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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/27

10:00 a.m., February 28, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
G. K. Arora	
	C. Enoch
	G. C. Noonan
Dai Q.	Zhang Z.
T. C. Dawson	
	P. Péterfalvy, Temporary
E. T. El Kogali	
E. A. Evans	
	R. J. Lombardo
	G. García, Temporary
R. Filosa	
M. Finaish	
	I. H. Thorláksson
	M. A. Hammoudi, Temporary
G. Grosche	B. Goos
J. E. Ismael	T. Sirivedhin
A. Kafka	
J.-P. Landau	
	C. V. Santos
	M. Al-Jasser
G. A. Posthumus	
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present
IBRD: D. Pearce, C. Wallich, Asia Regional Office. Asian Department: P. R. Narvekar, Director; U. Baumgartner, D. Burton, S. Dunaway, L. M. Koenig, J. E. Leimone, G. Szapary. Exchange and Trade Relatations Department: A. Basu, B. C. Stuart. Fiscal Affairs Department: M. I. Blejer. IMF Institute: Wang X., Zhang J., Participants. Legal Department: J. W. Head. Research Department: P. Isard. Western Hemisphere Department: H. E. Khor. Bureau of Language Services: Li L. Advisors to Executive Directors: N. Adachi, M. A. Ahmed, J. Basiuk, J. M. Jones, K.-H. Kleine, J.-L. Menda, P. O. Montórfano, A. Raza. Assistants to Executive Directors: J. R. N. Almeida, B. A. Christiansen, H. E. Codrington, Di W., A. Y. El Mahdi, A. Fanna, B. R. Fuleihan, S. Gurumurthi, M. E. Hansen, J. Heywood, L. Hubloue, K. Ichikawa, P. Kapetanovic, H.-J. Scheid, J.-P. Schoder, M. J. Shaffrey, Shao Z., Yang J.

1. PEOPLE'S REPUBLIC OF CHINA - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with the People's Republic of China (SM/90/2, 1/2/90, and Cor. 1, 1/12/90). They also had before them a report on recent economic developments in China (SM/90/14, 1/17/90).

Mr. Dai made the following statement:

My authorities found the Article IV consultation held in Beijing last November very constructive and helpful. They appreciate the staff's analysis of the recent economic developments in China and their policy recommendations. In general, they agree with the thrust of the staff report. I should like to just highlight a few main developments.

1. Initial results of rectification in 1989

In late 1988 when China was confronted with surging inflation as a result of a prolonged overheated economy for the past few years, the Chinese Government determined to undertake decisive measures to reverse the critical situation. A stabilization program entitled "Improvement of Economic Environment, Rectification of Economic Order and Deepening of Reform" was launched. The key objectives of the program for the first year were to cool down the overheated economy while maintaining steady growth, bring down the rate of inflation, and improve bottleneck sectors. In the course of stabilization, tight monetary and fiscal policies were implemented; at the same time, some administrative measures were also employed to strengthen control over excessive domestic demand. After a year's effort, the following initial economic results have been achieved:

(1) The overheated economy has cooled down. Real GNP growth was reduced to 3.9 percent from 11.2 percent in 1988. The growth rate for industrial output was reduced to 8.3 percent, 12.5 percent lower than the previous year. Excessive domestic demand has been brought under control to a certain extent. Fixed investment decreased by 11 percent and wage increases slowed down by 9.1 percent.

(2) The surging inflation has been checked. In 1989, with the introduction of a tight credit policy and a more realistic interest rate policy, money growth has been sharply reduced to 9.8 percent compared with 46.8 percent in 1988. The rate of price increases declined each month--for instance, the 12-month rate of the retail price increase was 27.9 percent in February 1989 but fell to 6.4 percent in December. Household savings increased by Y 133.4 billion, a doubling of the previous year's figure.

(3) There was a fairly good harvest. Total agricultural output increased by 3.3 percent in 1989. Grain output was 407.45 million tons, attaining about the same record level of 1984.

(4) The external sector has maintained a steady growth. In 1989 foreign trade totaled $111.6 billion, an increase of 8.6 percent from the previous year; exports were up 10.5 percent and imports were up 7 percent. Foreign investment commitments increased to $5.6 billion, of which wholly owned foreign investment grew to $1.6 billion compared with $0.48 billion in 1988.

Notwithstanding the above initial results, which are generally in line with the objectives of the stabilization program, my authorities are fully aware that there is little room for complacency. First, there has not yet been a fundamental improvement in the overall imbalance between aggregate supply and demand. Second, many deep-seated structural problems remain unresolved. Third, the average annual rate of inflation is still high in 1989. Moreover, new problems have emerged. The most prominent ones are the serious overstock of some products due to the market slump, a sharp decline of production in some industries, a deterioration in economic efficiency, and increasing unemployment pressures. Under these circumstances, the crucial tasks before us are to persevere with stabilization as top priority and to speed up the process of restructuring the economy while strengthening macrocontrol; meanwhile, efforts should be made to revitalize the market and smooth out difficulties in the operation of the economy.

2. Main goals of further rectification and reform

On the basis of the review of the economic policies and stabilization program, my authorities decided in late 1989 to continue unswerving efforts to rectify the economy and deepen the reform so as to ensure a sustained, stable, and harmonious development. It was also decided to basically complete the task of improving the economic environment and rectifying the economic order in three years or a little longer. The main goals of the economic program for further rectification and reform are the following:

(1) to gradually reduce the rate of retail price inflation to under 10 percent per annum;

(2) to gradually achieve compatibility between monetary supply and economic growth;

(3) to gradually reduce and eliminate the budget deficit;

(4) to maintain a 5-6 percent annual growth in GNP on the basis of improvement in economic efficiency and advancement of science and technology;

(5) to rationalize the economic structure so as to ensure the steady increase in output of major agricultural products and to gradually reduce shortages of energy, basic materials, and transportation services; and

(6) to further deepen and perfect various reform measures and gradually develop a system of macroeconomic control.

In order to achieve the above goals, a combination of macroeconomic and structural policies will be employed.

First of all, tight fiscal and credit policy must be continued to contain the growth of domestic demand. On fiscal policy, revenue will be increased through adjustment of taxes and strengthening of the tax administration; while continuing tight control of capital construction, current expenditures will be cut by a uniform percentage from the previous year's level, and subsidies to local budgets will also be reduced. On monetary policy, the strengthened credit control measures of last year will be continued and improved. Strenuous efforts will be made to restructure the orientation of loans, with priority given to agriculture, energy, transportation, communications, essential raw materials, and other infrastructure projects. The management of interest rates will be further perfected, and more savings deposits will be mobilized.

Second, the industrial structure needs to be readjusted in light of the industrial policy so as to increase the effective supply and reinforce the economic growth momentum and, in particular, to vigorously promote the development of agriculture and ensure a steady increase in primary products such as grains and cotton.

Third, continuous efforts should be made to straighten out the economic order so as to overcome the serious confusion in the spheres of production, construction, circulation and distribution.

Fourth, it is a persistent and arduous task to improve management of enterprises, tap internal potential, and raise economic efficiency.

While keeping the main goals of rectification in mind, my authorities have undertaken and will undertake appropriate and selective reforms in the process of stabilization and will continue attaching great importance to price reform which is central to building a planned commodity economy. During the course of last year's stabilization program, several important measures in price adjustment were taken, despite continued inflationary pressures. For instance, procurement prices for a few major agricultural products were adjusted upward to produce a favorable effect on supply response. Railway passenger fares were substantially raised as a means of reducing subsidies. This year, some further price reform measures will be carried out.

In the enterprise reform, priority will be given to in-depth reform and perfection of the "contract responsibility system," which aims at encouraging enterprises to undertake more financial accountability with expanded autonomy.

Regarding fiscal reform, emphasis is placed on the improvement of the revenue-sharing system between the central and local budgets, as well as on further tax reforms such as value-added tax and other new taxes, budget presentation, and tax administration. A system separating taxes between central and local governments is also under discussion, with a view to strengthening the fiscal position as well as the macroeconomic regulatory power of the central government. A program of Fund technical assistance in fiscal and tax reform was recently discussed and formulated in Beijing.

Reforms in the monetary system and foreign trade contracted system will continue. My authorities will strive to make the People's Bank of China (PBC) a strong central bank. The International Central Banking Conference, cosponsored by the Fund, UNDP, and the People's Bank of China, was held in Beijing last month and was of great importance in this respect. Banking supervision and prudential regulation is also on the agenda of technical assistance.

Transactions in the foreign exchange swap centers have been encouraged and expanded. Trading volume reached $8.5 billion in 1989, an increase of 36 percent over 1988. On December 16, 1989, the official exchange rate of the renminbi was devalued by 21 percent. This is an important step in pursuing a managed floating exchange rate policy and also a sign of the authorities' determination to consistently carry forward the reforms.

3. Some key policy issues

(1) The relationship between rectification and reform

My authorities have firmly indicated that economic reform in China is an unswerving state policy. The ongoing rectification and economic reform are mutually complementary and reinforcing.

While emphasis is presently on rectification, it does not mean that the reform will be halted or revoked. On the contrary, rectification will not only create necessary conditions for healthy, in-depth reform, but will also require the support of the reform measures. During the period in which efforts are concentrated on rectification, reform should center around the rectification effort. In sum, both rectification and reform are not aims per se, but means to achieve the goal of a sustained, stable, and harmonious growth.

(2) Indirect instruments versus direct measures

In building a planned commodity economy, the aim through various reform measures is to gradually establish a macroeconomic control system in line with the principle of integrating a planned economy with market regulation in which all economic, administrative, and legal means will be combined and employed. In the circumstances of an underdeveloped market mechanism, direct administrative measures are necessary means to supplement and support indirect macroeconomic instruments to stabilize the economy, especially at a time when strains on the economy become acute and extraordinary measures are called for. When strains ease, the combination of direct and indirect measures could be readjusted. However, my authorities continue to attach great importance to indirect instruments and keep extending their use whenever possible. In the fight against inflation, for example, while strengthening control over credit ceilings, interest rate policy was also emphasized and employed to tighten credit as well as to encourage savings. In addition, the indexing rate for time deposits was introduced as a special measure at a time when the expectation of inflation was strong.

