1/ and renumber footnotes 2/ and 3/ to read
1/ and 2/.

Page 122: Delete reference to footnotes 2/ and 3/.

Page 130, last para., line 3: for "full unemployment" read "full employment"

Page 149, line 2, column 2: for " " read "5.8"
line 3: delete "5.8"
penultimate line: delete "26.0"
columns 1 and 2: for "21.0" and " "
read "26.0" and "21.0"

Corrected pages are attached.

Att: (7)

Other Distribution:
Department Heads

measures were also taken to ensure supplies of construction materials to key projects, so as to prevent a recurrence of the shortages that had slowed their implementation in earlier years.

(2) Savings

Reflecting the authorities' greater emphasis on providing resources for consumption, the overall savings ratio fell steadily from 1978 to 1981 (from 35.5 percent to 29 percent of GDP) (Table 6). This trend was reversed in 1982 and 1983, however, as a result of strong growth in household savings and a partial recovery in 1983 of savings generated through the state budget. The recovery in gross savings, which reached 32 percent of GDP in 1983, made possible the combination of strong growth in investment and substantial surpluses on the external current account achieved during the last two years.

The structure of savings generation in China has changed substantially over the last five years, as a result of the greater decentralization of control over financial resources brought about by the reforms and the policy of protecting living standards through budgetary support (mainly by price subsidies). Because of a combination of low revenue buoyancy, associated with the increased share of profits retained by state enterprises, and the continuing growth of current expenditures, savings generated through the current account surplus of the state budget fell steadily from 1978 to 1982, both in nominal terms and as a share of GDP (Table 6). This trend was partially reversed in 1983 when the introduction of new taxes on extrabudgetary operations led to a moderate increase in budgetary savings.

Household financial savings ^{1/} have increased substantially in recent years, rising from the equivalent of 1 percent of GDP in 1978 to 6 percent in 1983. ^{2/} In 1983, there was also a major increase in direct household investment, so that overall household savings grew sharply (from 7.9 percent of GDP in 1982 to 10.6 percent in 1983), while the rapid growth in household incomes, particularly in rural areas, made possible a continued increase in total private consumption of about 9 percent (Appendix Table 33). Living standards of urban residents were also supported by the substantial price subsidies on basic living necessities.

The largest share of savings is now generated by retained earnings of state- and collectively-owned enterprises and extrabudgetary operations of provincial and local governments; in 1982, they accounted for

^{1/} Change in household savings deposits plus estimated change in cash holdings of households plus subscriptions to Treasury bonds by households.

^{2/} Trends in household financial savings are discussed in detail in "Household Savings Behavior in China, 1955-81," Annex II to SM/83/221.

Table 6. China: Trends in the Composition of Gross Domestic Savings, 1978-83.

	1978	1979	1980	1981	1982	1983
(In billions of yuan)						
Gross domestic investment	126.6	136.2	138.5	133.9	146.7	166.9
Balance on external trade in goods and services <u>1/</u>	-2.2	-5.1	-5.8	-1.3	9.6	7.8
Gross domestic savings	<u>124.4</u>	<u>131.1</u>	<u>132.7</u>	<u>132.6</u>	<u>156.3</u>	<u>174.7</u>
Households <u>2/</u>	<u>...</u>	<u>...</u>	<u>...</u>	<u>...</u>	<u>39.1</u>	<u>57.6</u>
Change in savings deposits <u>3/</u>	2.6	7.7	12.9	12.1	15.4	21.4
Change in currency holdings <u>4/</u>	1.5	4.8	6.6	4.3	3.6	7.8
Subscription to Treasury bonds	--	--	--	--	2.0	2.1
Direct household investment	18.1	26.1
State budget						
Current account surplus	<u>54.1</u>	<u>40.1</u>	<u>35.1</u>	<u>34.5</u>	<u>31.7</u>	<u>36.8</u>
Other <u>5/</u>	<u>...</u>	<u>...</u>	<u>...</u>	<u>...</u>	<u>85.5</u>	<u>80.5</u>
(As percent of GDP)						
Gross domestic savings	35.5	33.6	30.9	28.9	31.7	32.3
Of which:						
Household financial savings <u>6/</u>	(1.2)	(3.2)	(4.5)	(3.6)	(4.3)	(5.8)
Current account surplus of state budget	(15.4)	(10.3)	(8.2)	(7.5)	(6.4)	(6.8)

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

1/ Conversion is made at the following yuan per dollar rates for the years 1978 to 1983: 1.6836, 1.5550, 1.4984, 1.6704, 1.8540, and 1.9721.

2/ Does not take account of borrowing by households, which is negligible.

