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January 2, 1990

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of China - Staff Report for the 1989 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1989 Article IV consultation with China, which has been tentatively scheduled for discussion on Wednesday, February 28, 1990. A draft decision appears on page 25.

Mr. Szapary (ext. 7365) or Mr. Burton (ext. 6531) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 1989 Article IV Consultation

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by P.R. Narvekar and A. Basu

December 28, 1989

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I. Introduction

The 1989 Article IV consultation discussions with China were held in Beijing and Shenyang from October 30 to November 16, 1989. 1/ The Chinese representatives included Mme. Qiu Qing and Mr. Chen Yuan, Deputy Governors of the People's Bank of China (PBC), Mr. Liu Zhongli, Vice Minister of Finance, and other senior officials of the PBC, Ministry of Finance, other economic ministries, state commissions, and financial institutions. The staff team also met with Mr. Jiang Zemin, General Secretary of the Communist Party and Chairman of the Central Committee Military Commission; Vice Premier Tian Jiyun; Mr. Li Guixian, State Councillor and Governor of the PBC; and Mr. Wang Bingqian, State Councillor and Minister of Finance. Mr. Dai Qianding, Executive Director for China, participated in the discussions as an observer.

China continues to avail itself of the transitional arrangements under the provisions of Article XIV.

II. Background

1. Economic reform since 1978 2/

Since 1978, China has undertaken a far-reaching program of economic reform that has involved a substantial relaxation of direct planning controls, the decentralization of decision making, an increased role for market forces including in price setting, and the opening of the economy to the outside world. 3/ These reforms have had a major impact on economic performance: real GNP rose by almost 10 percent per year during the period 1978-88 and living standards improved substantially.

Despite these considerable achievements, a number of difficulties emerged as decision making became increasingly decentralized and direct planning controls were replaced by the indirect instruments of monetary and fiscal policy. In this environment, China's central bank, the People's Bank of China, established in 1984, had difficulty in resisting the strong credit demands of enterprises and localities eager for rapid

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1/ The staff comprised Ms. Koenig (head), Messrs. Szapary, Burton, and Dunaway (all ASD), Mr. Blejer (FAD), Mr. Stuart (ETR), Mr. Harrold (IBRD), and Ms. Valencia (secretary, ETR). Mr. Narvekar joined the mission for the last week of the discussions.

2/ The reforms are described in detail in "Economic Reform in China Since 1978," SM/89/205 (10/6/89).

3/ The reforms included the introduction of two-track or dual systems for prices and the exchange rate (see Section III.4). In the case of prices, the planned output of a range of commodities is sold at controlled prices, while output in excess of planned amounts is sold at market or negotiated prices.

development. Also, in the fiscal area, the evolving tax system allowed a high degree of discretion in the effective tax rates facing individual enterprises, and, more generally, did not provide a buoyant source of revenue for the Government.

These difficulties with monetary and fiscal policy were closely related to the incompleteness of price and enterprise reforms (see Section III.4). The resulting weaknesses in macroeconomic management were reflected in periods of excess demand pressure that were manifested either in rising inflation or growing external deficits. When confronted with such imbalances, the authorities tended to fall back on traditional administrative controls to stabilize the economy. While this response typically was effective in the short term in restoring macroeconomic stability, it also resulted in stop-go cycles in the reform process that tended to undermine confidence in the durability of reforms.

2. Developments in 1988-89 1/

The economy seriously overheated in 1988 as bottlenecks in key sectors, especially energy, transportation, and raw materials production became severe, and inflation rose sharply, reaching 27 percent by end-year (Table 1 and Chart 1). This was principally the result of rapid credit expansion that fueled large increases in wages and bonuses and a high level of investment; broad money growth was close to 30 percent for most of the period from late 1986 to mid-1988 (Appendix Table 4). At the same time, fiscal policy was expansionary, with the budget deficit growing from 0.5 percent of GNP in 1985 to 2.5 percent in 1988 (Chart 2 and Appendix Table 5); central bank financing of the deficit also contributed to reserve money growth. As sustained excess demand resulted in an escalation of inflation during 1988, interest rates on time and savings deposits became substantially negative in real terms, contributing to widespread deposit withdrawals and panic buying of goods in August 1988. 2/ Strong demand pressure in 1988 was also reflected in the external sector, where the current account moved into deficit as imports grew rapidly while export growth weakened (Chart 3 and Appendix Table 6).

The authorities moved decisively to curb demand and reduce inflation late in the third quarter of 1988. Steps to tighten monetary conditions formed the cornerstone of the stabilization effort. Deposit and lending interest rates were raised substantially on two

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1/ Further details of recent trends and policy measures are provided in the forthcoming report on recent economic developments.

2/ Concern about further adjustments to controlled prices, following the liberalization of some prices during the early summer, also fueled inflation expectations.

Table 1. China: Selected Economic Indicators, 1985-89

	1985	1986	1987	1988	1989 Est.
			(Changes, in percent)		
Real GNP	12.7	8.3	11.0	10.8	5.0
Agriculture	2.7	3.1	4.5	2.3	4.0
Industry	19.6	9.6	13.1	17.4	8.0
Retail prices (period average)	8.7	5.1	7.2	18.6	20.0
Terms of trade	-1.6	-9.8	3.3	-0.6	...
			(In percent of GNP)		
Gross domestic investment	40.1	40.4	39.2	38.9	36.5
Gross national savings	36.0	37.8	39.3	37.9	35.5
External current account	-4.1	-2.6	0.1	-1.0	-1.0
Overall budgetary balance	-0.5	-2.0	-2.2	-2.5	-2.0
Revenue	26.6	25.1	22.6	20.4	19.2
Expenditure (incl. net lending)	27.1	27.1	24.8	22.9	21.2
			(Changes, in percent)		
Banking system's net domestic assets	23.4	33.9	21.5	20.7	14.4 1/
Domestic credit	(19.3)	(32.4)	(22.0)	(17.1)	(11.4) 1/
Total liquidity	17.1	29.3	24.2	21.0	13.2 1/
Currency in circulation	24.8	23.3	19.4	46.6	12.5 1/
Interest rate (1-year time deposit)	7.20	7.20	7.20	8.64	11.34
			(In billions of U.S. dollars)		
Current account balance	-11.8	-7.3	0.3	-3.8	-4.1
Exports	25.1	25.8	34.7	41.1	44.3
Imports	-38.2	-34.9	-36.4	-46.4	-49.3
Services and transfers (net) 2/	1.3	1.8	1.9	1.5	0.9
Capital account balance 3/	7.2	5.3	4.6	6.0	1.5
Of which: Net external borrowing	(6.7)	(3.7)	(4.4)	(5.9)	(1.8)
Change in net international reserves (increase -)	4.6	2.0	-4.9	-2.2	2.6
Gross reserves	13.2	12.0	16.9	19.1	16.5
(In months of imports)	(4.2)	(4.1)	(5.6)	(5.0)	(4.0)
External debt	20.5	26.9	36.7	49.6	51.1
Short-term debt (as percent of gross reserves)	75.0	72.8	70.9	86.3	100.0
Debt service ratio (percent)	7.4	9.9	9.8	8.6	10.8
Exchange rate at end period (Yuan per U.S. dollar)	3.2	3.7	3.7	3.7	4.7 4/
Effective exchange rates 5/ (end-year; 1980=100)					
Nominal	72.8	56.1	51.0	54.6	63.3 6/
Real	53.9	42.5	38.4	46.7	52.6 6/

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

1/ End-September 1989 compared with end-September 1988.
2/ Adjusted for estimates of the underreporting of interest and principal payments.
3/ Includes errors and omissions.
4/ Effective December 16, 1989.
5/ In terms of the basket of currencies used in the IMF Information Notice System. These indices are based on the administered exchange rate for the renminbi. A decline in the indices indicates a depreciation.
6/ October.

occasions, 1/ and the rate on long-term savings deposits was indexed to inflation. Other indirect measures included an increase in the reserve requirement, the introduction of a requirement for the holding of excess reserves, and the tightening of control over central bank credit to specialized banks. In addition, credit ceilings under the credit plan were more strictly enforced. As a result of these steps, the rate of broad money growth was reduced to about 13 percent at end-September 1989 from 26 percent a year earlier. At the same time, control over the direction of credit was substantially increased, with the bulk of new lending to be channeled to medium- and large-scale state enterprises operating in priority sectors, and to agriculture. 2/

The authorities also sought to tighten the stance of fiscal policy. The budget for 1989 envisaged that the growth in total expenditure would be limited to 8 percent, substantially less than the projected inflation rate, with particularly tight control of capital construction. On the revenue side, a new 10 percent tax on extra-budgetary funds, expected to yield revenues equivalent to 0.7 percent of GNP, was introduced. 3/ Given the limited buoyancy of most sources of revenue, however, total revenue was projected to increase by only about 9 percent. Consequently, the budget deficit was expected to decline only moderately in 1989 to 1.8 percent of GNP. As 1989 progressed, it became apparent that the budgetary position was weaker than originally projected, and additional measures were implemented to contain the deficit, including broad-based cuts in expenditure and a strengthening in tax administration.

In addition to tightening financial policies, the authorities implemented a range of administrative actions also intended to restrain demand and to control inflation. A nationwide review of ongoing investment projects was conducted, and 18,000 projects with a total value equivalent to about 4 percent of GDP were stopped. New projects were also sharply curtailed. To contain cost pressures and limit consumption demand, steps were taken to strengthen the regulation of wages and bonuses. In addition, price controls were intensified: State Council approval was made a requirement for all adjustments to prices regulated by the central government, and upper limits were placed on the

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1/ For example, the interest rate on one-year deposits was raised cumulatively by a total of 4 percentage points, the rate on one-year loans by 3 percentage points, and rates on longer-term loans by up to 9 percentage points. However, a preferential system was also introduced in early 1989 under which loans to basic industries carry interest rates 10 to 30 percent lower than loans to other industries.

2/ The priority sectors included energy, transportation and communications, and raw materials production.

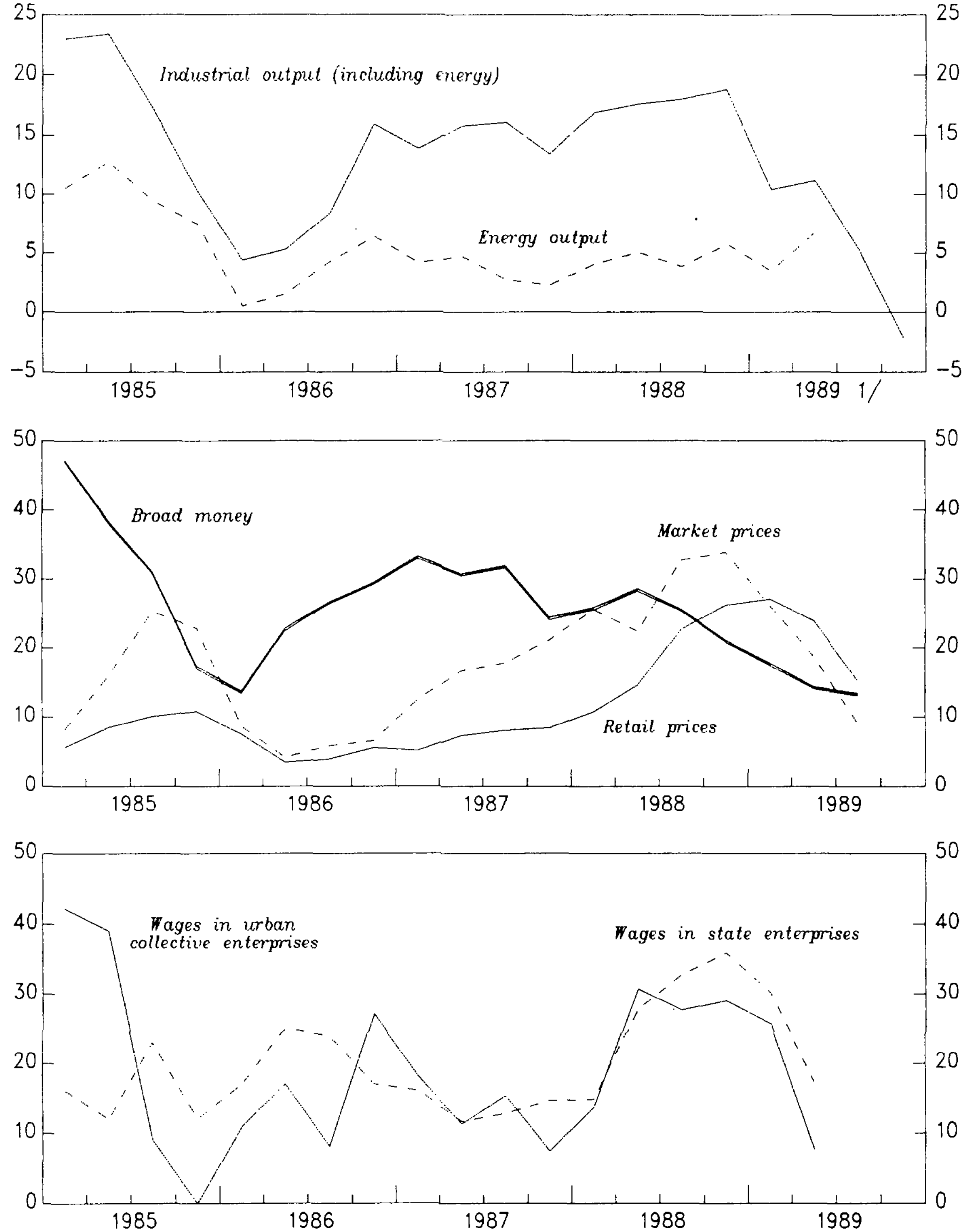
3/ Extrabudgetary funds include the retained profits of enterprises and local government revenues that are outside the budget.