(3) Perseverance in the opening policy

My authorities have repeatedly reaffirmed that it is imperative to continue with the policy of opening to the outside world. Further efforts will be made to boldly absorb foreign investment and import advanced technology while effectively expanding foreign trade and economic and technical exchanges. The basic policies and measures adopted for the special economic zones and coastal open regions remain unchanged and will be further perfected. In order to further encourage foreign investment, my authorities have decided to make greater efforts at improving the laws and regulations for investment; simplifying application and approval procedures; and upgrading services for foreign-invested enterprises. A prudent foreign debt policy has been continued, the debt structure was further rationalized, and the debt-service ratio has been contained at a reasonable, manageable level. My authorities will firmly adhere to the policy of maintaining credibility and honoring their commitments, irrespective of what difficulties may be encountered.

In conclusion, I would like to emphasize one more point. Drawing on the experience and lessons learned from the economic development history of China over the past four decades, my authorities have come to the conclusion that it is of the utmost importance always to persist with the long-term policy of a sustained, stable, and harmonious economic development and resolutely guard against one-sided emphasis on too rapid development. An overly ambitious pace, either of economic growth or of economic reform, should be avoided. In a large developing country such as China, it is absolutely essential to base policy measures strictly on the specific circumstances and conditions of the economy, taking fully into account not only the needs but also the possibilities. In so doing, we are confident that China's economy will certainly be able to achieve sustained, stable, and harmonious development.

Mr. Yamazaki made the following statement:

The Chinese economy has undergone a wide-ranging transformation away from direct and centralized planning since the authorities initiated a courageous economic program to restructure the economic system in late 1978. There is little doubt about the impressive achievements made in the past decade. During the ten years from 1978 to 1988, GNP grew at an average rate of 9.5 percent, in significant contrast to the annual population growth of 1.4 percent during the same period. The economic reforms involving relaxation of direct planning controls, decentralization of economic decision making, increased reliance on market forces, and development of nonstate-owned enterprises have removed distortions which impeded the efficient allocation of resources. This economic management, which has brought both rapid growth and improved living standards, is certainly commendable.

Despite the considerable progress, however, the Chinese economy remains in a transitional phase. With the pervasive legacy of the pre-economic reform period, economic reform has had to be a time-consuming, iterative process. During this process of transition, difficulties have inevitably arisen in reining in the economic forces that have been unleashed on production units. The domestic and external imbalances facing China have stemmed mainly from the transitory structure of the economy. The repeated rekindling of inflationary pressure, including the recent inflation of 1988-89, has been a clear reflection of the transitory nature of the price mechanism introduced into the economy. Thus, it is essential for the authorities to remove impediments to the efficient allocation of resources as well as to stabilize excess demand in order to regain control over inflation. So far the authorities have made their best efforts by utilizing a whole range of policy instruments open to them. Nonetheless, it was unfortunate, though understandable, that the stabilization program involved some direct control measures. While the authorities appear to recognize the importance of removing bottlenecks in the economy as well as of containing inflation, in the long run, greater weight will need to be given to indirect controls if the gains from the transformation of the economy that is currently under way are to be consolidated fully.

The recent slowdown of inflation attests to the authorities' skillful management of the economy. The rapid credit expansion in 1988, which coincided with the increasing decentralization of economic decision making, led to escalating inflation and the first decline in real income since 1978. The expansionary fiscal policy, financed by the central bank, also contributed to the growth in reserve money and excess demand pressure. However, the tightened reserve requirement, supplemented by monetary control, has effectively moderated the excess credit demand in 1989. Under the circumstances, with indirect control instruments not yet being fully developed, it was inevitable that direct control measures, such as the quarterly ceilings on the credit expansion of each specialized bank, had to be introduced, and subsequent events have proved their effectiveness.

As Mr. Dai emphasized in his informative statement, the authorities consider the reduction of the inflation rate one of their main goals and are aiming at achieving compatibility between money supply and economic growth. We welcome the importance that the authorities continue to attach to controlling inflation. Given that the favorable prospects for inflation in 1990 would create some margin for price adjustments, it would be appropriate for the authorities to stay on the safe side on credit policy and aim at somewhat lower monetary growth than in 1989. The reported increase in intermediation outside the financial system also points in this direction.

We can understand the authorities' intention of intensifying control over the direction of bank lending. However, it should be noted that credit demand from state and collectively owned enterprises may reflect bottlenecks in some sectors of the economy or the need to finance unsold stocks. Thus, as the authorities have clearly recognized, such a measure should be of a temporary nature and be removed.

A flexible interest policy would also be helpful in attaining efficient resource allocation. The widespread withdrawal of deposits was well reflected in the upturn in velocity in 1989. Since it is certainly necessary to sustain savings in order to finance investment, we welcome the recent increase in deposit rates. Nonetheless, we must also emphasize the need for the financial institutions to be able to achieve sustainable profitability.

Turning to fiscal policy, we find the thrust of the staff's recommendations appropriate. The authorities intend to reduce and eliminate the budget deficit and recognize the need to improve the deficient budgetary system, in particular the revenue-sharing mechanism. Although the declining inflation rate may lessen the shortcomings of the current revenue-sharing mechanism, corrective steps need to be taken as a matter of urgency.

The authorities are to be commended for their expenditure reform efforts and the continued reduction of expenditure in terms of GNP. Nonetheless, the recent rise in expenditure is a worrisome sign. The increasing subsidies have certainly created pressure to undercut capital expenditures. While we sympathize with the authorities in their concern over inflation, we are concerned about inflationary pressure arising from the expansionary expenditures. Bolder steps should therefore be taken in state enterprise reform, including price adjustment. In any case, central bank financing of the budget deficit should remain prudent.

The deterioration in capital inflows, as well as rising external debt, highlights the significance of exchange and trade policy in China. In response to the weakening of exports, coupled with reduced access to financial markets, the authorities relied on import compression and foreign exchange regulations. With the help of the decline in domestic demand, the authorities seem to have managed the situation successfully, as evidenced by the recent rise in international reserves. We also welcome the depreciation of the renminbi, which led to an increase in exports. Active use of a flexible exchange rate policy would ensure a better allocation of resources. Nonetheless, it is also clear that China will have to relax import restrictions further in order to achieve higher growth. The unification of the exchange markets, coupled with an assured pass-through via domestic channels, would be a necessary step for the authorities to pursue smoothly. Meanwhile, we encourage the authorities to strengthen the flexible exchange rate policy.

The increasing external debt casts a shadow over the balance of payments situation of China. However, the staff's medium-term scenario expects a manageable debt-service burden, given the wide-ranging economic reform. Although we should not underestimate the difficulties facing China, it is encouraging to note that continued high growth can be envisaged over the medium term. While the difficulty involved in projecting the supply-side capacity of the economy points to the need to be ready to implement timely macroeconomic adjustment, improved economic efficiency would contribute to attaining a desirable growth path.

The authorities have unquestionably made great progress during recent years. Nonetheless, the transitional stage of the economy calls for further efforts to remove impediments to efficient resource allocation. Adjustment of energy and material prices would remove serious constraints on output growth. The dismantling of subsidies on consumer goods would improve not only overall resource allocation but also the fiscal position. It is also important to ensure that a differential for quality be reflected in prices. Moreover, the role of the price mechanism should be further expanded. In this vein, we welcome the authorities' intention to raise the official price of key commodities and services as well as to review the two-track price system. Having said this, we certainly understand the authorities' cautious stance in view of the need to further curb inflation, and we welcome Mr. Dai's assurance that economic reform in China is an unswerving state policy. However, it should be noted that the need to strengthen the adjustment effort will increase as the reforms proceed. We must emphasize that continued wide-ranging efforts will be the only means of realizing China's enormous potential.

To conclude, while China has enjoyed a relatively high savings ratio, it will have to continue to rely on capital inflows and direct investments. Thus, China must continue to demonstrate its ability to persevere with its economic goals. We are quite confident that China will fulfill our hope that the economic reform efforts will make expeditious progress as was the case during the last decade.

Mr. Ismael made the following statement:

A look at the macroeconomic indicators shows us how impressively the Chinese economy has performed under the impetus of its reform efforts. Real GNP has been growing by almost 10 percent a year on average, and living standards have improved considerably. Over the past five years, industrial production has grown by over 13 percent a year. China's savings and investment ratios are among the highest in the world. The tight monetary policy introduced in the third quarter of 1988, with the aim of easing inflationary pressures, has slowed the economy somewhat. Even so, China's overall economic performance remains striking.

The Chinese authorities were vigilant in implementing stabilization measures during 1988-89. This has had the satisfactory result of reducing retail price increases from nearly 30 percent in 1987/88 to a rate of only 6.4 percent by December 1989.

I support the authorities' intention to continue with their stabilization program. It does appear, however, that some measure of stability may have already been achieved, and that, therefore, the stage may already be, or is nearly, ready for a slightly faster pace of reform. In particular, in case prices slow down further, it may be opportune for the authorities to take further steps to relax price controls. Such steps may also contribute toward achievement of the other objective of the stabilization program--namely, the alleviation of bottlenecks in certain sectors. To ensure a successful reform effort, these steps should, as the authorities realize, continue to be accompanied by macroeconomic stabilization measures.