3/ Including individual deposits with the Agricultural Bank of China.

4/ Actual for 1983; for 1978-82, on assumption that 85 percent of the increase in currency in circulation is held by households.

5/ Calculated as a residual. Mainly state- and collectively-owned enterprises and extrabudgetary operations of local governments.

6/ Change in savings deposits and currency in circulation plus subscription to Treasury bonds.

the European Community (EC). A new textile agreement with the United States was signed in August 1983, replacing a previous agreement which expired in December 1982. This new five-year agreement allows for an average annual growth of 3.5 percent in Chinese textile and clothing exports to the United States. More stringent rules on origin labeling of textile exports to the United States came into effect on September 7, 1984 and may further restrict China's exports of textiles to the U.S. ^{1/} A new five-year agreement with the EC, covering the period January 1, 1984-December 31, 1988, was signed in March 1984. This agreement sets annual limits on the growth of imports of 54 items of textile and clothing which are virtually unchanged from those included in the 1979 agreement. However, the broader coverage of textile exports now subject to quotas, makes it more difficult for China to increase its exports through a policy of diversification. China became a signatory to the GATT Multifibre Agreement on December 15, 1983.

Export volumes of paper and paperboard increased sharply in 1983; yet, the share of light manufactured products other than textiles and clothes in total exports continued to decline. Exports of machinery and transportation equipment continued to increase in 1983 and the first half of 1984. Exports of specialized industrial machinery, particularly for the textile industry, and of ships also performed well. Exports of chemicals, which declined in 1982, expanded rapidly in 1983 and early 1984. In contrast, "manufactured goods classified chiefly by material," which expanded rapidly in 1982, contracted in 1983 and early 1984. Iron and steel, a major item in this category of exports, fell again in 1983 and early 1984, reflecting higher domestic construction activity.

Exports of mineral fuels and oils, which grew rapidly through 1981, declined steadily in 1982 and 1983, owing mainly to declining prices. In recent years, crude oil exports have accounted for about three fifths of total exports of mineral fuels and oils, refined petroleum products for about one third, and coal exports for less than 10 percent. In 1983, crude oil exports declined by about 20 percent in value, as a result of a further decline in prices and of somewhat lower export volumes (Appendix Table 49). Export prices declined by 16 percent in 1983, following a 6 percent decline in 1982. The decline in the volume of exported crude oil (about 5 percent) reflected mostly stagnant production. In the first half of 1984, however, crude oil exports expanded rapidly, reflecting increased production of onshore oil. The exported volume of refined petroleum products remained unchanged in 1983, but its value declined by 7 percent, reflecting a decline in prices. The export volume of coal increased by 11 percent in 1983 but the export value remained virtually unchanged at \$330 million, as export prices fell. Although the share of mineral fuels and oils in total

^{1/} Under these new rules, garment manufacturers' freedom to put together clothes from sections produced in other countries will be curtailed.

exports has been declining steadily since 1981, these exports still account for more than two fifths of total exports.

Among primary products, exports of foodstuffs, beverages, tobacco, and animal oils and fats have shown little or no growth since 1981. In the first half of 1984, however, exports of foodstuffs expanded rapidly, reflecting continuing good agricultural output and increased domestic production of processed agricultural products.

(3) Imports

Imports in U.S. dollar terms, which grew rapidly until 1980, began to level off in the second quarter of 1981 and fell sharply in the second half of 1981 and the first half of 1982 (Chart 5). Imports stagnated during the second half of 1982 and the first half of 1983, but expanded rapidly in the second half of 1983, resulting in a substantial increase in both value and volume terms in 1983 as a whole. Imports continued to increase at a relatively rapid annual rate in the first half of 1984 (Table 26). The growth of imports in domestic currency since mid-1983 has been even more impressive (Appendix Table 50).

In recent years, the growth, as well as the composition, of total imports has been directly influenced by developments in aggregate expenditures and domestic production. Imports fell in 1981 and 1982, following the introduction of stabilization measures in 1981. Imports of raw and intermediate materials fell sharply in 1981, while the further cuts in budgetary investment and the cancellation of a large number of new orders during 1981, were reflected in a fall in imports of machinery (including complete plants) and transportation equipment in 1982 (Table 28, Chart 7). However, these imports increased sharply again in 1983, reflecting the decision taken in mid-1982 to relaunch a number of the major projects cancelled or suspended in 1981 and in 1982. Imports of heavy industrial and chemical products rose by 50 percent in 1983, mostly on account of sharply increased imports of machinery and heavy industrial products other than chemicals. These imports continued to grow rapidly in the first half of 1984.