CHART 1

CHINA

INDICATORS OF OUTPUT, MONEY, PRICES, AND WAGES, 1985-89

(Percentage change over four quarters)



Source: Data provided by the Chinese authorities.

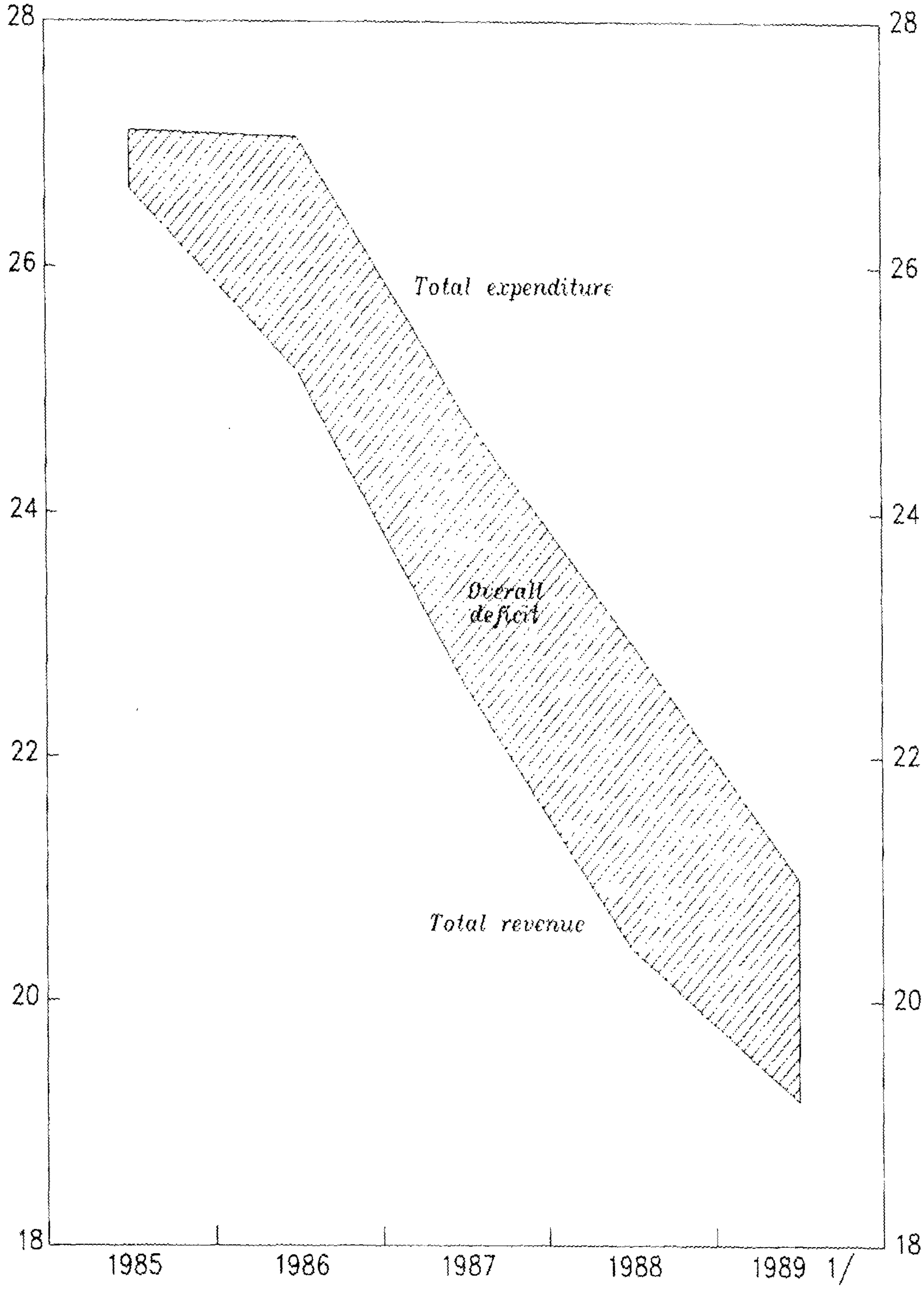
1/ The figure for industrial production in the fourth quarter of 1989 is an average of data for October and November.

CHART 2

CHINA

FISCAL DEVELOPMENTS, 1985-89

(In percent of GNP)



Source: Data provided by the Chinese authorities.

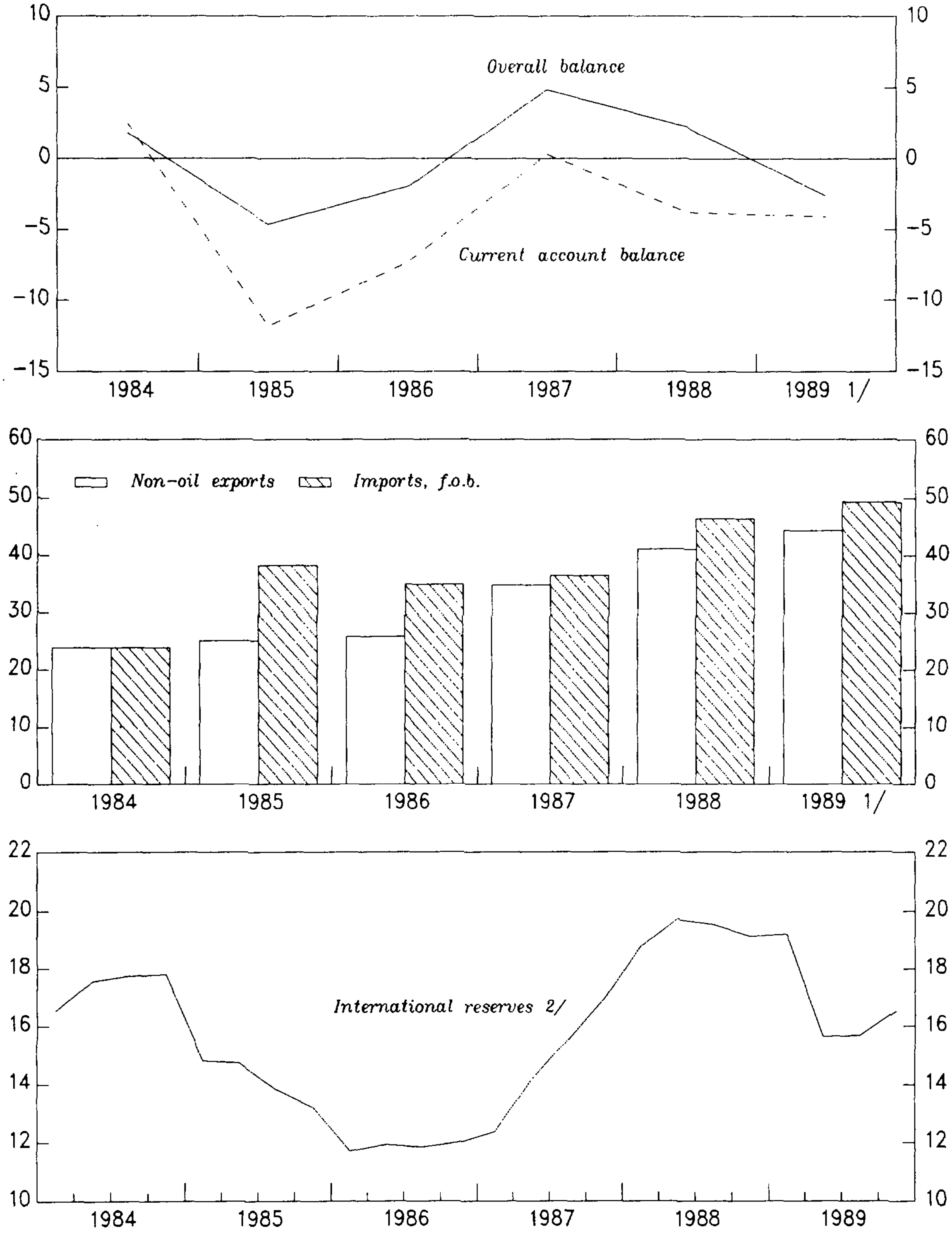
1/ Budget estimate.

CHART 3

CHINA

BALANCE OF PAYMENTS, 1984-89

(In billions of U.S. dollars)



Sources: Customs Administration; State Administration of Exchange Control; and staff estimates.

1/ Staff estimate

2/ End-period.

previously unregulated prices of above-quota production of certain intermediate inputs; controls over prices regulated at the provincial level were also strengthened. Upward adjustments were made in 1989, however, to some controlled prices, including those for grains and cotton procured by the Government, and railway passenger fares. In the external sector, import restrictions were tightened and tariffs, especially on consumer durables, were substantially increased during 1989.

The stabilization program, particularly the tightening of monetary policy, has so far proved effective in restraining demand and slowing inflation. The 12-month increase in retail prices declined progressively during 1989, falling to below 9 percent in October; the growth of wages and bonuses also slowed markedly. At the same time, the 12-month growth rate of industrial production declined sharply and as of November the level of production was less than 1 percent above that of a year earlier. Uncertainties in the period following the June events may have contributed to the weakening of production. There was also a sharp buildup of inventories of unsold goods; at end-September stocks held by state enterprises were over 60 percent higher than a year earlier. The weak performance of industry was reflected in a rise in unemployment, which was expected to reach 4 percent in urban areas by end-1989. It was also responsible for a sharp increase in losses by state enterprises, adding to pressures on the budget. In contrast to industry, agricultural performance strengthened during the first nine months of 1989, with the help of a bumper summer harvest. Overall, real GNP in the first three quarters of 1989 is estimated to have been about 5 percent higher than in the same period a year earlier.