Monetary policy has been appropriately tight over the past 18 months. I welcome the upward adjustments in interest rates, which have been effective in halting runs on deposits, and agree with the staff that rates on both deposits and loans should be kept flexible so as to maintain them at suitable levels in real terms. The indexing of time deposits reflects the authorities' determination to do so. I welcome the authorities' stated intention to increase reliance on indirect monetary instruments, including increases in reserve requirements as well as the tightening of control by the Head Office of the People's Bank of China over lending by its branches. Attention should also be paid to creating other monetary instruments. Continued stringency in the target for credit expansion appears to be appropriate. While agreeing with the staff that preferential interest rates for key sectors should ideally be eliminated, I can understand the authorities' desire to direct bank lending to priority sectors, particularly in the medium term.

At the discussion of the 1988 Article IV consultation, Directors recognized the need for a tighter fiscal policy and welcomed the authorities' intention to reduce the fiscal deficit as a percentage of GNP. We stressed the need for tax reforms in order to broaden the tax base and the need to improve revenue-sharing arrangements with the local governments. Tighter control over expenditure was advocated. I think these comments remain valid today and would urge the authorities to implement the measures without delay; I welcome their intention in this area, as stated by Mr. Dai. Moreover, additional efforts should be made to raise revenue through the issuance of government bonds to the general public so as to reduce reliance on the People's Republic of China.

I also welcome the recent courageous adjustment of the administered exchange rate, as well as the authorities' intention to work toward unification of the exchange markets. As a result of the adjustment, the margin between the administered rate and the floating exchange rate has narrowed substantially, and the competitiveness of China's exports should be improved.

China's external debt indicators remain low by international standards. The sharp increase in the level of external debt in 1988 was a potential cause for concern, however, and the authorities were right in moving quickly to take control of the situation by requiring registration of all foreign borrowing and limiting the number of entities that are permitted to borrow commercially overseas. A prudent external debt policy, as well as prudent domestic policies, are a prerequisite for foreign investment inflows. In this connection, the authorities' intention to devote greater effort to improving laws and regulations and simplifying investment procedures is also welcome.

To conclude, I am in agreement with most of the staff's analysis and can support the proposed decision.

Mr. Péterfalvy made the following statement:

Mr. Dai's statement and the staff's papers on the 1989 Article IV consultation with China were all the more interesting for their timely presentation of additional information on the latest developments which have occurred in China since the elemental anger of the people swept away whole regimes in Central and Eastern Europe together with their gradualistic, piecemeal approaches to economic and social reforms. In that region, popular discontent hardened into a determination to replace the totalitarian regimes which in the first place had imposed and maintained the centrally planned economic systems. The new regimes emerging in Central and Eastern Europe seem to be moving not toward market-oriented but to pure market economies based on the predominance of private ownership, and not toward the liberalization of long-standing political structures but toward their replacement by pluralistic parliamentary democracies based on traditional human values.

From the papers before us, it is clear to me that the Chinese authorities have not opted to discontinue the gradualistic approach, which in itself guarantees that the reform process will proceed in a stop-and-go fashion. If the authorities are unwilling to accompany the economic reform process with substantial changes in the political sphere, we may even expect long periods of growing conservatism.

With this as the context, I would like to question, again, the general approach to centrally planned economies which is reflected in the staff papers prepared for our hopefully rescheduled seminar, and also in some parts of the papers before us today. Can we, or should we, assess the progress of reform in a centrally planned economy on the basis of random bits and pieces? Can this be any better than trying to judge the merit of a mosaic from randomly chosen stones, without any notion of how the whole picture will look when it is completed? Is there any such thing as a "market-oriented" economy? Is it conceivable that an economy can operate over the long term on the basis of a mixture of central planning and market mechanisms? Is it not likely that individual market mechanisms introduced into a centrally planned economy will fail to transform it, but will instead be distorted themselves into something other than market mechanisms and sink out of sight into the swamp of central planning? Is not the world, in this respect at least, really black and white? And should we not say that no durable change for the better is therefore possible until a certain critical mass of market mechanisms and political democracy is in place?

This being said, I should now like to elaborate on some specific aspects of the staff report for the 1989 Article IV consultation with China.

First, I must commend the staff for its courageous forecasts in the chapter on China's medium-term outlook, which I understand in the following way: if wide-ranging reforms are introduced, or to apply the terminology I was just using, if the critical mass of change is put into place, a real GNP growth rate of 7.5 percent could be realized; but if the critical mass of reforms is absent, the growth rate will be much lower. This presents the Chinese authorities with a sort of black and white alternative, and I would like to take the liberty of asking Mr. Dai what economic or political considerations lie behind the slowing down, rather than the acceleration of the growth with reform process? My question applies, of course, to the whole stabilization program that the Chinese authorities have undertaken. It is obvious both to the staff and to myself that under the gradualistic approach, the Chinese authorities may be the main contributors to the signs of instability in their economy. Why have the Chinese authorities opted to strengthen the centrally planned aspects of their economy, instead of speeding up the reform process in its progress toward the critical mass? This is a basic question, and we cannot avoid seeking a more informative answer than the authorities' statement, on page 7 of the staff report, that central planning was strengthened "because market mechanisms in China were not fully developed."

My second commentary is on monetary policy, which of course I know is an appendage in centrally planned economies with directive planning, with or without some autonomy, of the central plan. The degree of autonomy in any given case depends on the role of directive planning in the economy. Monetary policy here may play a role only in the private or household sector, if one exists, similar to its role in market economies.

My understanding from the papers before us is that the tightening of monetary policy in China includes both the state enterprises and the private sector. In the state enterprise sector, tightening means a strengthening of directive planning, as is clearly indicated by the establishment of priorities in lending to industry which results, as the staff observes, in "the stifling of development of the most dynamic parts of the economy," thereby adding to the negative impact of stabilization on output growth. For the private sector, tightening means a curtailment of growth. I do not think the Chinese authorities can very well supplement their stabilization programs with monetary policy measures unless and until they have put monetary policy into place. First, they must abolish directive planning. Second, they must give autonomy to the central bank: monetary policy cannot be autonomous so long as the State Planning Commission can draw up a list of large enterprises that are to receive priority in the allocation of credit. Third, they must develop all the instruments that monetary policy should use. And fourth, these monetary policy instruments should be calibrated to the needs of the stabilization program, which among other things means that positive real interest rates have to be introduced and maintained, as the staff suggests.

My final remark on monetary policy is that if there exists a reform concept in China similar to that in some countries of Central and Eastern Europe, then monetary policy should help to develop the private sector by giving it preferential treatment. This approach could really contribute to the success of China's stabilization program.

My third comment relates to fiscal policy, the section on which was one of the most interesting in the staff report. I appreciate the authorities' acknowledgment that the fiscal system does not yet play an adequate role in either the implementation of the reforms or the success of the stabilization efforts. But do they possess the necessary fiscal policy instruments and mechanisms? The section on fiscal policy clarifies a feature of the Chinese system that up to now has baffled me, namely, the so-called contractual responsibility arrangement. If I understand correctly, the state enterprises currently pay taxes on a contractual basis and the revenues are shared, also on a contractual basis, between the Central Government and the provinces. If this is really the arrangement, I do not see in it the instruments and mechanisms needed for fiscal policy to aid stabilization. Here again, many administrative measures can be taken--the contracts can be altered through what we may call coercion, and subsidies to loss-making enterprises can be offset by selective price adjustments decided by the authorities. But let us not call such interventions fiscal policy measures. I also agree with the staff that nothing should be done to intensify the distortions in the financial system. However, all administrative or planning instruments and mechanisms will only intensify the distortions. What is needed here is fiscal reforms, including budget reform, tax reform, and so forth.

My fourth comment concerns exchange rates. I would strongly urge the Chinese authorities to follow the exchange rate solution incorporated in Poland's recently approved stand-by arrangement. It is well known that in central planning environments, exchange rate policy plays a secondary role, at least in the state sector. In the present Chinese environment, administrative measures and strengthened central planning will only increase the economic distortions which a realistic exchange rate would help to eliminate. We cannot have it both ways: we cannot hope to integrate a country into the world economy and at the same time disregard the unmet need for measures that would make such an integration possible. I welcome the intention of the Chinese authorities to proceed accordingly.

Finally, I welcome any expression of commitment to reforms, both economic and political, of the Chinese decision makers, or any such statement on their part, like Mr. Dai's opening statement. I am firmly convinced that a courageous, comprehensive reform effort is required for China to reach the critical mass which will put it on the path to rapid and sustainable economic development. Until then, I am afraid that in the best case, China's future holds a "muddling through" scenario, and I do not even care to imagine a worst case scenario. The Chinese reformers really deserve our support.

Mr. Finaish made the following statement:

Over the past decade or so, the Chinese authorities have implemented a wide-ranging set of structural economic reforms including the relaxation of direct planning controls, decentralization of economic decision making, increased reliance on market forces in setting prices and output, and an opening of China's economy to the outside world. By all accounts, these measures have brought great benefit to the country. Economic growth has been rapid and has been accompanied by a significant improvement in the well-being of the Chinese people.

It was perhaps natural that, in the delicate and complex transition to a more market-based system, difficulties would be encountered that would seem intractable enough to lead to some caution in implementing the reform program. In 1988, the economy seriously overheated and inflation rose sharply. The authorities moved decisively to arrest, and reverse, the momentum of inflation by curbing the growth of aggregate demand. In addition, the authorities reinforced their tight financial policies by imposing some administrative controls. The stabilization program has, as the staff report and the supplement point out, been very effective in dampening demand pressures and controlling inflation, and the authorities deserve to be commended for the firmness with which they have tackled the inflation challenge.

The staff report, I believe, essentially deals with an important, but complex, issue of timing and sequencing of reform measures. The staff takes the view that the present weakening of demand and decline in inflation provides a good opportunity for the authorities to move boldly forward with their reform effort, particularly in the area of price liberalization and the associated removal of administrative controls, which they regard as an important complement to effective and sustained stabilization. It would, in the staff's view, strengthen macroeconomic control mechanisms and the foundations for balanced growth in the future.