Imports of primary products, after declining by 5 percent in 1982, fell by 23 percent in 1983; available information points to another decline in the first half of 1984. In 1982, the decline was caused by a 25 percent fall in imports of crude industrial materials, which was only partly offset by a 19 percent increase in foodstuffs (mainly cereals and sugar). In 1983, imports of primary products fell sharply, as a result of a 27 percent decline in imported foodstuffs and a 15 percent decline in imported crude industrial materials. Imports of foodstuffs were lower in 1983, mainly because of the exceptionally good agricultural crops which necessitated lower imports of grain and cotton.

Some of the decline in imports in 1983 was related to restrictions imposed in 1982, some of which were relaxed in the second half of 1983

Bank of China by mid-1983. Drawings on commodity credits, buyers' credits backed by official export credit agencies, and other concessional long-term credits directly provided by foreign governments to the Government of China rose significantly to \$0.79 billion in 1983 from \$0.33 billion in 1982; most of this amount (\$0.67 billion) was on Japanese commodity credits. Drawings were also made on concessional loans at low interest rates received from a number of Western European countries, including Belgium, Italy, France, the Federal Republic of Germany, and Kuwait. In 1983, China also started to draw on a significant scale on credits provided by the World Bank Group. However, at \$73 million (including \$2.3 million from the Agricultural Development Fund), drawings on credits received from international financial institutions remain small.

Since 1981, China has attracted increasing amounts of capital in the form of direct investment. In 1983, gross inflows of direct investment increased by almost 50 percent, compared with 36 percent in 1982; net inflows increased by one third, for the second year in a row, to almost \$0.5 billion. This development reflects the increasingly favorable treatment ^{1/} accorded to foreign direct investment in China as part of the authorities' policy to open the economy to the outside world. Direct investment is viewed as an efficient means to help meet China's need for foreign capital, advanced technology, and improved management.

Net outflows on other medium- and long-term capital increased sharply in 1983 to \$0.87 billion from \$0.38 billion in 1982, as a result mainly of large outflows on account of portfolio investment abroad. China made substantial investments (\$0.77 billion) in foreign bonds--

^{1/} A detailed description of existing incentives offered to foreign investors is provided in Annex VI; 2,300 foreign direct investment contracts were signed between 1979 and 1983 for a total value of \$6.7 billion. The breakdown is as follows:

<u>Types</u>	<u>No. of Contracts</u>	<u>Value (In US\$ millions)</u>
Total	2,300	6,700
Of which:		
Chinese and foreign joint ventures	188	340
Contractual joint ventures	1,047	2,950
Offshore oil exploration and development units	23	2,000
Compensation trade	998	930
Wholly-owned foreign enterprises	53	420

Fifty-five new joint ventures were approved in the first half of 1984, compared with 188 between end-1979 and end-1983.

mostly Eurobonds and bonds issued by the Japanese Government. In addition, China continued to extend loans to finance its exports, albeit at a much slower pace than in 1982. Net short-term capital inflows increased in 1983 to \$0.33 billion from \$0.06 billion in 1982. Short-term deferred payments extended to foreign importers were reduced, while China's net credit position resulting from the normal implementation of ongoing bilateral payments agreements increased by \$83 million in 1983, following a decrease of \$56 million in 1982 (Appendix Table 55).

e. External debt

China's external debt remains small. Medium- and long-term debt at end-1983 was \$6.4 billion (Table 31), or 2.3 percent of GDP, representing a very small increase from the end-1982 level of \$6.1 billion. As a result of the substantial advanced repayments on commercial debt made in 1981 and 1982, it is estimated that more than half of total debt at end-1983 was on concessional terms. Reflecting the large drawings on inter-governmental loans, debt owed to foreign governments (mostly energy credits and Japanese commodity loans) increased sharply in 1982 to \$2.2 billion at the end of the year, from \$1.5 billion at end-1982. The stock of debt due to foreign commercial banks, which was cut by almost half in 1982, remained virtually unchanged between end-1982 and end-1983, representing about one fifth of total debt (including debt due to the Fund).

Available information on undrawn foreign credits, mostly on concessional terms, are estimated to amount to about \$30 billion by end-June 1984. A significant proportion of these undrawn credits was accounted for by credits made available by the Japanese Eximbank and Overseas Economic Cooperation Fund.