In spite of the measures undertaken to restrain demand, the external current account continued to weaken in the first half of 1989. This was partly the result of an increase in imports, particularly of grains and cotton to compensate for shortfalls in supply, but it also reflected sluggish export growth. While international reserves remained steady at about $19 billion during the first five months of the year, they dropped by about $4 billion during June and July, largely because of deposit withdrawals from overseas branches of the Bank of China (mainly in Hong Kong). Trade data indicate that there was some recovery of export performance and a sharp decline in import growth in the third quarter of 1989. Together with the cessation of short-term capital outflows, the improvement in the trade account enabled international reserves to stabilize despite an abrupt drop off in tourism and a reduction in access to capital markets. The staff projects that the current account deficit in 1989 will be limited to about $4.1 billion (0.9 percent of GNP), only slightly higher than in 1988, and that the overall deficit will be about $2.6 billion, implying an overall surplus of about $1 billion in the second half of the year. Since August, international reserves have increased and, as of end-October, stood at $16.5 billion, the equivalent of four months of imports.

3. The previous consultation

During the previous Article IV consultation in February 1989, Executive Directors reiterated their strong support for the bold economic reforms implemented since 1978. Directors recognized that new challenges for macroeconomic management had been created by the relaxation of planning controls and were unanimous that strengthening the indirect levers of macroeconomic control was essential for further progress to be made toward a more market-oriented economy. There was also a consensus that top priority should be given to reducing inflation. Directors welcomed the steps that had been taken to tighten monetary policy, and it was emphasized that a sharp reduction in credit and money growth in 1989 was essential if inflation was to be brought under control. The authorities also were encouraged to increase interest rates to levels that were positive in real terms. At the same time, most Directors were concerned that the tightening of administrative controls over prices ran counter to the paramount need to eliminate price distortions. Directors also expressed concern about the widening fiscal deficit, and believed that tax reforms would be necessary for a sustained improvement in the deficit. Tight control over expenditures, especially subsidies, was also considered important. In the external sector, Directors noted with concern the appreciation of the official exchange rate in real effective terms. Adequate progress with exchange system reform was viewed as important for promoting export diversification and sustained export growth.

III. Report on the Discussions

The tightening of administrative controls since late 1988, coupled with official statements referring to deficiencies of the reforms, has raised questions in the minds of many observers about the prospects for economic reform in China. Consequently, the policy discussions focused on the strategy underlying the authorities' stabilization and longer-run development programs, with particular emphasis on the extent to which further progress with reforms was needed to support effective and sustained stabilization, and to ensure rapid growth and external viability over the medium term.

1. Overall policy strategy 1/

The authorities said that their firm intention was to continue with the stabilization program for a further two years, or possibly a little longer. The broad objectives of the program were to provide a stable economic and financial environment in which to deepen reforms and to move to a sustainable and coordinated development path. A specific objective was gradually to reduce inflation to below 10 percent; real GNP growth was targeted at about 5-6 percent during the stabilization program. While the authorities recognized that progress had already been made in cooling the economy, they felt that it would be some time before the underlying imbalances were fully eliminated. Tight monetary and fiscal policies (the "double tight policy") were regarded as essential for the achievement of the program's objectives. The authorities stressed, however, that indirect instruments of macroeconomic control would need to be combined with direct administrative measures, particularly in the short term, because market mechanisms in China were not fully developed.

An important objective of the stabilization program was to ensure that scarce resources were directed to key sectors where severe bottlenecks and shortages were viewed as contributing to macroeconomic imbalances and inflationary pressures. Industrial and credit policies were aimed at rationalizing the structure of industry, with emphasis placed on revitalizing medium- and large-sized state enterprises engaged in energy, transport and communications, and raw materials production, industries where shortages were most pronounced. Capital investment was also being directed to expanding capacity in those sectors. The activities of township and village enterprises, especially those that were inefficient in their use of energy or raw materials, were being curbed. Also, the number of companies engaged in distribution, particularly those taking advantage of arbitrage opportunities presented by the two-track price system, would be reduced. In agriculture, investment, especially in irrigation, was being increased, and steps were being taken to improve the supply of inputs.

The authorities indicated that during the period of stabilization, certain reform measures would be taken to help to achieve the goals of the austerity program. In particular, a priority would be to strengthen the instruments of monetary and fiscal policy, the latter through a rationalization of the tax system and through improvement of the contract management system. The authorities also strongly emphasized that the open door policy would continue; it was their intention to

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1/ In addition to being described in detail during the consultation discussions, the authorities' current policy strategy was outlined in the official communique of the fifth plenary session of the Chinese Communist Party's Central Committee, released while the mission was in Beijing.

continue to absorb foreign investment and to expand foreign trade. Looking beyond the stabilization program, the authorities stressed that while there might be some increase in administrative controls in the short run, the longer-term objectives for reform had not been changed.

2. Monetary policy

The authorities said that the major objective of monetary policy in 1989 had been to bring about a sharp reduction in inflation. Accordingly, the credit plan had allowed for an increase in credit of 15 percent for the year as a whole, which had been judged consistent with broad money growth of about 16 percent. The introduction of quarterly ceilings for the credit extended by individual banks, as part of the annual credit plan, had helped to limit credit expansion during the first three quarters of the year and had created adequate room for an increase in credit to meet the sharp seasonal peak in credit needs, especially for agricultural procurement, in the last quarter. The Chinese representatives emphasized that the use of indirect monetary instruments, including increases in reserve requirements and the tightening of PBC head office control over the lending by its branches, had played a central role in keeping credit expansion within the quarterly limits established under the credit plan.

A second objective of monetary policy had been to improve the structure of bank lending. The State Council's statement on industrial policy issued in March 1989 had established sectoral priorities that were being used to guide lending; also, the State Planning Commission had drawn up a list of key enterprises that were to receive priority. The increase in control over the allocation of credit in 1989 was regarded as a temporary measure necessary to protect production in key sectors at a time when credit was being tightened.

The staff team observed that the policies adopted to slow money and credit growth had met with substantial success. At the same time, it noted that the increase in the extent to which bank lending was directed to particular uses or enterprises was likely to stifle the development of the most dynamic sectors of the economy, and hence add to the negative impact of stabilization on output growth. The staff team agreed with the authorities on the importance of relying on indirect instruments to control money and credit expansion. Regarding the specifics of policy, the staff cautioned that any reduction in the requirement on excess reserves, which the authorities indicated was under consideration, would need to be offset by a corresponding increase in the basic reserve requirement or by a reduction in PBC credit to banks. Equally, any net PBC financing of the budget deficit should be counteracted by a corresponding reduction in PBC credit to banks, as well as in the overall credit ceiling (which excludes credit to Government). The staff welcomed a recent decision that the appointment of presidents of PBC branches should be approved by head office, and also a plan to experiment with PBC regional branches that cut across provincial boundaries. Both steps should help to augment the PBC's capacity to withstand provincial pressures for credit expansion and enhance monetary control through indirect instruments.

The authorities told the staff that the recent increases in deposit rates, especially the indexation of long-term time deposits to inflation, had been very effective in halting panic buying and in encouraging a recovery in financial saving. Nevertheless, they remained concerned about the potential for large-scale withdrawals from deposits that could result in an resurgence of inflation. On the lending side, while increases in rates had helped to dampen the demand for credit, disintermediation had occurred during 1989 indicating that lending rates were still below the levels necessary to bring the demand for and supply of credit into balance. 1/ In addition, recent adjustments to interest rates had raised deposit rates more than lending rates, with adverse implications for bank profitability, and indirectly also for the budget. Consideration was being given to a further increase in lending rates, but there was concern about the impact such a move might have on the financial position of enterprises. The staff team strongly recommended that interest rates be adjusted flexibly so as to maintain them at appropriate positive real levels given developments in inflation, and also to provide banks with an adequate margin over the cost of funds. In the case of deposit rates, the maintenance of adequately positive real returns would prevent a repeat of the deposit withdrawals that occurred in 1988. To promote efficiency in the allocation of credit, it was recommended that the system of preferential interest rates for key sectors, introduced earlier in the year, be abandoned.

With regard to the stance of monetary policy in 1990, the authorities agreed that it was essential for the credit plan to be set in the context of an overall financial program that was consistent with a further slowing of inflation and that allowed for adequate economic growth. Although the objectives for output growth and inflation for 1990 had not yet been decided, the authorities believed that the target for the rate of credit expansion was likely to be similar to that set for 1989. They noted, however, that account would have to be taken of factors such as enterprise profitability and the level of inventories, and indicated that consideration was being given to providing credit to help enterprises finance stocks of unsold production. The staff suggested that since it should be possible to reduce the inflation rate to well below 10 percent in 1990, even with additional price reform measures, broad money growth somewhat lower than that envisaged for 1989 would be appropriate. It was also recommended that demands for credit

1/ The disintermediation principally took the form of direct borrowing by township and village enterprises from their employees; precise data were not available.

to finance inventories not be accommodated, as this would discourage the needed adjustments to the structure of production and to prices sought by the stabilization program.

3. Fiscal policy

The authorities said that despite the measures taken to strengthen revenue collection and cut expenditure in the course of 1989, the budget deficit was likely to be about 2 percent of GNP, slightly higher than anticipated in the budget. While it was believed that revenues would reach or even exceed the budget target, expenditure, particularly for subsidies, was also likely to be higher than budgeted. With regard to the financing of the budget deficit in 1989, it was possible that there could be a shortfall in domestic bond sales. Looking to 1990, although the budget had not yet been formulated, the objective was to reduce the deficit in relation to GNP. In following years, the ratio of revenue to GNP would be raised substantially and the deficit gradually eliminated.

The authorities acknowledged that the fiscal system had serious structural deficiencies which, if not addressed, would impede a major improvement in the budgetary position. Weaknesses in the tax system have resulted in a very low buoyancy of revenues and a high degree of discretion in the tax structure. These characteristics are related to the way in which the Government has promoted decentralization of decision making to enterprises and local authorities, as well as to the incompleteness of reforms, especially price reform. In particular, under the enterprise contract responsibility system, quota profits and minimum tax obligations are fixed in nominal terms for the duration of the contract, and hence revenue as a ratio to GNP tends to fall as the economy and enterprise profits grow. 1/ Also, the case-by-case negotiation of tax liabilities involved in the contract system makes a hardening of the budget constraint facing enterprises more difficult to achieve. A further reason for the weakening of government revenue from enterprises has been the erosion of taxable profits, as price controls have prevented many enterprises from passing on to consumers increased costs owing to such factors as rising input prices and higher borrowing costs. The policy of allowing enterprises to deduct the repayment of

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1/ The contract responsibility system, which was introduced in 1985 to increase enterprise autonomy, currently covers about 95 percent of state enterprises. Under the system, the Government and the enterprise manager negotiate a contract that covers a multiyear period (typically 3-5 years) and that stipulates a minimum amount of profit to be realized and tax to be paid. To provide added incentives to enterprises, above-quota profits are taxed at a substantially lower rate.

loan principal as a cost in calculating taxable profits has also adversely affected tax revenues. 1/

Another structural weakness of the revenue system arises from the revenue-sharing arrangements between the central and local governments in effect since 1988. In China, most taxes are collected by local governments and, with a view to encouraging collection, current revenue-sharing arrangements feature a quota system fixed in nominal terms similar to that embodied in enterprise contracts. 2/ The authorities recognize that this system tends to erode the revenue transferred to the central government and weakens the latter's ability to use fiscal policy for macroeconomic control.

The authorities said that the enterprise contract responsibility system would be retained and perfected. Their intention was to allow only after-tax profits to be contracted, to apply a uniform tax rate or structure to profits as a whole, and to eliminate the pretax treatment of loan repayments. These practices had already been introduced on a trial basis in a few cities, and the experiments would be extended to other cities in 1990. The experience with the new contracts would then be evaluated. The authorities noted that some difficulties, particularly concerning the ability of enterprises with substantial outstanding bank credit to repay principal on a before-tax basis, had already been encountered. Because of the large variations in economic conditions across the country, different types of contract systems might be allowed to coexist.

The authorities also planned to revise the center-province revenue-sharing arrangements when current contracts expire. The new system would divide taxes into three categories: those set aside exclusively for the central government, those accruing to local authorities, and those that would be shared. Simultaneously, the system of tax administration would be reformed and the expenditure obligations of the central and local governments would be more clearly defined.