I understand, however, from reading the staff report and Mr. Dai's statement, that the authorities have a somewhat different perspective on this question. In their view, a major realignment in relative prices at this juncture would seriously detract from their commitment to hold inflation down to levels which they regard as being acceptable. They believe that while substantial progress has been made in the fight against inflation, there is a need to continue further with restrictive policies to remove underlying imbalances. The use of direct administrative controls along with indirect instruments of macroeconomic policy has been necessitated by the consideration that the instruments of macroeconomic policy at their command are, as yet, somewhat imperfect, and that controls are required as a temporary, additional safeguard against market distortions because markets in China were not yet fully developed.

In this environment, the authorities feel that price liberalization of the magnitude suggested by the staff would merely lead to a resumption of high rates of inflation, thereby mitigating many of the hard fought gains in the battle against inflation.

The authorities are also skeptical as to whether price adjustments would elicit the correct supply response, given the existence of market imperfections and other impediments to factor and resource mobility.

The staff's arguments for moving ahead on the price front are based on a number of considerations but there are two points on which I would like some clarification. First, it is stated that the staff has done some preliminary work which demonstrates that there is no evidence of a substantial liquidity overhang in the economy at the moment and therefore price liberalization could proceed without seriously adverse consequences. The authorities dispute this contention. I wonder whether the staff would share the study's results with the Board.

Second, the staff argues that the impact of price liberalization on the overall price level would be limited if financial policies remained tight. This is, of course, the crux of the issue and one of the major uncertainties facing the authorities. Perhaps the staff could elaborate on this proposition, in particular, on what it means by the word "limited" and whether this assertion is merely a matter of judgment or whether it has any solid empirical support in the context of the Chinese economy. On the other hand, it appears from the projections of retail prices contained in Scenario 1 on page 19 of the staff report that there would be no upturn in annual inflation rates even if wide-ranging price reforms were to be undertaken. I wonder whether the staff would comment on the realism of these figures. To the point that the inflation is accepted as a monetary phenomenon, and financial policies are kept tight, it is not unreasonable to expect at least an initial surge in inflation that is not to be found in the staff scenario. The point is important, and was emphasized by Mr. Enoch in the statement he circulated for the forthcoming seminar on market-oriented reform in planned economies, in which he stated that: "the inflation bias inherent in recent attempts to liberalize centrally planned economies must be seen as a serious and potentially decisive obstacle to the sustainability of these reform efforts, particularly given the prevailing social and political environment." It follows that future approaches to market-oriented reforms must focus more clearly on how inflation can be averted or contained.

Although I share some of the authorities' concerns about the pace of reforms at this time, I note their assurances that the longer-term objectives and goals of their reform program remain unchanged and that the thrust of the reform effort is irreversible. Economic reforms have brought substantial benefits to China and there is reason to believe that the authorities will forcefully resume their efforts once they feel assured that the conditions are appropriate. I note the assurance that the authorities remain committed to making adjustments to official prices, to reviewing the two-track price system, undertaking enterprise reforms with a view to refining the contract management system, and taking further steps to develop macroeconomic instruments and institutions.

Before concluding, I should like to make two additional points. The first point relates to the medium-term balance of payments outlook in Scenario 1 on page 19 of the staff report. This scenario assumes that comprehensive reforms are undertaken by the authorities that would support the diversification and expansion of exports and raise overall efficiency in the economy. I note, however, first of all, that despite all the reforms assumed under this scenario, a continuing rise in the merchandise trade deficit and, to a smaller extent, in the external current account deficit, although the latter probably falls as a percentage of GNP. Furthermore, and largely as a consequence of the above, I note that foreign exchange reserves remain only slightly above the authorities' target of three months' import cover.

A closer inspection of the figures suggests that an explanation for these trends is to be found in two factors: first, export growth is actually projected to slow down after 1991 and it is not clear why this should happen. Staff comment on this point would be welcome. Second, the rates of growth of exports and imports are very close in nominal terms; with unchanged terms of trade, they would be close in real terms as well. I believe a somewhat higher rate of growth of real exports relative to imports, and certainly one that is well in excess of the projected real increase in GNP, would be warranted and would still be in line with the experience of other countries which have adopted strong outward-looking policies.

Finally, I wonder what impact the wide-ranging economic reforms that have been implemented in China during the past twelve years or so has had for the distribution of income. Has, for example, reform been attended by initial income inequalities in recognition of the role individual incentives can and do play in economic development? If so, have these inequalities diminished over time? The background paper on recent economic developments contains some interesting tables on movements in nominal and real wages and income per capita but it is difficult to discern from these data what exactly has happened to income inequalities. Staff comment would be appreciated.

Mr. Al-Jasser made the following statement:

During China's impressive reform effort, the economy overheated, and in 1988 inflation reached 27 percent. In response, the authorities commendably attempted to contain excess demand and to control inflation. Indeed, a tightening of monetary conditions was coupled with an attempt to reduce the fiscal deficit. Unfortunately, the authorities also resorted to administrative actions, including the tightening of price controls, as a further tool to combat inflation.

The Chinese authorities are currently faced with the apparent dilemma of maintaining a tight rein on inflation while simultaneously pursuing their economic reform program. While I agree with them that combating inflation should be awarded high priority, this need not be at the expense of the reform effort. Indeed, as the first staff scenario indicates, it may be possible to intensify the reform program and achieve a reasonable rate of growth without rekindling inflation. Thus, although I can understand the authorities' instinctive attempts to reintroduce direct controls, I would urge them to resist the temptation of embracing the false security of familiar policies. It is imperative for them to persevere with the essential, albeit difficult, economic reform process. Despite the fact that an enhanced use of price controls may provide the appearance of restrained inflation, such controls merely repress nascent inflationary pressures that will inevitably re-erupt. Therefore, it is more appropriate to contain inflation through the sharpening of indirect instruments of macroeconomic controls, such as a tightening of the monetary stance and a reduction of the fiscal deficit. However, the success of such a strategy crucially hinges on the appropriate sequencing of broad-based microeconomic reforms that promote an expansion on the supply side of the economy. This sequence is essential for successful control over inflation.

The staff correctly indicates that an improvement in the fiscal position requires the strengthening of the tax system and a reduction in the subsidies provided to public enterprises. Both of these objectives can be attained through the implementation of additional price and public enterprise reforms. Indeed, fine-tuning of the creative enterprise contract responsibility system, which injected dynamism into the economy, would enhance the buoyancy of the revenue system. The planned revision of the center-province revenue-sharing arrangements is also welcome.

Just as significant is the need to improve the efficiency of public enterprises. This goal can be attained by enhancing enterprises' decision-making authority and by subjecting them to hard budget constraints. The latter would involve the transfer of some costs to consumers, and entail a further elimination of price controls that would assist in reducing domestic demand and allowing for further increases in exports. Over the medium term, the elimination of price controls would enhance domestic production through the provision of appropriate price signals, thereby promoting an efficient allocation of resources. Moreover, the hardening of public enterprise budget constraints entails the elimination of preferential credit for some parastatals. There is also a need to reduce government control over intermediate inputs that obstructs the efficient allocation of resources.

The improvement in the fiscal position, through an increase in tax revenues and a reduction in government subsidies, reduces the pressure for credit expansion and facilitates the role of monetary policy in combating inflation. In this context, I encourage the authorities to conduct their interest rate policy with a view to preventing the recurrence of the speculative inflationary bubble that led to a reallocation of wealth from financial savings into consumer durables. Such a policy should also lead to a more efficient allocation of savings among the various investment opportunities, which, in turn, should improve so as to enhance the efficiency of investment and the supply response of the economy. In addition, I strongly endorse the staff's view that the authorities' tight monetary stance be maintained, and that any reduction in the reserve requirement or any financing by the People's Bank of China of the deficit should be compensated for by a corresponding reduction in overall credit. Moreover, a relaxation of controls on the direction of bank lending is also warranted.

With respect to the external sector, I agree with the Chinese authorities' view, which is not inconsistent with the staff's view, that a rationalization of the exchange system would need to go hand in hand with price reforms. Thus, while I welcome the recent adjustment in the official exchange rate, I hope that it will be fully passed through to domestic prices. Indeed, a flexible exchange rate policy that is channeled through to domestic prices would help curb the demand for imports, thereby reducing the need for administrative controls. More significantly, such a policy would also enhance export growth, thereby reducing the need for import compression and enhancing growth.

In conclusion, a discontinuous approach to policy reform could endanger the gains from the reform process and reduce its credibility. The current standstill in microeconomic reforms and back-tracking in certain areas need to be reversed. Thus, despite the latest experience with high inflation, the authorities would be well advised to strengthen their indirect macro policy tools through the intensification of price and public enterprise reforms rather than through the reintroduction of administrative controls. Although the elimination of price controls may lead to a one-time increase in the price level, it will inevitably help contain the rate of inflation through the impact on aggregate demand and supply. Therefore, the staff's first scenario seems to be attractive. I would appreciate Mr. Dai's and the staff's comments on the difficulties of implementing policies leading to that outcome. I can support the proposed decision.

Mr. Landau made the following statement:

After ten years of successful implementation of economic reforms, China has entered a period of disturbances characterized, on the economic front, by a period of overheating. Inflation rose sharply in 1988, reaching 27 percent by end-year. The stabilization policy put into place seems so far to have been successful. The commitment of the Chinese authorities to strict macroeconomic policies, expressed during the 5th Plenum of the Central Committee, is certainly positive and encouraging.

However, China seems to stand at a crossroad in its history, having to choose between the pursuit of reforms and the return to more centralism and administrative controls. The staff report is very clear on the present dilemma faced by the authorities, and I fully share its view that too heavy a reliance on administrative controls will endanger the long track record of growth experienced by China since 1978.

That being said, I would like to comment on the process of reform, which has been particularly successful in China, before turning to macroeconomic policies and the external sector.

First, I would like to underline the main characteristics of the reform process in China.