China's debt service payments remain small. Including payments to the Fund, the debt service ratio (as a percent of exports of goods and services) was 5.5 percent in 1983, compared with 10.9 percent in 1982 and 8.6 percent in 1981, when large early repayments estimated at \$1.1 billion and \$0.8 billion, respectively, were made. Excluding these advanced repayments as well as the early repurchase of Fund drawings made in 1981, the debt service ratio decreased from 6.6 percent in 1982 to 3.7 percent in 1983 (Table 32). In 1983, interest payments accounted for only about one fifth of total debt service payments (including Fund repurchases); one third of total debt service payments in 1983 was on account of the early repurchase of Fund credits of \$482 million. According to the amortization schedule for debt outstanding as of December 31, 1983 (Appendix Table 56), there is no bunching of repayments in the next five years. ^{1/} This, together with the likely low interest payments (as a result of the improved debt profile), indicates

^{1/} Data in Appendix Table 56 are staff estimates and, although they are based on relatively detailed information provided by the Chinese authorities, should be treated with caution.

Table 57. China: International Reserves, 1980-84

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

	1980	1981	1982	1983	1984 End-June
Foreign exchange					
Foreign exchange					
balance total <u>1/</u>	-388	3,507	7,738	9,730	...
Minus bilateral					
payments assets (net)	<u>908</u>	<u>798</u>	<u>742</u>	<u>829</u>	<u>814</u>
State foreign exchange	-1,296	2,708	6,996	8,901	...
Plus Bank of China					
borrowed reserves	<u>3,558</u>	<u>2,065</u>	<u>4,139</u>	<u>5,575</u>	<u>...</u>
Total foreign exchange					
reserves <u>1/</u>	2,262	4,774	11,135	14,476	16,481
Gold (People's Bank of					
China holdings <u>2/</u>	571	516	491	464	457
Reserve position in the					
Fund	191	--	--	176	233
SDRs	<u>92</u>	<u>275</u>	<u>214</u>	<u>335</u>	<u>395</u>
Total reserves	3,116	5,565	11,840	15,451	17,109

Sources: Bank of China; and staff estimates.

1/ Including purchases of World Bank bonds.2/ Valued at SDR 35 per fine troy ounce.

Table 58. China: Real Effective Exchange Rate and Related Series, 1978-84

(Indexes: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices in Local Currencies	Official Exchange Rate in U.S. Dollars <u>1/</u>	Consumer Price Index
<u>Quarterly</u>					
1978 I	103.3	90.0	114.8	89.2	91.3
II	97.7	86.5	112.9	87.3	91.3
III	92.1	83.2	110.8	88.0	91.3
IV	93.5	85.7	109.0	91.6	91.3
1979 I	97.5	90.8	107.4	95.0	91.5
II	98.4	93.8	104.9	94.6	91.9
III	97.9	95.8	102.3	97.2	92.3
IV	103.9	99.6	104.3	98.6	96.7
1980 I	104.0	100.6	103.4	98.9	99.3
II	101.7	100.6	101.1	99.8	99.8
III	100.2	100.9	99.3	102.3	100.4
IV	95.6	98.2	97.3	99.0	101.0
1981 I	90.4	94.7	95.4	93.9	101.7
II	87.1	93.0	93.6	87.4	102.2
III	87.4	95.0	92.0	84.7	102.9
IV	85.2	94.1	90.5	86.0	103.5
1982 I	83.8	93.7	89.4	83.0	103.9
II	82.8	93.9	88.2	80.9	104.2
III	81.4	93.8	86.7	77.3	104.6
IV	81.2	95.0	85.5	75.9	104.9
1983 I	79.5	93.6	85.0	76.7	105.5
II	79.7	94.8	84.1	75.4	106.2
III	82.0	98.5	83.2	75.5	106.9
IV	81.4	99.7	81.6	75.7	107.5
1984 I	77.0	96.3	79.9	73.0	107.2
II	73.9	92.4	80.0	69.4	109.0
<u>Monthly</u>					
1983 Nov.	81.0	99.1	81.7	75.3	107.5
Dec.	81.2	99.9	81.2	75.4	107.6
1984 January	78.6	97.9	80.3	73.4	107.0
February	76.9	96.4	79.7	72.8	107.2
March	75.4	94.7	79.6	72.7	107.4
April	75.0	94.1	79.7	71.7	108.2
May	73.4	91.7	80.0	68.6	109.0
June	73.3	91.2	80.4	67.7	109.8
July	72.6	90.5	80.2	65.3	110.2

1/ Increases mean appreciation.

was the diversification of the distribution channels. The state and collective sectors were gradually supplemented by free markets and by individually operated shops. This private sector trade, which had been basically suspended in the 1966-76 period of the Cultural Revolution, has been given greater operational freedom since 1979. The regulations pertaining to individual trade in rural areas were streamlined in March 1984, specifying, among other things, the formalities required and the scope of their operation, tax obligations, and rights. 1/ This formalization recognizes the contribution made by private trade (13 percent of retail sales in rural markets) in improving the living conditions in rural areas, in supporting the production responsibility system, and in providing employment. Individual trade in urban areas has also gained considerably in recent years (10 percent of total urban retail sales). Individuals and collectives have been invited to contract with the State to run small-scale, state-owned commercial enterprises.