The staff team encouraged the authorities to adopt the proposed revisions to the enterprise contract management system on a nation-wide basis. At the same time, it emphasized that the contract system had infused a great measure of dynamism into the economy, and therefore cautioned against changing the system in a way that would eliminate its

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1/ This practice was adopted as a transitory arrangement to put enterprises that rely on bank loans to finance investment on an even footing with enterprises that continue to receive government grants.

2/ Local governments contract to remit a specified minimum amount of taxes to the central government and are allowed to retain all or the bulk of revenue in excess of the quota. As in the case of enterprises, the contract covers several years (typically three years) and the minimum amount of taxes due is set in nominal terms.

incentive features. Furthermore, the staff suggested that a more fundamental separation of ownership and management, including through shareholding systems, would be desirable to strengthen incentives, especially for long-run planning, and would represent a better permanent solution. The authorities' intention to revise the revenue-sharing arrangements with local governments was welcomed. The proposed improvements in both systems would help to halt the erosion of government revenue and to enhance the flexibility of tax policy so that it would be better able to meet the needs of macroeconomic management.

The authorities stressed that reform of the enterprise and local government contract systems would take time to implement. As an immediate step to increase revenue performance, tax collection had been strengthened by strictly enforcing the fulfillment of contracts and the collection of taxes from individually owned and collective enterprises. Steps also were planned to improve the system of indirect taxation. With regard to subsidies, the authorities agreed that it was important to reduce the present burden that they placed on the budget. Subsidies to loss making enterprises were to be curbed through selective price adjustments and efforts to raise efficiency. The weakening of demand pressures as a result of the austerity program provided new impetus for enterprises to improve efficiency and product quality. Also, consideration was being given to reducing consumer subsidies by adjusting prices, but there was concern about the impact this could have on inflation.

During 1990, there will be a sharp increase in the amount of maturing domestic debt as a result of the shortening of the maturity structure of bonds issued in recent years. The authorities are considering a number of approaches to this problem, including the compulsory purchase of new bonds by existing holders. The staff recommended that, as far as possible, the Government adopt a voluntary, market-based, approach to meeting its financing needs. The new bonds should be issued in a wider range of maturities, should offer competitive interest rates, and should be tradeable in the secondary market. Such an approach would not only facilitate the necessary volume of bond sales but would also help to develop the domestic capital market. Any residual financing need that could not be covered by an improvement in fiscal performance should not be met by the imposition of a requirement for banks to hold treasury bonds as this would intensify distortions in the financial system.

4. External sector issues

With the recent tightening of import controls in response to sluggish export growth, a deterioration in access to capital markets, and rising external debt, the discussions focused on exchange and trade system policies and on issues related to foreign borrowing.

a. Exchange and trade policies

China continues to have a dual exchange rate system, with an administered exchange rate for transactions carried out under the state plan and a floating exchange rate determined in foreign exchange swap centers. 1/ Much of the discussion in the external area related to the need for adjustment of the administered rate. At the time of the consultation discussions, the administered rate was at the level of Y 3.72 per dollar adopted in mid-1986 (Chart 4). 2/ The renminbi had recently appreciated in the swap centers from Y 6.5-7 per dollar in the first half of 1989 to about Y 5 per dollar, reflecting the tightening of financial policies and the intensification of administrative controls over the purchase of foreign exchange for imports.

The authorities said that as a result of the large increase in domestic prices and costs since mid-1986, the renminbi was clearly overvalued at the administered exchange rate. The extension of the use of the adjustment centers to all exporters had helped to boost exports in 1988. However, the problem with the existing level of the administered rate was reflected in the stagnation of exports in the first half of 1989 and in the growing need to subsidize certain exports, in particular agricultural products and processed foods. The authorities also stressed that the existing dual rate system was only transitional and that the intention was to limit the spread between the two exchange rates and move eventually to a unified system.

The authorities noted that the recent narrowing of the spread between the two exchange rates presented an opportunity to act on the administered rate and move toward exchange rate unification. However, they stressed the need for caution. Adjustment of the official rate would have implications for the domestic price level, which would come at an unfortunate time in the Government's battle against inflation; alternatively, adjustment of the rate without raising domestic prices would increase government subsidies of certain basic imported items and place added pressure on the budget. The rationalization of the exchange system would need to go hand in hand with price reform.

1/ Some 80 foreign exchange swap centers, where firms in need of foreign exchange may purchase foreign exchange retention quotas of other firms which are fully convertible for approved imports, operate in major cities throughout China. Retention quotas vary with the degree of processing of exported goods up to 100 percent for some goods and for exports of foreign investment enterprises.

2/ This is an average of the buying and selling rates.

The staff team noted that the recent weakening export growth placed too great a burden of balance of payments adjustment on import compression, with adverse implications for growth. It recommended a substantial depreciation of the renminbi, followed by the pursuit of a flexible policy with a view to the unification of the two exchange markets in the near future at a rate that would allow a substantial relaxation of import restrictions. Unification could be pursued through a combination of further adjustments to the administered rate and the shifting of additional transactions to the swap centers. The staff emphasized that an improvement in export competitiveness would allow the growth in imports needed for modernization of the Chinese economy.

After the mission's return, the administered rate for the renminbi was, effective December 16, adjusted to Y 4.72 per dollar, a depreciation of 21 percent. 1/ The devaluation, which has brought about a narrowing of the spread between the rates in the two markets, should help improve the competitiveness of China's exports, although it only partially offsets the appreciation of the real exchange rate since late 1987. To be effective in stimulating exports and also in curbing import demand, it will need to be fully passed through to domestic prices. Also, the restrictions on the use of foreign exchange in the adjustment centers should be reduced so as not to undermine the role that these centers can play in allocating foreign exchange efficiently and in indicating a realistic level of the exchange rate.

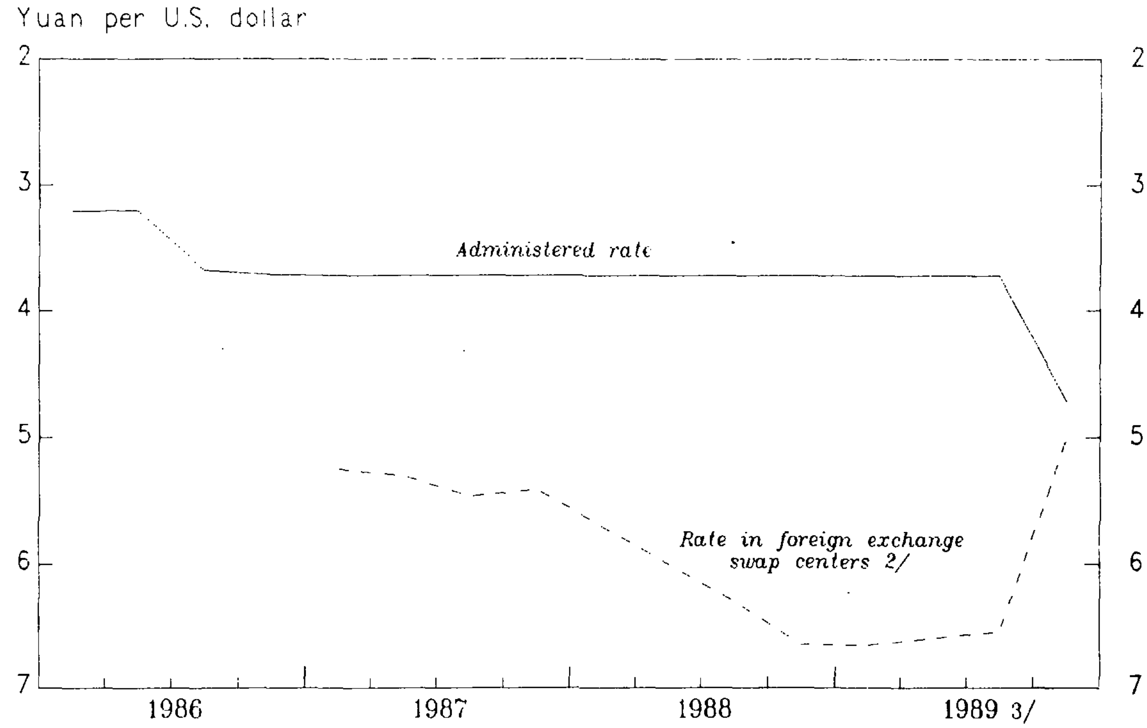
The authorities noted that as a result of the decentralization of the control over foreign trade corporations in early 1988, the number of enterprises engaged in foreign trade had increased rapidly, and some firms had failed to honor their contractual obligations, thus frustrating the orderly development of trade. The authorities stressed that the situation called for steps, including the closing or merging of trade corporations, to improve management and reduce the incidence of illegal activities. The staff acknowledged that there might be a need to improve the regulation of trade corporations. However, the increase in the number of companies engaged in foreign trade had undoubtedly increased competition and added to the dynamism of the external sector. The staff stressed the importance of continuing with efforts, including those in the area of trade reform, to bring domestic prices into line with prices abroad and thus integrate China more fully into the world economy.

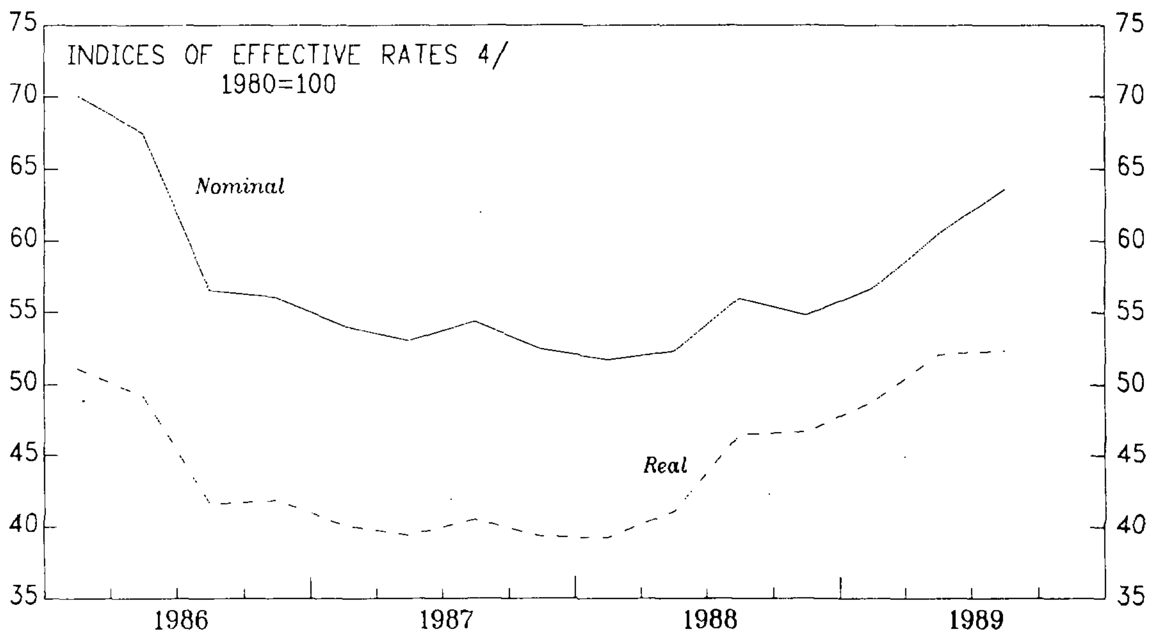
1/ Y 4.72 is an average of the new buying and selling rates.

CHART 4

CHINA

EXCHANGE RATES, 1986-89 1/





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

1/ Period average; downward movement indicates depreciation of the renminbi.

2/ These centers were established in late 1986. The figure for the fourth quarter of 1989 is a staff estimate based on partial data.

3/ Effective December 16, 1989, the administered exchange rate was devalued from 3.72 yuan per U.S. dollar to 4.72 yuan per U.S. dollar.