One important feature is the success of China's reforms and the good performance achieved during the 1980s. Indeed, during the period 1978-88, real GNP rose by 10 percent a year, investment was buoyant, and external equilibrium was maintained. This outcome can be explained by the fact that China has gone particularly far in the process of decentralization of decision making and the introduction of price liberalization.

First, under the enterprise contract responsibility system, the authorities have granted considerable autonomy to enterprises and provided sufficient profit incentives.

Another important element of the reform process was the introduction of a two-tier price system as well as a dual exchange rate system, providing proper market signals on which to base production decisions at the margin. It is therefore worrisome to read in the staff report that the authorities contemplate the possibility of returning to the previous system of controls. Such a course of action would certainly ruin one major element behind the economic success of the 1980s.

However, China has also faced some difficulties. To a certain extent, China's experience in recent years is not different from that of other centrally planned economies. The focal point of reform is to effect a major realignment of relative prices so as to eliminate distortions. The result is generally a period of high inflation at the precise moment when the efficiency of macroeconomic instruments is not yet secured. In this transition period, neither households nor firms react to macroeconomic and price signals in a stable and predictable way. So the efficiency of indirect instruments to control demand cannot be taken for granted. But I do not think that the reimposition of controls and regulations in the economy is the right answer to that problem. First, it does not suppress the underlying roots of inflation. Second, it creates new price distortions and misallocations of resources which become embedded in the system and will impede future growth and supply response. I believe, on the contrary, that the authorities should deepen the process of liberalization and rely more on indirect instruments of controls.

That is why I agree with the staff that monetary policy has an important role to play in controlling the expansion of demand. Indeed, in the period of overheating, the role of monetary expansion has been obvious. From 1983 to 1988, the rate of money growth reached about 25 percent a year against 15 percent to 18 percent during the preceding years. As far as monetary instruments are concerned, it seems that the People's Bank of China does not lack adequate means of controlling the monetary base. The use of reserve requirements and the control of credit to the specialized banks proved useful last year in curbing inflation. The latest information indicates that the 12-month rate of increase of retail prices continued to decline to 6.4 percent in December. But the authorities also seem to rely on quantitative credit controls in a rather detailed way, a practice that should be limited as much as possible since it very often leads to a misallocation of resources in the economy and to an inadequate orientation of investment. Rather, greater reliance should be placed on a flexible interest rate policy and the maintenance of appropriate positive real rates.

As concerns fiscal policy, I agree with the staff that more should be done to reduce the deficit and the burden placed on monetary policy. Such a course is all the more important since the contribution of fiscal adjustment to the stabilization process has been rather weak, the fiscal deficit declining only from 2.5 percent of GNP in 1988 to 2 percent in 1989. Moreover, it appears that the stabilization process has relied heavily upon the reduction of productive investment rather than on an increase in public savings. Therefore, I believe that no fiscal slippages should occur, especially on the expenditure side, hence the particular importance of limiting subsidies to loss-making companies.

Improving the buoyancy of tax revenues is also of great importance, given the continuing erosion of revenues in relation to GNP from 26.3 percent of GNP in 1985 to about 19 percent in 1989. In this regard, I would like to stress the adverse consequences of price controls on profits and, therefore, on taxes, which provide an additional reason to resume the process of price liberalization.

Turning to the external sector, I would like to comment briefly on the exchange rate policy and on direct foreign investment.

On the first issue, I believe that the unification of the exchange rate should be realized as early as possible in order to avoid the distortions implied by a multiple exchange rate system. The adjustment of the official exchange rate in December was a first step in the right direction. The staff is right to stress that the unification process should be closely linked to price and other domestic reforms and especially that exchange rate charges should be fully passed through to internal prices.

Lastly, foreign investment has played a significant role in China until the events of last June. I also agree that the recent emphasis on administrative controls and the questioning of the future of reforms in China could play a role in deterring foreign investment. This is all the more important since many Eastern European countries have made the clear choice of further transforming their economies and will certainly attract significant amounts of foreign investment. China should avoid returning to a different path of policies which have proved unsuccessful so far.

In conclusion, I believe with the staff that it is of the utmost importance that the present stabilization process be accompanied by a deepening of the reform process. I am confident that if this course is taken, China should resume the high growth and remarkable economic performance it has enjoyed in the last 10 years.

Mr. Enoch made the following statement:

For much of the last decade, China was in the vanguard of the move toward market-oriented reform in centrally planned economies. Indeed, the effects of this reform strategy were perhaps more pronounced and more impressive in China than in any other country over the 10 years to 1988 national income rose by an average of nearly 10 percent per annum, permitting a sharp increase in living standards for China's population. More recently, however, the situation has changed. While other countries, spurred on by increasing dissatisfaction with gradualist solutions, have decided to pursue more rapid and comprehensive programs of reform, in China the process of economic liberalization has apparently slowed.

In some ways, perhaps, this is not surprising. Throughout the last decade, the broad sweep of the Chinese reform program has been punctuated by short periods of consolidation, as the authorities have struggled to maintain control over macroeconomic conditions. Indeed, it was quite clear, at the time of the Board's last discussion on China, that the main economic priority for 1989 would be the need to curb inflation. As Mr. Dai noted on that occasion, nothing would do more damage to the credibility and sustainability of the wider reform program than a failure to get to grips with inflation.

It is clear from the evidence presented in the staff report that the policies implemented by the authorities have largely achieved their intended effect. Indeed, the price level actually fell in the second half of last year. Nevertheless, it is also clear that this reduction in inflation has been won at considerable cost. There has been a dramatic reduction in the rate of growth of output. The update in the supplement to SM/90/2 reports growth of only 3 1/2 percent last year, much less than expected earlier and significantly lower than what was achieved in the years before. Moreover, the slowdown has been considerably more substantial than the year-on-year output figures suggest. Month-by-month data indicate that industrial production was virtually flat in the second half of the year, after the significant rise seen in 1988. In addition, China now faces a mounting unemployment problem, with 4 percent of the urban labor force out of work by the end of last year.

In the discussion of the staff report for the 1988 Article IV consultation, I suggested that the use of direct controls to fight inflation would bring with it a number of significant problems. First, even limited recourse to administrative measures might have serious effects, since direct controls have a tendency to multiply once put in place, with additional controls being required to offset the distortions created by the initial set of policy measures. An overvalued exchange rate, for example, leads to administered import compression in order to safeguard the external position. Second, the introduction of direct controls may tend to weaken the leverage of conventional fiscal and monetary policies at precisely the time when their efficacy is most important. Third, direct controls--particularly price controls--tend to exacerbate bottlenecks and introduce new distortions into the allocation of resources. By preventing price signals from fulfilling their essential allocative function, the authorities may well be vitiating the supply response that could play a key role in reducing excess demand in the economy and restoring noninflationary growth. By attacking the symptom rather than the cause, such controls might therefore serve only to increase the momentum of inflation. And finally, recourse to controls can create uncertainty as to the future direction of policy, jeopardizing the credibility of the reform program itself.

In the event, many of these fears have been proved well founded. The administrative controls have clearly served to reduce supply. At the same time, while the authorities have recognized the need for further strengthening of indirect policy instruments, and have made some welcome although limited progress in this regard, it is clear that both fiscal and monetary policy have remained inadequate in the face of the task to which they have been directed. This, in turn, has implied over the past year a need for a much greater ex ante fiscal and monetary squeeze than might otherwise have been necessary, and one which has impinged particularly on the less protected sectors of the economy.

The situation can be illustrated in a number of ways. For example, while credit conditions generally have been significantly tightened, they have been accompanied by an increase in the State Planning Commission's control over the allocation of credit, with priority being given to--less efficient--medium and large-scale state enterprises. In similar vein, while the authorities have been prepared to raise the cost of borrowing, an implicit subsidy has been maintained--and in some sectors enhanced--reflecting the authorities' reluctance to push inefficient enterprises to the point of bankruptcy. This, in turn, has weakened financial discipline in the enterprise sector, reduced bank profitability, and given added impetus to financial disintermediation. It has also seriously complicated the fight against inflation, by--perversely--giving the enterprise sector a strong incentive to accumulate inventories and increase investment.

Similar problems have arisen on the fiscal side. In 1989, government revenue continued to fall in proportion to GNP, as taxable profits in the enterprise sector were held down by continuing price controls. At the same time, the negotiability of the tax system gave the authorities ample scope to mitigate the impact of the credit squeeze on the financial position of favored enterprises. In addition, expenditure on subsidies rose by over one third to more than 5 1/2 percent of GNP--a direct measure of the cost of maintaining prices below market-clearing levels.

Overall, it seems reasonable to conclude that the necessary reduction in inflation could have been achieved at lower cost if the authorities had laid less emphasis on the reapplication of controls, and more on the strengthening of indirect policy instruments. Indeed, this argument is further strengthened if account is also taken of the indirect costs of a control-based strategy which arise through the impact on confidence in the authorities' longer-term commitment to reform. Even fairly brief retreats from progress in reform may have long-lasting effects on confidence.

Against this difficult background, the question that arises is how to take China's reform program forward. The authorities themselves appear to be extremely reluctant to resume the process of liberalization until aggregate demand is brought firmly under control. In response, I would offer two brief remarks.

First, although inflation itself clearly can threaten the entire reform process, and while there is clearly no room for complacency regarding the curbing of inflation, the available evidence, as I have already noted, suggests that domestic demand pressures have already abated. Second, and more fundamentally, it is by no means clear that direct controls are essential, or even helpful, in the fight against inflation. In some respects, the maintenance of direct controls has served only to complicate the authorities' task in reducing demand pressures, by weakening the leverage and effectiveness of conventional policy instruments. At the same time, the price of further delay in resuming the reform process could be enormous. This would not only perpetuate the existing misallocation of resources, it could also seriously undermine the credibility of the entire reform plan, with adverse implications for China's long-term economic prospects.