Rural supply and marketing cooperatives, which had been run as state-owned stores since 1978, are being restored to their cooperative status in the hope that this will make them more responsive to the needs of the rural population. This transition is the last in a series of similar changes imposed on the cooperatives since the mid-1950s. 2/

The share of total retail sales transacted by the state and collective sector has diminished every year since 1979 and now stands at 75 percent. Methods introduced to bring production more in line with market demands include: (a) enterprises purchasing more according to prior orders and are given greater power to reject defective products; (b) sales agents and price reduction assisting the sale of slow-moving items; (c) manufacturers participating in market research and assisting in final sales transactions.

Administrative barriers between various jurisdictions and between urban and rural areas resulted in the present multi-tiered commercial sector. Its many restrictions often prevent rational trade transactions from taking place, burden administrative and transport facilities, and contribute to the maintenance of excessive levels of inventories. Experiments are presently under way (e.g., Chongqing in Sichuan) to merge several levels of wholesale trade and to create a streamlined supply network based on central cities, thereby integrating urban and rural markets. Trade centers are to emerge where wholesale and retail transactions will take place and where all enterprises, regardless of their ownership, will do business. Although this reform has received

1/ "Certain Regulations Governing Individual Industry and Commerce in Rural Areas", (Xinhua News, March 11, 1984).

2/ Founded in the mid-1950s, these cooperatives became state-owned enterprises in 1958, were switched back to cooperatives in 1962, returned to state-run status in 1970, back to cooperative status in 1975, and again to state-owned status in 1978. See also Renmin Ribao, June 10, 1984.

full support from the center, progress has been slow so far, largely because of the desire of many jurisdictions to protect their enterprises.

5. Prices

Prices in China have remained largely unchanged over a long period of time and, as such, has become increasingly divorced from productivity developments and international prices. As a result, profitability differs greatly across sectors and among products. In the absence of capital mobility, no mechanism exists to even out these differences. Yet, relative profitability affects production and consumption decisions, causing shortages of low profit items and surpluses of high profit items. Hence, the irrational price structure cannot be relied upon to provide the signals necessary to guide resource allocation, limiting the potential benefits from greater use of decentralized decision-making under the reforms. This situation is recognized by the authorities, who intend to overhaul the present price system in due course. In the meantime, some prices are being realigned, and indirect tax rates will be changed so as to eliminate some of the differences in profitability across sectors.

Agricultural procurement prices were increased in 1979 by about 20 to 25 percent, followed by increases in the prices to the consumer of nonstaple foods; consumer prices of staple foods remained unchanged, giving rise to substantial subsidies. In subsequent years, selective price increases were made mainly for consumer goods that were in short supply or for which input costs had risen (e.g., furniture, leather, cotton, cigarettes and liquor). Some prices were also reduced (e.g., synthetic fiber material and watches). However, a large number of officially fixed prices have not been adjusted so far.

Greater flexibility has been given to enterprises to sell their above- and outside-quota productions at negotiated prices, and to dispose of overstocked commodities at lower prices. Free market prices have also been introduced; these prices are agreed between buyer and seller, but the State supervises the developments and intervenes when it judges it necessary, mainly by the supply of additional products. The share of total retail sales that is transacted at other than the State fixed price has risen over the years.

6. Employment and wages

Until the end of the 1970s, a system of job assignments and strict limitation of rural-urban migration were in force. This contributed to full employment, but at the same time led to overstaffing and underutilization of professional skills. In rural areas, the entire labor force was assigned tasks by the commune, brigade, or team, so that full-time unemployment was nonexistent, although underemployment (not only seasonal) was frequent. Unemployment emerged after the Cultural

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Administrative barriers between various jurisdictions and between urban and rural areas resulted in the present multi-tiered commercial sector. Its many restrictions often prevent rational trade transactions from taking place, burden administrative and transport facilities, and contribute to the maintenance of excessive levels of inventories. Experiments are presently under way (e.g., Chongqing in Sichuan) to merge several levels of wholesale trade and to create a streamlined supply network based on central cities, thereby integrating urban and rural markets. Trade centers are to emerge where wholesale and retail transactions will take place and where all enterprises, regardless of their ownership, will do business. Although this reform has received

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