4/ In terms of the basket of currencies used in the IMF Information Notice System. These indices are based on the administered exchange rate for the renminbi.

b. External debt and foreign direct investment

While China's debt service payments remain low, China's external debt has increased rapidly in recent years. 1/ In February, 1989, the authorities took steps to control foreign commercial borrowing, complementing the actions adopted in 1987 requiring the registration of all borrowing with the State Administration of Exchange Control (SAEC). Under the terms of the new regulations, all commercial borrowing must receive the approval of the PBC, and commercial borrowing is to be channeled through only ten domestic entities. Also, the short-term external debt of each institution may not exceed 20 percent of their total debt.

According to official data, China's external debt rose by only about $1 billion in the first half of 1989. The authorities attributed this in part to the new regulations that had been adopted to limit new external borrowing, but it was also noted that the events of June had adversely affected China's access to foreign financial markets. Although short-term credit lines had been reduced only slightly, deposits in Bank of China branches abroad had declined in June; access to medium- and long-run credits had also been affected, and in the first half of 1989, only one bond issue of approximately $160 million had been made.

Regarding future access to financial markets, deposits in foreign branches of the Bank of China were increasing again and the authorities expected them to reach their pre-June levels by, at the latest, early 1990. However, the authorities were doubtful about the prospects for medium- and long-term borrowing in the near future. In this respect, the attitude of foreign governments in the wake of the June events was of key importance. Also, the recent downgrading of China's credit rating by a U.S. and a Japanese rating agency was worrisome. The authorities noted that the possibility of downgrading had been

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1/ Official data indicate that total foreign debt rose by almost US$10 billion in 1988, to a level of US$41 billion by year end. Estimates prepared by the OECD on the basis of creditor information suggest that China's external debt rose by about US$13 billion in 1988 to almost US$50 billion by end-1988. OECD estimates may overstate China's debt because some borrowing by nonresidents (particularly foreign companies participating in joint ventures in China) guaranteed by Chinese institutions may be recorded as Chinese liabilities and because in some cases the value of short-term lines of credit instead of amounts actually drawn may be included in the OECD data. However, official Chinese data underestimate the level of China's debt as they do not include suppliers credits of less than 90 days, and, in the view of the staff, this exclusion probably explains a large part of the discrepancy between the two estimates of the debt.

developing for some time, related to external perceptions of difficulties emerging in the Chinese economy.

The authorities indicated that through mid-1989, China had continued to be very successful in attracting the interest of foreign investors. However, they noted that the June events and the foreign economic sanctions that followed had adversely affected the investment climate, particularly in the case of projects under negotiation in Beijing and other areas in northern China. It was also suggested that the austerity program and the attendant economic uncertainty might have affected investment. The staff commented that the recent emphasis on administrative controls and the attendant uncertainty about the fate of market-related reforms were also likely to have a negative effect on foreign investment.

China maintains restrictions on payments and transfers for current international transactions in accordance with Article XIV in the form of limitations on the availability of foreign exchange for travel and education abroad as well as restrictive features of bilateral payments agreements with Fund members. In addition, the authorization for trading of foreign exchange in foreign exchange adjustment centers and a 10 percent tax on remitted profits of foreign investment enterprises give rise to multiple currency practices subject to approval under Article VIII, Section 3. With regard to the tax on remitted profits, the authorities said that while many enterprises were exempt and the revenue raised was small, its removal was not under consideration.

5. Prospects for reforms

The authorities emphasized that the market-oriented reforms of the past ten years and the opening to the outside world had brought great economic benefits to China. This process was irreversible and a return to rigid central planning was ruled out. The general direction of future reforms remained unchanged, but the underdevelopment of markets made it necessary to rely, to some degree, on administrative measures to stabilize the economy. The inadequate development of macroeconomic instruments and institutions also justified the need for administrative controls. This was particularly the case in view of the substantial decentralization of decision making to local governments that had taken place over the last decade. Local governments had an important responsibility in developing their regions and enjoyed substantial autonomy in the organization of production in their jurisdictions. They had a strong desire to expand investment and output, and the central government found itself forced to use administrative means to rein in their investment enthusiasm.

The authorities saw a conflict between price liberalization and the efforts to curb inflation. In their view, the process of price liberalization could not be resumed until aggregate demand had been brought under firm control. The downturn in inflation, while a source of encouragement, was not regarded by the authorities as signaling that the battle against inflation had been decisively won. They believed that the rapid monetary expansion of previous years had created a liquidity overhang that would take some time to be absorbed. The authorities also explained that there were large imbalances in the structure of production, and that price distortions, particularly for key services and products, such as energy, transportation, and raw materials, were severe. Price liberalization at the present would result in very steep increases in prices that would have a major disruptive effect on the economy. Moreover, since market mechanisms were underdeveloped, market signals would not necessarily elicit the correct supply responses.

The authorities stated that the austerity program did not mean that reforms had stopped on all fronts. The official prices of certain key commodities (e.g., coal and grains) and services (e.g., transportation) were notoriously low and would be adjusted. Also, consideration was being given to eliminating the two-track price system for a number of controlled goods because it had given rise to profiteering and corruption. However, it was not yet decided whether unification would be brought about through removing controls or through extending them to the entirety of production. In the area of enterprises, as mentioned previously, the reforms would focus on refining the contract responsibility system. In agriculture, the household responsibility system would not be changed, but the pooling of land to take advantage of economies of scale would be encouraged; such pooling would be carried out strictly on a voluntary basis. Steps to develop macroeconomic instruments and institutions, such as the strengthening of the role of the central bank and the reform of the tax system and tax administration discussed earlier, would continue.

The staff argued that stabilization and reforms should be viewed as mutually reinforcing and that price reform, in particular, had a crucial role to play in strengthening the authorities' ability to maintain firm control over aggregate demand. Further development of indirect instruments of monetary, fiscal, and exchange rate policy could not be achieved without additional progress in increasing the role of market prices. Similarly, enterprise reforms, including measures to perfect the contract responsibility system, would require further steps in price reform to reduce distortions in the pattern of profitability. The staff also argued that the role of market forces in allocating resources had become important, and that, in any case, further price reforms were essential to encourage increases in supply in bottleneck sectors, as well as to curb demand. Reforms that hardened enterprise constraints would help to increase the responsiveness of enterprises to price signals.

The staff noted that the weakening of demand and the decline in the rate of inflation provided a good opportunity for the authorities to move boldly with price reforms. Preliminary work by the staff did not show evidence of a substantial liquidity overhang in the economy. The high rate of inflation during 1988 and early 1989 had probably absorbed most of the growth of the money supply. In any case, the impact of price liberalization on the overall price level would be limited if financial policies remained tight and the incentives for holding money were adequate. With regard to the possible elimination of the two-track pricing system for some commodities, the staff hoped that the approach adopted would be to allow greater flexibility of controlled prices. While recognizing that the two-track pricing was a transitory arrangement toward a more market-oriented system, the staff noted that elimination of market-determined prices would be a major step backward in the process of reform.

6. Medium-term outlook

Over the medium term, China's ability to achieve a satisfactory rate of growth while maintaining a viable balance of payments position hinges on the future course of economic reforms. To illustrate this point, two alternative medium-term scenarios, based on different assumptions about the course of economic reforms, were discussed with the authorities. It was noted that the impact of reforms on economic performance is extremely difficult to quantify, and that the scenarios should be regarded as only illustrative of the qualitative effects of reforms.

Scenario 1 (Table 2) assumes that wide-ranging price, enterprise, and external reforms are undertaken, while cautious monetary and fiscal policies would support output growth without rekindling inflationary pressures. In this environment, the authorities' objective of 7 1/2 percent a year real GNP growth established in the Seventh Five-Year Plan could probably be realized. Exchange rate, price, and enterprise reforms would support the diversification and expansion of merchandise exports and also would raise the efficiency of capital. In addition, continued progress with reforms would improve the climate for investment, contributing to increased capital flows. The resources generated by exports and inflows of foreign capital would enable imports to grow by more than 10 percent annually, while allowing the level of international reserves to remain consistent with the authorities' target of three months of imports.

The external current account deficit, while rising after 1992, would not exceed 1 percent of GNP. Viewed in terms of the savings-investment balance, savings in relation to GNP, which is at present very high by international standards, might tend to decline with the greater availability of high-quality consumer goods, but improved efficiency would enable the investment/GNP ratio to be reduced. With the need for external borrowing limited, the debt service burden would be maintained

Table 2. China: Near-Term Outlook and Medium-Term Scenario 1

	1987 Act.	1988 Est.	1989 Proj.	1990	1991	1992 Scenario	1993	1994	1995
					(Percent change)				
Real GNP	11.0	10.8	5.0	4.5	6.0	7.0	7.5	7.5	7.5
Retail prices	7.2	18.6	20.0	8.0	6.0	5.0	5.0	5.0	5.0
					(Percent of GNP)				
Gross domestic investment	39.2	38.9	36.5	35.0	33.7	33.5	33.5	33.5	33.5
Gross national saving	39.3	37.9	35.5	34.2	33.0	32.8	32.7	32.6	32.5
Current account balance	*0.1*	*-1.0*	*-1.0*	*-0.8*	*-0.7*	*-0.7*	*-0.8*	*-0.9*	*-1.0*
					(In billions of U.S. dollars)				
Current account balance	0.3	-3.8	-4.1	-3.2	-2.8	-3.4	-4.2	-5.2	-6.2
Merchandise balance	-1.7	-5.3	-5.0	-4.4	-4.2	-4.8	-5.6	-6.6	-7.6
Exports	34.7	41.1	44.3	50.1	57.6	65.1	71.9	79.5	87.9
(percent change)	(34.9)	(18.2)	(7.9)	(13.0)	(15.0)	(13.0)	(10.5)	(10.5)	(10.5)
Imports	-36.4	-46.4	-49.3	-54.5	-61.8	-69.9	-77.5	-86.0	-95.5
(percent change)	(4.3)	(27.4)	(6.3)	(10.5)	(13.5)	(13.0)	(11.0)	(11.0)	(11.0)
Net services and transfers	2.0	1.5	0.9	1.2	1.4	1.4	1.4	1.4	1.4
Of which: Travel receipts	(1.8)	(2.2)	(1.4)	(1.8)	(2.2)	(2.5)	(2.8)	(3.2)	(3.5)
Capital account, net 1/	4.6	6.0	1.5	4.0	4.5	5.5	6.5	8.0	8.5
Direct investment, net	1.7	2.3	1.4	1.5	1.5	2.0	2.5	3.0	3.0
Other, net 1/	2.9	3.7	0.1	2.5	3.0	3.5	4.0	5.0	5.5
Of which: Debt repayments	(-2.8)	(-2.5)	(-2.9)	(-4.1)	(-5.1)	(-6.8)	(-7.3)	(-8.2)	(-9.6)
Overall balance	4.9	2.2	-2.6	0.8	1.7	2.1	2.3	2.8	2.3
Financing	-4.9	-2.2	2.6	-0.8	-1.7	-2.1	-2.3	-2.8	-2.3
Change in reserves (-increase)	-4.9	-2.2	2.6	-0.4	-1.3	-2.1	-2.3	-2.8	-2.3
Use of IMF credit	--	--	--	-0.4	-0.4	--	--	--	--
Official reserves	16.9	19.1	16.5	16.9	18.2	20.3	22.6	25.4	27.7
(months of imports)	(5.6)	(5.0)	(4.0)	(3.7)	(3.5)	(3.5)	(3.5)	(3.5)	(3.5)
External debt	36.7	49.6	51.4	53.5	56.1	59.6	63.6	68.6	74.1
(percent of GNP)	(12.0)	(13.2)	(11.6)	(10.5)	(9.6)	(8.9)	(8.2)	(7.8)	(7.5)
Debt service ratio	9.8	8.6	10.8	11.8	11.9	13.1	12.8	12.9	13.3
World trade (percent change) 2/	17.6	13.6	7.3	8.7	9.5	9.5	9.5	9.5	9.5
China's share of world trade	1.7	1.8	1.7	1.8	1.9	1.9	2.0	2.0	2.0

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

1/ Includes errors and omissions.