I would therefore urge the authorities to maintain the drive against inflation through monetary policy, by raising interest rates and maintaining tight credit conditions, while resuming the process of liberalization. More specifically, over the coming year they should focus their attention on four particular areas for liberalization. First and foremost, the system of price controls should be dismantled as soon as possible; this would greatly strengthen the budget, and it would also be the most effective and practical way of ensuring that China's scarce resources are allocated efficiently. Despite the authorities' pessimism, the evidence suggests that price liberalization in China might elicit a fairly vigorous supply response; this would certainly appear to be the case in the agricultural sector, if previous experience is any guide to the future.

Nevertheless, full price liberalization would need to be matched by a further strengthening of indirect policy instruments. Some progress has been made in this area over recent years, particularly with the increased authority of the People's Bank of China. However, macroeconomic policy remains much too discretionary. As a minimum, the authorities should move quickly to eliminate sectoral credit allocations and preferential interest rates. In addition, lending rates need to be freed and applied consistently across the productive sector. In similar vein, the authorities should build on the more successful elements of the enterprise contract responsibility system. The new contracts already in place in a number of cities should be extended nationwide, enhancing the uniformity of the tax system and eliminating the scope for protracted bargaining over tax liabilities.

Reforms of this kind should strengthen financial discipline in the enterprise sector. However, to create the appropriate incentive structure within the economy, the authorities will need to go further and address the issue of property rights.

Finally, to buttress a reform program of this scope, and to enhance factor mobility, the authorities should consider the establishment of a social insurance system. Financial discipline, privatization, and social safety nets need to be taken forward together if China's inefficient and overmanned state enterprise sector is to be transformed into a wealth-creating, internationally competitive, engine of growth.

This reform agenda is a formidable one. But the authorities start with two major advantages--they start from a position of macroeconomic stability which--as Mr. Finaish has remarked--is an essential prerequisite, and with a history of successful reform behind them. I am much heartened by the authorities' assurances that the process of reform is irreversible. I trust that they will therefore soon move forward, and re-establish the momentum of reform, so that the economic achievements of the 1990s will be commensurate with those of the decade past.

Mr. Kafka remarked that economic growth in China had been impressive but perhaps too fast in relation to savings. Thus, imbalances and distortions had emerged, but it must be recognized that certain anti-inflationary measures had been rapidly deployed. For that the authorities deserved to be commended, even though a more market-conforming approach might have been preferable.

The macroeconomic problems in a stage of transition should not be underestimated, Mr. Kafka said. Public enterprises had greater freedom to save, as the ratio of fiscal revenue to GDP fell. As control over interest policies declined, the need for indirect market instruments became more urgent than ever. He agreed with the staff that stabilization policies and economic reforms should be mutually reinforcing; indeed, when inflation was declining seemed to be the right time to liberalize prices and the economy. That point could not be too strongly stressed. The question on the liquidity overlap posed by Mr. Finaish was relevant in that respect.

The budgetary gap had declined, but had not disappeared, Mr. Kafka noted. A worrisome development was the resurgence of subsidies. The continuation of public enterprise reform appeared urgent. On the other hand, perhaps too much emphasis had been put on direct credit controls to promote a deceleration in inflation. Inter alia, rising interest rates tended to increase public expenditure to a level that inhibited further flexibility in fiscal policies. He was not sure that the introduction of indexation on long-term savings was a good way to increase private savings; when nominal interest rates were kept positive in real terms, the spread of indexation seemed to weaken inflation control efforts, and at a high price, as experience showed.

The two illustrative scenarios prepared by the staff based on clearly differentiated assumptions were very helpful, Mr. Kafka considered. It was worth noting that even in the worst scenario, debt service would still be at a very modest level of 15 percent of exports in 1995.

The recent depreciation of the exchange rate had shown--as emerged also from Mr. Dai's statement--that the authorities were very sensitive to a weakening in export growth, Mr. Kafka observed. Like Mr. Al-Jasser, he wondered how fast depreciation was going to be fully passed on to the domestic economy. Many restrictions on the use of foreign exchange persisted.

Finally, Mr. Kafka said that he agreed with the staff appraisal, in particular with its recommendations regarding the urgent need to review the revenue-sharing arrangements between local and central government. He supported the proposed decision and wished the authorities success in their economic policies.

Mr. Dawson made the following statement:

> The staff papers present a mixed picture of China's economic policies and prospects. On the one hand, China's policies have been successful in some respects: for the decade to 1988, economic growth was impressive, averaging almost 10 percent a

year; meanwhile, market forces were allowed to play an increasing role in the economy. More recently, when the economy showed signs of overheating, the authorities prudently adopted more constrained policies which have succeeded in moderating domestic demand and sharply reducing the rate of inflation.

The economic liberalization which has occurred since 1978 has produced a burst of economic growth, but because liberalization has been incomplete, the supply response has been inadequate, and the system has encountered bottlenecks, shortages, and inflation. At the same time, with incomplete reform, the authorities have lacked sufficiently refined policy tools to temper the pace of economic activity. When domestic demand spins out of control, attention focuses on the need for stringent stabilization policies and the policy reform process is allowed to slow. Meanwhile, the appearance of "stop-go" economic management is likely to discourage savers and investors from making longer-term decisions, and the image of an "on-again-off-again" commitment to economic liberalization is likely to thwart the government's objectives of attracting foreign investment and expanding foreign trade.

We commend the authorities efforts, beginning in the third quarter of 1988, to contain domestic demand and reduce inflation. Clearly, this was necessary. We also recognize that some steps have been taken to develop indirect levers for macroeconomic control. In our view, however, more attention needs to be given to developing indirect macromanagement tools and improving price signals.

In the monetary area, the authorities have rightly concentrated on limiting credit growth in the fight against inflation. We welcome the use of increased reserve requirements and the strengthening of the Bank of China's head office control over branch lending. However, we are concerned about the greater reliance on administrative credit allocations and preferential interest rates for key enterprises. In our view, the singling out of certain enterprises for preferential treatment is likely to result in a misallocation of resources, hampering the growth of the most dynamic sectors of the economy and giving rise to new bottlenecks elsewhere. Uniform access to credit across enterprises and sectors would tend to ensure that the limited amount of credit is used as efficiently as possible.

The policy on interest rate levels also bears some re-examination. We agree with the staff that interest rates need to be managed flexibly, so as to provide sufficient returns in real terms to savers to ensure the stability of deposits and sufficient margins to banks to ensure their financial viability. We understand the authorities' concern about the adverse impact of higher lending rates on the financial position of state enterprises. However, this problem points to, among other things, the need for greater price liberalization so that enterprises can pass on costs to customers, not artificially low interest rates.

With regard to fiscal policy, there has been some progress in reducing the budget deficit in terms of GDP, but structural shortcomings in the fiscal system have hampered the authorities' efforts. The problem appears to be one of incomplete liberalization: the incentives provided through the enterprise contract responsibility system have made for a more dynamic economy, but the way in which taxes are negotiated has reduced the buoyancy of tax revenues and introduced a high degree of discretion in the tax structure. Similar problems exist with the revenue sharing arrangements between the central and local governments. At the same time, price controls have eroded the profitability of enterprises and, along with it, government revenues. The proposed reforms of the enterprise contract system and the revenue sharing system would help increase the buoyancy of revenues and the usefulness of fiscal policy for macroeconomic control. However, we share the staff's view that a more satisfactory long-term solution for ensuring that enterprises operate profitably and generate appropriate levels of tax revenue should include a clearer separation between management and ownership and a stronger role for market-determined prices.

In the external sector, an overvalued official exchange rate weakens China's export potential and requires heavier emphasis on import compression for balance of payments adjustment. We welcome the recent depreciation of the official rate, and hope that the exchange rate change will be reflected in domestic prices so that the adjustment will have the desired effect on imports and exports. However, this adjustment only partially offsets the real exchange rate appreciation which has occurred since late 1987. While it is true that the gap between the official and the swap center rates has narrowed, this seems to be partially due to the imposition of new restrictions in the swap centers which have contributed to an appreciation of the swap center rate.

We support the staff's recommendation for a substantial depreciation of the renminbi and pursuit of a flexible exchange rate policy thereafter, with a view to unifying the two rates. The staff's suggestion that this be accomplished through a combination of further adjustments in the official rate and the transfer of additional transactions to the swap centers would seem to offer a pragmatic approach. In any event, we hope that the authorities will not postpone a rationalization of the exchange system indefinitely out of concern about the impact on inflation and the budget. Rather, exchange rate action should be accompanied by price and other domestic reforms; such reforms would help to mitigate the adverse effects of exchange rate adjustment and help to bring about the longer-term benefits of stronger trade performance and fuller integration of China into the world economy.

Looking to the future, the two medium-term scenarios outlined in the staff paper provide interesting insight into the policy alternatives facing China. One choice would be for China to combine its cautious monetary and fiscal policy with a bolder program of wide-ranging price and other reforms, and thereby reap significantly stronger growth, moderate inflation, higher export growth and stronger foreign investment. A second alternative would be for China to continue on its present course of strong monetary and fiscal policies, but make little headway on economic reform; this would yield lower growth, slightly higher inflation, lower export growth and lower foreign investment. Clearly, there is a need for strong macropolicies to keep domestic demand under firm control. However, with a bolder approach to economic liberalization, there appears to be considerable opportunity for still better economic performance. We hope that the Chinese authorities will recognize and seize this opportunity.

We support the proposed decision.

Mr. Grosche said that he broadly shared the staff's analysis on economic developments in China and supported its policy recommendations. He could, therefore, limit himself to a few remarks.

China appeared to be one example from which potentially helpful lessons could be drawn for the bold reform attempts that were now being undertaken in Central and Eastern Europe, Mr. Grosche went on. The most impressive results that China had achieved during the first years of reform could have conveyed the impression that the transition to a system of indirect controls actually was fairly easy. But China's experience was demonstrating that that was not the case and that reform efforts could be stalled if not undertaken comprehensively and with a lot of determination. China's serious economic difficulties most likely had to do with the fact that the transition to indirect controls had been pursued only halfheartedly. As a result, structural and institutional deficiencies persisted and were creating serious bottlenecks that impeded growth and fostered inflation.

The authorities' reaction to those challenges was rather disappointing, Mr. Grosche remarked. They had slowed down the reform process significantly, and he shared the staff's view that there was even a substantial risk of reversal. Although the inflation rate had been reduced considerably, the growing reliance on administrative controls was worrisome, particularly when seen against the background of the most recent economic data.

Those data pointed to the danger of a severe recession, the more so as private initiative was being hampered by heavy administrative interference.

The staff had made it very clear in the medium-term scenario that China's economic prospects depended critically on a stepping-up of economic reforms, Mr. Grosche remarked. He had, therefore, doubts about the policy priorities of the authorities. They should bear in mind first that a firm stance of fiscal and monetary policy, as necessary as it was, could be brought about more efficiently through indirect means, as Mr. Enoch had explained so clearly. The second point to bear in mind was that firm macroeconomic conditions would help to better allocate the scarce resources so necessary for higher and stable growth only if the proper institutional framework for a functioning market economy was in place. The efficiency of resource allocation depended on free markets and a proper balance between individual freedom--including property rights--and individual obligations within a proper institutional and regulatory framework. For that purpose, what was needed was a state which set clear and uniform rules for market participants but stayed away from market interference. In that regard, he fully agreed with the staff that the so-called contracting system could be only an imperfect substitute for a strict separation of ownership and control, and, he added, for putting control and accountability into the hands of private individuals.

Most important, the institutional framework for a market-oriented monetary policy had to be further developed, Mr. Grosche considered. That meant, in his mind, first of all, a fully independent central bank that had firm control over monetary policy down the line of command to the regional level. In addition, financial markets had to be extended, which would also permit interest rate policy to control money creation more effectively.

A policy of liberalization was also of key importance in fostering export growth, Mr. Grosche noted. The recent partial correction of the exchange rate, therefore, must be embedded in price reforms, allowing the exchange rate changes to be passed through fully to domestic prices. He supported the proposed decision.

Mr. Santos made the following statement:

The major challenge facing the Chinese authorities in 1989 was the surge in inflation that started in 1988 and threatened to undermine the important economic gains that had been achieved. From Mr. Dai's informative statement and the staff report, we note that the authorities took decisive actions to address the problem. We commend them for implementing appropriate fiscal and monetary measures that have helped to reduce aggregate demand, and for taking steps to redirect scarce resources to key sectors where bottlenecks and shortages had emerged. Nevertheless, as noted by the staff, these measures were supplemented by direct administrative controls that can lead to market distortions, and we would therefore encourage the authorities to rely more on market-determined prices for the allocation of resources. The expected slowing down of inflation this year should give the authorities some leeway to continue with price reform. In this context, we are encouraged to note that the authorities remain committed to the longer-term objective of economic reform and that they had ruled out a return to a rigid central planning system.

In the area of government finances, we note that the authorities have been able to contain the deficit at about 2 percent of GDP, despite the fall in the ratio of revenue to GDP. This declining trend is a major source of concern, especially as the economy has made impressive gains in real output over the past few years. We concur with the authorities that this trend is an indication of structural deficiencies in the fiscal system that must be addressed to enable fiscal policy to play an effective role in the stabilization as well as in the process of reforming the Chinese economy. The staff has identified the major causes of the weaknesses in the tax system and has made some useful recommendations toward finding a solution to the problem. We are pleased to note that the authorities plan to review the present system with a view to introducing the necessary reforms.

On the financial side, we welcome the increasing use of indirect monetary instruments in the conduct of monetary policy as well as the improvement in the structure of bank lending. However, the introduction of the system of preferential lending rates could promote inefficient investment and we would encourage their elimination. As regards monetary policy for 1990, the decision of the authorities to maintain a tight monetary policy is appropriate, and we would also urge them to speed up the reform in the banking sector.

In the external sector, while we regret the recent tightening of import controls and the continued reliance on a system of dual exchange rates for external transactions, we welcome the views expressed by the authorities that the present dual rate system is only transitional and that they intend to limit the spread between the two exchange rates and move eventually to a unified system. We also share the views of the authorities on the implications for the domestic price level and agree that the rationalization of the exchange system would need to go together with price reform.

Regarding external debt, we note that despite its increase in absolute terms, the servicing of the debt has remained manageable, with growth in export receipts keeping pace with debtservice payments. The recent regulations on foreign borrowing should also help to keep external debt under control, and we commend the should also help to keep external debt under control, and we commend the Chinese authorities for their cautious approach to debt management.

Finally, we note, like other speakers, that the far-reaching economic and financial reforms implemented by the authorities over the past decade have been very beneficial to the Chinese economy, which was able to register an exceptional rate of growth. With the problem of inflation now under control, we would encourage the authorities to resume their efforts aimed at economic reforms. We would also like to express our appreciation to the Chinese authorities for their financial and technical assistance program which is benefiting many of the countries in my constituency. We support the proposed decision.

Mr. Lombardo made the following statement:

Despite the success in bringing inflation under control, the loss of momentum in the Chinese process of reform is a cause for concern. The authorities seem to understand that there is a conflict between price liberalization and the efforts to curb inflation. They think that the process of reform cannot be resumed until aggregate demand has been brought under firmer control. A key reason for this way of thinking is that they believe that the rapid monetary expansion of previous years has created a liquidity overhang that would take some time to be absorbed. The result is the continuation of a kind of dual economy, with administered sectors and a limited openness to the functioning of markets.

Nevertheless, the staff says that preliminary work has not shown evidence of a substantial liquidity overhang in the economy, and that control over inflation has been consolidated. Therefore, there is room for another interpretation if the authorities' key assumption is not valid. This other interpretation is that additional progress in increasing the role of the market prices is necessary for the further development of indirect instruments of monetary, fiscal, and exchange rate policy. Furthermore, the staff thinks that the weakening of demand and the decline in the rate of inflation has provided a good opportunity for the authorities to move boldly with price reforms.

It seems clear that in the case of market-oriented reform for centrally planned economies, there is also a choice between the shock treatment approach or the gradual approach. The Chinese option is providing us with almost a textbook case of the gradual approach; and, therefore, one has to avoid the temptation of comparing this process with that taking place in other countries. Nevertheless, there is the risk of the whole process being stuck in midstream, with the reform incomplete, and without the benefits of the changes being realized.

Both the medium-term scenarios prepared by the staff clearly show the benefits of accelerating the pace of reforms, and the problems emerging from the kind of stalemate that this dual economy implies. However, more specifically, there are monetary, fiscal, and exchange rate problems emerging from this dual approach.

Regarding monetary policy, one of the difficulties is, as the staff has noted, the increase in the extent to which bank lending was directed to particular uses or enterprises, which is likely to stifle the development of the most dynamic sectors of the economy. In addition, while the recent adjustment to interest rates in order to halt panic buying and encourage a recovery in financial savings is understandable, the fact that deposit rates have risen more than lending rates is highly distortionary, and has adverse implications for bank profitability and also indirectly for the budget.

Regarding fiscal policy, most of the weaknesses of the tax system are related to the way in which the Government has promoted the decentralization of decision making to enterprises and local authorities, as well as to the incompleteness of reforms, particularly price reform.

The exchange rate system is dual by definition, and we welcome the authorities' opinion that the existing dual rate system is only a transitory one and that the intention is to limit the spread between the two exchange rates and eventually move toward a unified system. However, despite our understanding of the cautious approach shown by the authorities regarding the implication of that unification for the domestic price level, we agree with the staff that unification could be pursued through a combination of further adjustments to the administered rate and the shifting of additional transactions to the swap centers.

Consequently, there is a common factor in the lack of effectiveness of all macroeconomic policies: the necessity of a more comprehensive price reform.

While China's is a textbook case of reform from a centrally planned economy to a market-oriented one, many developing countries have already experienced the process of moving from state-administered prices to liberalized markets. This process showed, in most cases, that if only a few prices or a few sectors were liberalized, the benefits of the changes would not be apparent or would be very limited, because the less efficient administered sector would have to catch up with the imminent efficiency of the "liberalized" sector. Therefore, the general efficiency of the economy would not reflect the better resource allocation and the lower cost.

China obviously is not a standard case, nor an easy one. I perceive as a sign of Chinese wisdom, Mr. Dai's statement that any overly ambitious pace, both in economic growth or in the economic reform should be avoided. On the other hand, we remain concerned because it seems clear that within the authorities' chosen option, there could be a dangerous stage if the benefits of the reform were not apparent and the process were to be stopped, so that the whole transformation was stuck in midstream. We hope that this will not be the case.

Mr. Thorláksson made the following statement:

Over the last decade, economic development in China has been noteworthy, not only because of the results but also because of the theoretical concept underlying the goals of the economic reform program, namely, the development of a planned commodity economy incorporating a macroeconomic control system and market mechanisms within the framework of predominantly state-owned enterprises and administered set targets.

In a sense, China has been at a crossroad for the last two years. In 1988, after maintaining a relatively stable economy, high rate of growth, tolerable rate of inflation and passable balance of payments for many years, China faced an overheated economy with rapidly rising inflation and a deteriorating balance of payments, caused mostly by an expansionary fiscal policy and lax monetary management. This development and serious structural rigidities and inefficiencies in the economy necessitated the implementation of adjustment measures.

The authorities' choice of economic policy instruments was in itself consistent with the underlying principles of the economic program. The restrictive monetary measures, combined with administrative control of prices, wages, imports, and investments, were clearly successful in bringing down the inflation rate and stabilizing the external position. This approach disclosed, nevertheless, the underlying weaknesses in the economy, inter alia, the ineffective allocation of resources and low productivity. Consequently, the consistency of the reform program itself, as well as the choice of future policy action, were called into question.