2/ Average value of world exports and imports.

at the comfortable level of about 13 percent. Overall, in this scenario the stage would be set for further rapid development.

The second scenario assumes that little additional significant progress is made with economic reforms (Table 3). In these circumstances, it would be difficult, in the staff's view, to achieve the authorities' present, more modest, annual output growth target of 5-6 percent for the period of the stabilization program, and GNP growth of about 4 percent a year might be expected. In the absence of reforms, total factor productivity would grow more slowly and both export and import growth would be substantially lower than in the first scenario. While the external current account balance as a ratio of GNP would fall to less than 1/2 percent, the debt service ratio would rise to over 15 percent by 1995, primarily as a result of slow export growth.

The medium-term projection outlined by the authorities lay somewhere between the staff's two scenarios. They felt that with partial implementation of economic reforms, the target of 5-6 percent a year GNP growth could be achieved during the stabilization period. The reduction in shortages in key commodities under the stabilization program and some further progress in external sector reforms, including an exchange rate adjustment, would help to stimulate exports. With some pickup in capital inflows after the decline in 1989, international reserves could be maintained at 3-4 months of imports, while the debt service ratio would not exceed 15-20 percent, which in their view was sustainable.

IV. Staff Appraisal

Economic reforms have infused dynamism into China's economy over the past decade. However, difficulties have been encountered in the transition from the reliance on planning controls to the use of indirect instruments of macroeconomic policy. These have produced repeated episodes of excess demand, the most recent of which, in 1987-88, brought the rate of inflation to almost 30 percent. Since late 1988, the authorities have moved decisively to curb the growth of aggregate demand and regain control over inflation. Their strategy has relied on a substantial tightening of credit policy, together with a strengthening of administrative controls, especially over investment, prices, the direction of credit, and imports. The stabilization program has so far been very effective in slowing inflation, but it also has resulted in a substantial weakening of industrial production. The authorities have indicated that control of inflation, along with the removal of bottlenecks in key sectors of the economy, will continue to be the major policy objectives for the next two years, and that during this period economic reforms will be carried out on only a limited scale. At the

Table 3. China: Near-Term Outlook and Medium-Term Scenario 2

	1987 Act.	1988 Est.	1989 Proj.	1990	1991	1992 Scenario	1993	1994	1995
					(Percent change)				
Real GNP	11.0	10.8	5.0	4.0	4.0	4.0	4.0	4.0	4.0
Retail prices	7.2	18.6	20.0	8.0	6.0	6.0	6.0	6.0	6.0
					(Percent of GNP)				
Gross domestic investment	39.2	38.9	36.5	35.0	35.0	35.0	35.0	35.0	35.0
Gross national saving	39.3	37.9	35.5	34.3	34.4	34.5	34.6	34.6	34.6
Current account balance	0.1	-1.0	-1.0	-0.7	-0.6	-0.5	-0.4	-0.4	-0.4
					(In billions of U.S. dollars)				
Current account balance	0.3	-3.8	-4.1	-3.5	-3.2	-3.0	-3.0	-3.2	-3.6
Merchandise balance	-1.7	-5.3	-5.0	-4.7	-4.6	-4.3	-4.4	-4.7	-5.1
Exports	34.7	41.1	44.3	47.8	51.6	55.8	60.3	65.1	70.3
(percent change)	(34.9)	(18.2)	(7.9)	(8.0)	(8.0)	(8.0)	(8.0)	(8.0)	(8.0)
Imports	-36.4	-46.4	-49.3	-52.5	-56.2	-60.1	-64.7	-69.8	-75.4
(percent change)	(4.3)	(27.4)	(6.3)	(6.5)	(7.0)	(7.0)	(7.5)	(8.0)	(8.0)
Net services and transfers	2.0	1.5	0.9	1.2	1.3	1.3	1.4	1.5	1.5
Of which: Travel receipts	(1.8)	(2.2)	(1.4)	(1.8)	(2.2)	(2.4)	(2.7)	(3.0)	(3.3)
Capital account, net 1/	4.6	6.0	1.5	3.4	4.2	4.2	4.2	4.5	4.5
Direct investment, net	1.7	2.3	1.4	1.2	1.5	1.5	1.5	1.5	1.5
Other, net 1/	2.9	3.7	0.1	2.2	2.7	2.7	2.7	3.0	3.0
Of which: Debt repayments	(-2.8)	(-2.5)	(-2.9)	(-4.1)	(-5.1)	(-6.7)	(-7.2)	(-8.0)	(-9.2)
Overall balance	4.9	2.2	-2.6	-0.1	1.0	1.2	1.2	1.3	0.9
Financing	-4.9	-2.2	2.6	0.1	-1.0	-1.2	-1.2	-1.3	-0.9
Change in reserves (-increase)	-4.9	-2.2	2.6	0.5	-0.6	-1.2	-1.2	-1.3	-0.9
Use of IMF credit	--	--	--	-0.4	-0.4	--	--	--	--
Official reserves	16.9	19.1	16.5	16.0	16.6	17.8	19.0	20.2	21.2
(months of imports)	(5.6)	(5.0)	(4.0)	(3.7)	(3.5)	(3.5)	(3.5)	(3.5)	(3.4)
External debt	36.7	49.6	51.4	53.2	55.5	58.2	60.9	63.9	66.9
(percent of GNP)	(12.0)	(13.2)	(11.6)	(10.7)	(10.1)	(9.6)	(9.1)	(8.7)	(8.3)
Debt service ratio	9.8	8.6	10.8	12.2	13.1	15.0	14.7	14.9	15.5
World trade (percent change) 2/	17.6	13.6	7.3	8.7	9.5	9.5	9.5	9.5	9.5
China's share of world trade	1.7	1.8	1.7	1.7	1.7	1.7	1.6	1.6	1.6

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

1/ Includes errors and omissions.

2/ Average value of world exports and imports.

same time, they have stressed that it is their intention to resume the reform process once stabilization has been consolidated.

The staff fully supports the priority the authorities have given to bringing inflation under firm control. At the same time, it is concerned about the stabilization program's heavy reliance on administrative controls and the limited progress with reform envisaged under the program. The staff feels that the failure to use price signals more actively to guide resource allocation is likely to increase the cost of adjustment in terms of foregone output, add to pressures for a relaxation of policy, and ultimately undermine the stabilization effort. The nature of the stabilization effort will also have important implications for future economic development: increased reliance on direct controls is likely to undermine confidence in the durability of reforms, and hence inhibit the investment and the development of institutions on which future growth will depend. These concerns are compounded by the danger that, in the delicate transitional stage in the reform process, the intensification of administrative controls, even if it is intended to be only temporary, could trigger a more serious reversal of reforms.

The sharp slowdown in the rates of money and credit expansion has been the major factor behind the substantial reduction in inflation. In order to consolidate control over inflation, a further slowing of money and credit growth should be targeted for 1990. The staff believes, however, that the recent increase in the extent of control over the direction of bank lending is counterproductive and should be reversed, as it is likely to stifle the development of the most productive sectors of the economy. At the same time, interest rates on both deposits and loans need to be adjusted flexibly so as to maintain them at appropriate levels in real terms and to provide banks with an adequate margin over the cost of funds. The staff would also strongly recommend that, to prevent a weakening of the banking system, the recently introduced system of preferential lending rates for basic industries be abandoned. The problems faced by those industries would be better addressed by appropriate structural measures, including price reforms.

Recent budgetary trends are a source of concern, with revenues continuing to fall in relation to GNP, while rising enterprise losses are putting pressures on expenditures. The resulting weakening of the budgetary position is placing an undue burden on monetary policy in achieving the goals of the stabilization program. A sustained improvement in the fiscal position requires measures to address structural weaknesses in the tax system. The authorities are therefore encouraged to adopt, on a nationwide basis, the modifications to the contract responsibility system currently under experimentation and to implement the proposed changes to the revenue sharing arrangements with local governments. Steps are also urgently required to reduce subsidies to enterprises and consumers.

The balance of payments position has strengthened since mid-1989, owing in part to the weakening of domestic demand. At the same time, the substantial overvaluation of the administered exchange rate was hindering export performance, and placing too much of the burden of external adjustment on import compression, with adverse implications for growth. In this context, the staff welcomes the depreciation of the administered exchange rate in mid-December, but would emphasize that to be effective, it will need to be passed through fully to domestic prices. Also, the staff urges the authorities to pursue a flexible policy with a view to reunification of the two exchange markets in the near future at a rate that would allow a substantial liberalization of import restrictions. Unification could be pursued through the transfer of additional transactions to the adjustment centers, as well as through further adjustments to the administered rate. In this connection, the staff strongly encourages the authorities to move swiftly to reduce the restrictions that apply to operations in the swap centers, so that the floating rate is effective in allocating foreign exchange efficiently and provides a better indication of the appropriate level for the exchange rate. The staff would also stress again the importance of accompanying action on the exchange rate with price and other domestic reforms.

Pending clarification of the authorities' timetable for unification of the exchange markets, the staff does not recommend Executive Board approval of the multiple currency practice arising from the operation of the adjustment centers. The staff also does not recommend approval of the multiple currency practice arising from the 10 percent tax on remitted profits of foreign investment enterprises, since the authorities have indicated that the removal of the tax is not under consideration.

With regard to the role of reforms in the stabilization program, the staff fully agrees with the authorities on the importance of strengthening the instruments of monetary and fiscal policy. If this is not achieved, excess demand and inflation are likely to return quickly once administrative controls are relaxed. However, further progress with other reforms, especially price reform, is necessary for the strengthening of macroeconomic control mechanisms. In particular, a reduction in the distortions in the pattern of profitability is needed for the more effective use of taxes or interest rates, and also to facilitate the reduction of subsidies to enterprises. Equally important, a major realignment of relative prices is necessary to allocate bottlenecks in key sectors, and hence to strengthen the foundation for balanced growth in the future. The weakening of demand and the reduction of inflation already to less than 10 percent, offer an excellent opportunity to move forward boldly with price reform. Provided that monetary and fiscal policies are tight, the short-run impact of price liberalization on inflation should be limited.

For price reform to be fully effective in improving the pattern of resource allocation, it needs to be supported by a hardening of enterprise budget constraints and a strengthening of enterprise autonomy. In this connection, the reduction of budgetary subsidies to enterprises and the elimination of bargaining over taxation in enterprise contracts represent steps in the right direction. Nevertheless, there is still a question of whether contracts between enterprise management and the level of government directly responsible for the enterprise can provide adequate freedom from government interference in day-to-day operations, or an appropriate structure of incentives in the long run. The staff recognizes that the contract management system has infused dynamism into the enterprise sector, but believes that a more fundamental separation of ownership and management, including through shareholding systems, would represent a better long-run solution.

The reforms implemented in China over the past decade have conferred great benefits in terms of rapid economic growth and increases in living standards. The staff is, therefore, heartened by the authorities' assurances that the progress with reforms is irreversible. At the same time, the staff is concerned that the recent intensification of administrative controls is likely to exacerbate the impact of demand restraint on production. Also, increased reliance on planning controls and a stop-go approach to reform risk undermining the effectiveness of the reform process. Continued progress with reforms on a broad front is a sine qua non for maintaining credibility in the momentum of reforms, and for ensuring that China is able to combine rapid development with low inflation and balance of payments viability. The staff therefore urges that China move ahead with reforms in key areas while, at the same time, taking steps to ensure that the instruments of macroeconomic policy are more effectively developed and that demand is kept under firm control.

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

V. Proposed Decision

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

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Sections 2(a) and 3, in concluding the 1989 Article XIV consultation with China, in the light of the 1989 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (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, as described in SM/90/ . In addition, the authorization for trading of foreign exchange in foreign exchange adjustment centers and the tax on remitted profits of certain foreign investment enterprises give rise to multiple currency practices subject to approval under Article VIII, Sections 2(a) and 3. The Fund urges China to implement further reforms in the exchange system with a view to unifying the exchange rates. The Fund also encourages China to eliminate the exchange restrictions maintained in accordance with Article XIV, including those arising from bilateral payments agreements with Fund members, as soon as possible.

Table 4. China: Monetary Survey, 1986-89

	1986	1987	1988				1989		
	Dec.	Dec.	March	June	Sept.	Dec.	March	June	Sept.
			(In billions of yuan; end of period)						
Net foreign assets	3.9	23.0	32.0	34.2	31.3	30.3	27.5	23.0	24.0
Net domestic assets	668.3	812.0	835.0	891.3	940.1	979.7	991.8	1,033.6	1,075.9
Loans to enterprises and individuals	814.5	980.3	1,003.2	1,057.5	1,102.6	1,141.8	1,151.4	1,180.2	1,223.2
Net credit to Government	5.8	20.8	9.6	10.3	17.1	30.5	24.3	30.2	23.7
Other items, net	-152.1	-189.1	-177.8	-176.4	-179.6	-192.7	-183.9	-176.7	-170.9
Money plus quasi-money	672.2	835.0	867.0	925.5	971.3	1,009.9	1,019.2	1,056.6	1,099.9
Money	474.1	568.5	575.3	623.8	669.9	695.0	668.5	672.0	676.6
Currency	121.8	145.4	144.2	154.2	184.9	213.3	209.7	207.9	208.1
Demand deposits	352.3	423.0	431.1	469.6	485.0	481.7	458.8	464.0	468.4
Quasi-money	198.0	266.5	291.6	301.7	301.4	314.9	350.7	384.7	423.5
			(Percentage change from a year earlier)						
Net domestic assets	33.9	21.5	22.2	26.0	23.8	20.7	18.8	16.0	14.5
Of which: Loans to enterprises and individuals	(29.5)	(20.4)	(22.7)	(23.8)	(21.1)	(16.5)	(14.8)	(11.6)	(10.9)
Money and quasi-money	29.2	24.2	25.7	28.4	25.5	21.0	17.5	14.2	13.2
Of which: Currency	(23.3)	(19.4)	(26.3)	(35.8)	(45.6)	(46.6)	(45.4)	34.9	12.5

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

Table 5. China: State Budgetary Operations, 1984-89 1/

	1984	1985	1986	1987	1988 Budget	1988 Actual	1989 Budget	1989 Estimated outcome
	(In billions of yuan)							
Total revenue	183.5	228.3	244.6	256.3	274.4	286.3	315.8	320.0
Tax revenue 2/	106.8	218.8	224.8	232.0	251.5	257.2	276.2	280.0
Nontax revenue	76.7	9.5	19.8	24.9	22.9	29.1	39.6	40.0
Total expenditure and net lending	193.9	232.4	263.3	281.5	305.0	321.3	346.2	353.0
Current	138.1	168.1	188.1	204.4	226.9	239.8	267.4	275.0
Of which: Subsidies 3/	(50.7)	(58.2)	(69.7)	(67.0)	(76.5)	(76.3)	(93.1)	(103.0)
Capital 4/	55.8	64.3	75.2	77.1	78.1	81.5	78.8	78.0
Overall deficit (-)	-10.5	-4.1	-18.7	-24.6	-30.6	-35.0	-30.4	-33.0
Financing	10.5	4.1	18.7	24.6	30.6	35.0	30.4	33.0
Domestic	8.7	4.0	13.4	17.8	22.3	23.5	18.4	21.0
People's Bank of China	(4.5)	(-2.1)	(7.1)	(6.4)	(--)	(7.9)	(--)	(5.0)
Nonbank 5/	(4.2)	(6.1)	(6.3)	(11.4)	(22.3)	(15.6)	(18.4)	(16.0)
Foreign 6/	1.8	0.1	5.3	6.8	8.3	11.5	12.0	12.0
Gross foreign borrowing	(3.5)	(2.9)	(7.6)	(10.6)	(12.8)	(13.9)	(16.5)	(16.5)
Amortization (-)	(-1.7)	(-2.8)	(-2.3)	(-3.8)	(-4.5)	(-2.4)	(-4.5)	(-4.5)
	(In percent of GNP)							
Revenue	26.3	26.6	25.1	22.6	19.6	20.4	19.0	19.2
Expenditure	27.8	27.1	27.1	24.8	21.8	22.9	20.8	21.2
Subsidies	(5.9)	(5.9)	(6.0)	(5.9)	(5.4)	(5.4)	(5.6)	(6.1)
Capital expenditures	(8.0)	(7.5)	(7.8)	(6.8)	(5.6)	(5.8)	(4.7)	(4.7)
Deficit (-)	-1.5	-0.5	-2.0	-2.2	-2.2	-2.5	-1.8	-2.0

Sources: Ministry of Finance; and State Statistical Bureau.

1/ These budgetary statistics represent a consolidation of the budget of the central government and the financial operations of provinces, counties, municipalities, and townships. Intergovernmental transfers are netted out. Extrabudgetary financial operations of the various levels of government are not included.

2/ Includes taxes on extrabudgetary revenues and investment introduced in 1983. Proceeds of the profit tax on state enterprises introduced in 1983 are included under nontax revenue, as official data for 1984 do not identify this item separately from profit remittances. Beginning with the 1985 budget, profit taxes on state enterprises are included under tax revenue.

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

4/ Includes extrabudgetary capital construction of Y 6.9 billion in 1987, Y 8 billion in 1988 (budget), Y 8.5 billion in 1988 (actual), and Y 9 billion in 1989 (budget).

5/ Mainly Treasury bonds. Includes special construction bonds in the amount of Y 6.9 billion in 1987, Y 8.5 billion in 1988, and Y 9 billion in 1989.

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

Table 6. China: Balance of Payments, 1984-89

	1984	1985	1986	1987	1988	1989 Staff est.
			(In billions of U.S. dollars)			
Current account	2.5	-11.8	-7.3	0.3	-3.8	-4.6
Trade balance	0.0	-13.1	-9.1	-1.7	-5.3	-5.5
Exports	23.9	25.1	25.8	34.7	41.1	44.0
Imports	-23.9	-38.2	-34.9	-36.4	-46.4	-49.5
Services, net	2.1	1.1	1.4	1.7	1.1	0.5
Services credit	4.8	4.5	4.9	5.4	6.3	6.2
Of which: Travel receipts	1.1	1.3	1.5	1.8	2.2	1.4
Services debit 1/	-2.8	-3.5	-3.5	-3.7	-5.2	-5.7
Net unrequited transfers	0.4	0.2	0.4	0.2	0.4	0.4
Capital account, net	0.2	6.6	4.8	6.0	7.1	2.4
Long-term capital inflow	3.3	7.2	10.3	9.7	11.1	7.4
Of which: Direct investment, net	1.1	1.0	1.4	1.7	2.3	1.4
Long-term capital outflow 1/	-1.7	-2.9	-3.3	-4.0	-4.1	-5.0
Short-term capital net	-1.4	2.3	-2.3	0.2	0.1	--
Errors and omissions	-0.9	0.6	0.6	-1.4	-1.1	-1.3
Overall balance	1.8	-4.6	-2.0	4.9	2.2	-3.5
Reserves and related items 2/	-1.8	4.6	2.0	-4.9	-2.2	3.5
Change in reserves	-1.8	4.6	1.3	-4.9	-2.2	3.5
Use of Fund credit	--	--	0.7	--	--	--
Memorandum items:						
External debt	12.8	20.5	26.9	36.7	49.6	51.1
(percent of GNP)	5.1	7.7	10.3	12.0	13.2	11.5
Debt service ratio 3/	4.7	7.4	9.9	9.8	8.6	10.9
International reserves	17.8	13.2	12.0	16.9	19.1	15.7
(months of imports)	(8.9)	(4.1)	(4.1)	(5.6)	(5.0)	(3.8)
			(In percent of GNP)			
Current account balance	0.8	-4.0	-2.6	0.1	-1.0	-1.0
Exports of goods and services	9.6	10.2	10.9	13.2	12.6	11.3
Imports of goods and services	8.9	14.3	13.6	13.1	13.7	12.5

Sources: State Administration of Exchange Control; and staff estimates.

1/ Adjusted for estimates of the underreporting of interest and principal repayments.

2/ A minus sign indicates an increase.

3/ Debt service as a percent of exports of goods and services and private remittances.

China--Fund Relations
(As of November 30, 1989)

I. Membership status

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

b. Status: Article XIV.

A. Financial Relations

II. General Department

a. Quota:	SDR 2,390.9 million
b. Total Fund holdings of currency:	SDR 2,686.0 million (112.34 percent of quota)
c. Fund Credit Of which: Credit tranches:	SDR 597.7 million (25 percent of quota)
d. Reserve tranche:	SDR 302.6 million
e. Current operational budget:	Not included
f. Lending to the Fund:	None

III. Stand-By or Extended Arrangements and Special Facilities

a. Current arrangement:	None
b. Stand-by and extended arrange ments in last ten years:	

Type of arrangement	Date of approval	Duration	Amount SDR mn.	Utilization SDR mn.
SBA	3/2/81	1 year	450.0	450.0
SBA	11/12/86	1 year	597.7	597.7

c. Special facilities in last two years:	None

IV. SDR Department

a. Net cumulative allocation:	SDR 236.8 million.
b. Holdings:	SDR 411.1 million (173.6 percent of cumulative allocation).
c. Current designation plan:	Not included

China--Fund Relations (continued)
(As of November 30, 1989)

V. Administered accounts

a. Trust Fund
   (i) Disbursed: SDR 309.5 million.
   (ii) Outstanding: SDR 92.9 million.
b. SFF Subsidy Account: None

VI. Financial obligations due to the Fund
(millions of SDRs)

	Overdue Financial Obligations 7/31/89	Principal and Interest Due			
		1989 Nov.-Dec.	1990	1991	1992
Principal					
Repurchases	--	--	298.9	298.9	--
Trust Fund repayments	--	--	61.9	31.0	--
Total	--	--	360.8	329.8	--
Charges and interest including SDR and Trust Fund (provisional)	--	0.3	47.3	19.0	0.3
Total due	--	0.3	408.1	348.8	0.3

B. Nonfinancial Relations

VII. Exchange rate arrangement

China maintains a dual exchange rate arrangement. One rate is administered as a managed float. Its representative rate is determined as the midpoint between the buying and selling rate of the renminbi vis-a-vis the U.S. dollar. As of December 16, 1989, the representative rate for the renminbi was Y 4.722 per U.S. dollar. There is also a floating exchange rate determined in foreign exchange adjustment centers by eligible participants. The centers were first established in 1986, and since then both the number of centers and the scope of transactions have been widened substantially.

VIII. Last Article IV consultation

The Executive Directors adopted the following decision at EBM/89/16 on February 15, 1989:

China--Fund Relations (continued)
(As of November 30, 1989)

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1988 Article XIV consultation with China, in the light of the 1988 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (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, as described in SM/89/17. In addition, the authorization for trading of foreign exchange in foreign adjustment centers and the tax on remitted profits of certain foreign investment enterprises give rise to multiple currency practices subject to approval under Article VIII, Sections 2(a) and 3. The Fund urges China to implement further reforms in the exchange system with a view to unifying the exchange rates. The Fund also encourages China to eliminate the restrictive features of the bilateral payments agreements with Fund members.

IX. Technical assistance

Since 1980, the IMF Institute has received many Chinese officials in its courses and seminars. In late 1983, the Institute organized a three-week course in Xian on "Banking and Monetary Policy." The Bureau of Statistics has sent four missions to discuss data presented in IFS, including a mission on balance of payments statistics in November 1985, and has presented seminars in China on balance of payments methodology in 1983, on government finance statistics (May 1986), on money and banking statistics (August 1987), and on financial programming (September 1989).

Two staff members of the Central Banking Department visited Beijing and Shanghai in May 1985 for discussions and lectures on central banking matters with officials and staff of the People's Bank of China. CBD missions visited China in March 1986, April 1987, and May 1988 for advisory work relating to financial programming, monetary policy instruments, and bank regulation. A CBD consultant provided assistance on aspects of external debt management in August 1986.

The External Relations Department has held two colloquia in China--in November 1982 and November 1986. The proceedings of the first colloquium were published in 1983 under the title, The Fund and China in the International Monetary System. The subject of the second colloquium was "Macroeconomic Management, Growth, and the Role of the IMF."

China--Fund Relations (concluded)
(As of November 30, 1989)

A Fiscal Affairs Department mission in July 1989 provided technical assistance on budget preparation and presentation; a comprehensive report is to be transmitted to the authorities by mid-November 1989.

A mission to study the inflationary process in China and develop recommendations for policy action visited Beijing in August-September 1988.

Fund staff also have participated in various IBRD activities in China, including a mission on external trade and capital issues (October 1986), a seminar on financial sector reforms (April 1988), a technical assistance mission on computerization of the payments clearing system (May 1988), a tax mission (June 1988), a country economic memorandum mission (June 1988), a seminar on budgetary law (September 1988), a seminar on social security reform (September 1988), and a financial sector study mission (August 1989).

X. Resident Representative/Advisor: None

China--Relations with the World Bank Group

The World Bank has been increasingly active in China in recent years, both in terms of lending and economic work. Loan commitments in FY 1989 totaled $1.3 billion, with particular emphasis on the agriculture, energy, and transport sectors. Since June 1989, the World Bank has suspended new lending to China, but it continues to disburse funds under previous loan commitments. Recent economic work includes a country economic memorandum and a study of fiscal policy, both completed in 1989 with the participation of Fund staff.

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

Capital subscription: China holds 25,142 shares or 3.32 percent of the total authorized capital of the Bank. China voted in favor of the Special Capital Increase under which it would be eligible to subscribe to 1,660 additional shares. Formal action to subscribe for these shares was taken on November 4, 1986.

Lending activities:

	Commitments		Disbursements	
	IDA	IBRD	IDA	IBRD
	(In millions of U.S. dollars)			
FY 1981	100.0	100.0	--	--
1982	60.0	--	0.1	--
1983	150.4	397.1	32.6	0.6
1984	423.5	615.2	100.8	19.6
1985	442.3	654.1	146.2	235.7
1986	450.0	687.0	251.9	352.2
1987	556.2	867.4	361.2	317.8
1988	639.9	1,053.7	399.2	302.3
1989	515.0	833.4	549.5	684.5
1990 (End-Oct.)	--	--	198.0	282.5
Total	3,337.3	5,200.9	2,039.5	2,095.29

Approved projects: FY 1981, University Development; FY 1982, North China Plain Agriculture; FY 1983, Three Ports, Agricultural Education and Research, China Investment Bank I, Petroleum I and II, and State Farms I; FY 1984, Polytechnic/TV University, Technical Cooperation, Rubber Development, Lubuge Hydroelectric, Railway I, Rural Credit I, Rural Health/Medical Education, China--Relations with the World Bank Group (continued)

Petroleum III, China Investment Bank II, and Agricultural Education II; FY 1985, Agricultural Research II, Power II, University Development II, Changcun (Luan) Coal Mining, Seeds, Rural Water Supply, Highway I, Railway II, Fertilizer Rehabilitation and Energy Saving, Forestry Development, PiShiHang-Chaohu Area Development, and Weiyuan Gas Field Technical Assistance; FY 1986, Rural Credit II, China Investment Bank III, Technical Cooperation II, Provincial University, Railway III, Tianjin Port, Freshwater Fisheries, Beilungang Thermal Power, Yantan Hydroelectric, Liaodong Bay Petroleum Appraisal, and Rural Health and Preventive Medicine; FY 1987, Red Soils, Power V, China Investment Bank IV, Shanghai Machine Tools, Xinjiang Agricultural Development, Shanghai Sewerage, Beijing-Tianjin-Tanggu Expressway, Gansu Provincial Development, Fertilizer Rationalization, Wujing Thermal Power, and Planning Support and Special Studies; FY 1988, Huangpu Port, Rural Credit III, Dalian Port, Northern Irrigation, Coastal Lands Development, Teacher Training, Pharmaceuticals, Sichuan Highway, Shaanxi Highway, Daxing An Ling Forestry, Beilungang II, Phosphate Development, Railway IV, and RSAL; FY 1989, Ningbo and Shanghai Ports, Xiamen Port, Jiangxi Highway, Shaanxi Agricultural Development, Tianjin Light Industry, Textbook Development Project, Integrated Regional Health Development Project, Inner Mongolia Railway, Shandong Agricultural Development, Hubei Phosphate, Shandong Provincial Highway, and Fifth Industrial Credit.

Economic Development Institute:

Since May 1981, the Economic Development Institute has held several courses a year for China, making it EDI's largest country program. Nine courses were given by EDI in FY 1984, ten in FY 1985, thirteen in FY 1986, ten in FY 1987, and nine in FY 1988, using UNDP funds. Chinese participants have also been attending EDI regional courses and programs in Washington. In June 1985, a three-week seminar on development policy and management was held in Washington and New York for senior Chinese officials. Since 1985, EDI has sponsored a series of seminars in each year, with the most recent one being on fiscal reform.

China--Relations with the World Bank Group (concluded)

Economic missions:	The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, "China: Recent Economic Trends and Policy Developments" (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984, an economic mission visited China to focus on long-term economic issues and options. A Fund staff member participated in this mission. A report by this mission (No. 5206-CHA) entitled "China: Long-Term Issues and Options" was discussed with the Chinese authorities in March 1985 and approved by the Bank's Executive Directors in June 1985. In October 1985 the report was published in book form by the Johns Hopkins University Press. In February-March 1986, a mission that included a Fund staff member examined finance and investment issues. The report (No. 6445-CHA) was discussed with the authorities in April 1987 and was published in 1988. In October 1986, a mission that included a Fund staff member examined issues in China's foreign trade and capital. The report was discussed with the authorities in June 1987 and was published in 1988. Two missions, which included Fund staff, visited China in June 1988 to analyze China's tax system and to prepare a country economic memorandum. The reports--No. 7483 CHA and No. 7605 CHA--were discussed with the authorities amd published in 1989. In March 1989, a mission visited China to examine the social security system and in September a mission was in the field to prepare a financial sector report. A Fund staff member participated in the latter. The study of Social security will be discussed with the authorities in December 1989 and the financial sector report in the spring of 1990. A CEM mission took place in November 1989 and its report is to be discussed with the Government by March 1990.
Resident mission:	A resident IBRD office in Beijing was opened in October 1985.
Technical assistance:	Since 1987, technical assistance has been under negotiation in the areas of tax policy, bank supervision, commercial bank financial management, and market development for government securities.

(CHC) radb9ch (12/22/89)

China--Relations with the Asian Development Bank

China became a member of the Asian Development Bank (AsDB) in 1986. The main areas on which the AsDB has focused are the industry and energy sectors. The AsDB's strategy in the industrial sector is to support industrial modernization, and in the energy sector to promote energy conservation, augment capacity, and increase efficiency in transmission.

In 1987, the AsDB approved its first two loans to China: a loan of \$100 million to the China Investment Bank (CIB) to finance the modernization of small and medium-sized industrial enterprises; and a loan of \$33.3 million for the Fuel Conversion Project to convert oil-fired generating facilities to coal-fired facilities. In 1988, the AsDB approved four loans to China totaling \$283 million: a loan of \$46.6 million to establish an integrated pigment plant; a loan of \$86.8 million to finance the modernization of three tire plants; a loan of \$100 million to the Shanghai Investment and Trust Company to finance small and medium-scale industrial development projects; and a loan of \$49.6 million to establish a chemical pulp mill. In early 1989, the AsDB approved one loan to China of \$39.7 million for the Shanxi-Xiaoliu Railway project. Since June 1989, the AsDB has suspended new lending to China although it continues to disburse funds under previous loan commitments. Total AsDB disbursements to China as of September 30, 1989 amounted to \$34.87 million.

The AsDB has also provided technical assistance, including project preparatory technical assistance for a steel mill and a pulp mill, and operational technical assistance for the CIB and the People's Bank of China.

CHINA

Basic Data--Social and Demographic Indicators

GNP (in billions of yuan, at current prices, 1987)	1,402	GNP per capita (US$, 1988)	344 1/
Area	**Population (1988)**	**Density (in persons)**	
3,749,000 sq. miles	1.096 billion	114 per sq. km	
(9,597,000 sq. km.)	Annual growth rate 1.3 percent	282 per sq. km. of agricultural land	

Population characteristics (1984)		**Health**	
Life expectancy at birth (years)			
Overall	70		
Male	68	Population per physician (1981):	1,000
Female	71	Population per hospital bed (1984):	500
Infant mortality rate (per '000 live births)	32.0		
Under 5 years of age mortality rate (per '000 live births)	40.0		
Income distribution (1987)		**Education (1983)**	
Percent of household income			
Highest 20 percent	39	Illiteracy rate: overall (percent of population age 15+)	30.7
Lowest 40 percent	18	female (percent of females age 15+)	44.5
Nutrition		**Access to safe water**	
Calorie intake per day	2,630	(In percent of population)	
Per capita protein intake (1982) (grams per day)	61	Total	50
		Urban	81
		Rural	40

Sources: Data provided by the Chinese authorities; IBRD, Social Indicators of Development in 1988; and staff estimates.

1/ Calculated with GNP converted into U.S. dollars at the administered exchange rate of Y 3.72 per dollar.

China--Statistical Issues

1. Outstanding statistical issues

a. Real sector

On national accounts, only two aggregates based on the System of National Accounts (GNP) and Material Product System (national income) compilation principles, respectively, are reported. Data on prices, production, employment, and wages are reported only in annual frequency, which impedes analyses of short-term trends.

b. Government finance

There is no presentation for China in the Government Finance Statistics Yearbook (GFSY). Data published in International Finance Statistics (IFS) have methodological shortcomings and are not comparable with those of other countries. The Ministry of Finance is presently making efforts to bring data on government operations into uniformity with the standard government finance statistics presentation. It is expected that the Chinese language version of A Manual on Government Finance Statistics will facilitate this task.

c. Monetary accounts

A technical assistance mission, scheduled to take place in February 1990, is under discussion with the authorities. The mission would review the compilation and presentation of China's monetary statistics with a view to enhancing their content and broadening their scope.

d. Balance of payments

Following a technical assistance mission by the Bureau of Statistics and the Asian Department in November-December 1985, recommendations were put forward to improve the quality of China's balance of payments statistics. No follow-up actions seem to have been taken so far by the Chinese authorities. In recent communications, however, the Chinese authorities have informed the Fund that discussions are under way with various departments concerned about the implementation of the recommendations made in the mission report and that the Fund would be advised in this respect in due course.

e. International banking

Because of weaknesses in China's monetary statistics, the Fund uses data reported by international banking centers to estimate the external position of China's banking system vis-a-vis the rest of the world. This is not entirely satisfactory, and it is expected that the money and banking mission planned for early 1990 will help ensure that China will be able to supply the data needed to compile the Fund's international banking statistics.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for China in the December 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the People's Bank of China, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in December 1989 IFS
Real Sector	- National Accounts	1988 1/
	- Prices: CPI	1988
	WPI	1988
	- Production	1988
	- Employment	1988
	- Earnings	1988
Government Finance	- Deficit/Surplus	1988
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	Q2 1989
	- Deposit Money Banks	Q2 1989
	- Other Financial Institutions	n.a.
Interest Rates	- Discount Rate	n.a.
	- Bank Lending/Deposit Rate	n.a.
	- Bond Yields	n.a.
External Sector	- Merchandise Trade: Values	July 1989
	Prices	n.a.
	- Balance of Payments	1988
	- International Reserves	August 1988
	- Exchange Rates	October 1989

1/ GDP at current prices; national income at constant 1987 prices.