The most fundamental question that arises from all these developments is how to make the market function within the context of administratively set production targets and lack of autonomy of enterprises. As the targets, and hence economic performance of enterprises, will probably not reflect the most profitable use of available raw material and labor, or the true picture of conditions and prices in the market, investment decisions will be unlikely to lead to an allocation of resources that can secure and sustain future growth. Even taking into consideration the substantial growth of GNP, the high investment rate of between 35 and 40 percent in China in past years is probably a sign of insufficient overall productivity. In this context, I also call attention to the medium-term scenarios where the investment rate is projected to remain at a very high level with the growth rate forecast to be substantially lower than in previous years. I would appreciate comment from the staff on this point.

A second and related question is how to conduct fiscal and monetary policy in the absence of the appropriate institutions and instruments necessary for the attainment of the economic policy objectives. Can monetary and fiscal policy effectively balance aggregate supply and demand if the price system does not work properly, and if enterprises are unable or are not required to react to changes in operating conditions? I believe that in this kind of situation macroeconomic policies can be seen largely as an administrative measure placing a band-aid on the wound but leaving the inherent causes unaddressed. As noted by Mr. Dai in his statement, there has been no fundamental improvement in the overall imbalance between aggregate supply and demand, despite the cooling down of the overheated economy, increased control of the inflation rate, and the restoration of the external balance.

With these general observations, and as I agree largely with the staff's appraisal, allow me to put forward only two concluding remarks.

The current account balance has been restored mainly by cutting imports and curtailing real investment. Thus, the improvement has been based almost completely on administrative measures. There remains a pent-up demand for imports, and, in light of recent inflationary developments, the competitiveness of exports has deteriorated considerably. It would seem that the adjustment of the administered exchange rate last December has not been sufficient to enable a correction of the underlying imbalances. It is clear that the external balance can only be fundamentally corrected if export industries are competitive and the effects of the adjusted exchange rate are allowed to be carried through to domestic prices. These conditions do not appear to have been met yet.

Finally, even though economic growth in China has been high for a number of years, it would seem that the still very low income levels of the population call for keeping high growth as the main economic objective over the next few years. Such a goal would also appear attainable in light of the relatively satisfactory external situation, and the high rate of investment and savings. However, positive economic developments are clearly contingent upon an enforced reform process that should include, inter alia, price reforms and fundamental changes in the management of the state-owned enterprises. I can support the proposed decision.

Mr. Noonan made the following statement:

The responsiveness of the Chinese economy to reform measures was well illustrated by the improved economic performance which followed the modifications to the then prevailing centrally planned economy, which were initiated in 1978, and, in particular, by a substantial increase in the rate of output growth and by improvements in living standards.

Having regard to China's relatively low average per capita income, relatively high growth rates are required in order to narrow the gap between living standards in China and those in more developed economies. Because the gap is a large one, China needs high rates of growth for the foreseeable future. The trouble in the past has been that the drive for high growth has not always been tempered by considerations of sustainability, particularly the sustainability of growth over the longer term. The final paragraph in Mr. Dai's statement, drawing on this experience, emphasizes "the conclusion that it is of the utmost importance always to persist with the long-term policy of a sustained, stable, and harmonious economic development and resolutely guard against one-sided emphasis on too rapid development. Any overly ambitious pace, either of economic growth or of economic reform, should be avoided." This chair must concur with that conclusion. However, given the high rates of growth that China needs, we believe that that conclusion needs to be balanced by a second, namely, that an inadequate pace of development should equally be avoided. That seems to be the thrust of the staff report, which also seeks to identify the steps open to the authorities to avoid underperformance by the Chinese economy.

Before commenting on those steps, I would like to refer briefly to some concern I have that the necessary preconditions of strengthened monetary and fiscal policies have been fully met. One example of unsustainability from the recent past has been the financing of the public sector deficit. In the late 1980s, the

People's Bank of China was called upon to finance ever-increasing deficits. The inevitable result was a major contribution to general price inflation. In this context, Mr. Dai's statement that his authorities will strive to make the Bank of China a strong central bank is welcome. At the same time, however, I note that official monetary policy excludes credit to the Government from the official credit plan. Neither does it apparently provide for the contingency of an increased government credit requirement. Consequently, if future fiscal deficits were to exceed budget, I am not clear whether, and if so, to what extent, the People's Bank of China might be better able than in the past to resist financing those deficits, if again pressed to do so. I would have reservations that the measures outlined in the staff report to strengthen the Bank would suffice. I would suggest that it is measures to define clearly the role of the Bank and to strengthen its independence in the discharge of that role that are required.

Insofar as inflationary pressures in the past have been driven, at least in part, by the fiscal deficit, the authorities are now seeking to strengthen the public revenues, which have fallen as a share of GDP. As explained in the staff report, this could prove quite difficult to achieve. Possibly equally important to containing a potential fiscal deficit is the need to strengthen expenditure control, which could supplement or support the effect on fiscal deficits arising from the strengthening of the revenue measures. One effective way to do this would be to keep down the level of subsidies, particularly through a rationalization of those state enterprises which at present constitute a drain on the public coffers.

Unless monetary and fiscal policy are capable of providing a balanced and consistent framework within which sustainable growth can take place, then excess demand and inflation could quickly return with a devolution of discretionary authority from the center to local and enterprise level. The importance of strengthening the instruments of monetary and fiscal policy is apparently widely recognized and therefore the concerns I have voiced may be unduly pessimistic. I hope so. At the present stage, there is also a broad consensus about the priority to be given to the control of inflation.

Insofar as a difference arises between the staff and the Chinese authorities, it is on the extent to which the various instruments that might be used should be used. Mr. Dai's view that where the market mechanism is underdeveloped, as in China, direct administrative measures can be required to supplement and support indirect macroeconomic instruments that may seem to have merit on first sight. On the other hand, when regard is had to experience with the responsiveness of the Chinese economy to reform measures, I am persuaded of the validity of the view that, given an appropriate strengthening of monetary and fiscal policy, a higher level of sustained and stable economic performance would be feasible if there were a greater emphasis on reform measures and less reliance on direct controls. Indeed, direct controls can, and apparently do, lock into the system the continued production of surplus output, requiring bank credit and/or government subsidies to finance it, while, at the same time, limiting the competitive production of goods in demand. By contrast, greater flexibility in the operation of the economy, within an appropriate monetary and fiscal framework, could be strongly supportive of the authorities' aim of removing bottlenecks and reducing inflationary tendencies.

In supporting the proposed decision, I wish the authorities well in their efforts to improve the sustainable performance of the Chinese economy and thereby raise living standards.

Mr. Filosa made the following statement:

Since the late 1970s, China has undertaken a wide program of economic reforms aimed at transforming the economy from a centrally planned economy into a market economy. While the economic authorities have been successful in creating the basis for economic agents to be more responsive to market signals, they have not yet completely put in place the system of indirect macroeconomic control as the central planning apparatus was being dismantled. Consequently, although the impact of these reforms on the economic performance has been remarkably positive, as is shown by the growth of real GNP by almost 10 percent a year during the period 1978-88, excess demand pressures have often emerged, leading to periods of rising inflation and growing external deficits.

In order to restore macroeconomic stability, the economic authorities have often resorted to traditional administrative controls over prices, investment, and imports, simultaneously slowing or stopping the process of economic reform. Indeed, the recent intensification of administrative controls in China, together with the announcement that reforms will be carried out on only a limited scale, is likely to have a negative effect on the credibility of the reform process, even if in the meantime, administrative controls might have helped the authorities to regain control over inflation and the growth of aggregate demand.

In Mr. Dai's useful statement, he stated that the longer-term objectives for reform have not been changed. While I welcome this intention, I would like to stress that it is of the utmost importance to strengthen the indirect instruments of macroeconomic management in order to better control possible future phenomena of excess demand and inflation without the aid of direct controls.

In the present economic system, economic agents have more financial instruments at their disposal and more discretion in decision making than previously. In such a setting, monetary policy should now play an essential role in ensuring price stability and maintaining a sustainable external balance. Such a role, however, has not been satisfactorily fulfilled, as the sharp acceleration of inflation over the past few years suggests. Moreover, this role should be played through the use of indirect monetary instruments. At present, monetary policy is formulated within the framework of the credit plan. The central bank implements its policy with regard both to quantities and interest rates, based principally on direct controls. In fact, the People's Bank of China sets ceilings on credit, controls the provision of credit to banks, sets basic interest rates on deposits and loans and also the redeposit requirements. In practice, the effectiveness of these instruments in conducting monetary policy has been rather limited for several reasons, among them, for example, the fact that adjustments of redeposit requirements and interest rates are only proposed by the central bank and require approval by the State Council.

I agree with the staff that the recent increase in the extent of control over the direction of bank lending should be reversed and that the recently introduced system of preferential lending rates for basic industries should be abandoned. In fact, these measures have no place in the role of a central bank.

Fiscal policy during 1989 has been more expansionary than desired, expenditure being a source of concern, particularly subsidies. In this respect, I appreciate the intention of the authorities to reduce the present burden of subsidies on the budget through selective price adjustments and efforts to raise the efficiency of loss-making enterprises. The tax system is still characterized by major weaknesses that result in a continued fall of revenues in relation to GNP and in a high degree of discretion in the tax structure. In particular, the contract responsibility system introduced in 1985 requires modifications. Moreover, it is essential to achieve a greater uniformity of tax and subsidy rates, avoiding discretionary modifications in response to enterprise pressures. This means that inefficient firms should not be given the chance to negotiate ad hoc subsidies and tax reliefs, while profitable firms should not be taxed at discriminatory rates, thereby reducing incentives for efficiency, innovation, and the development of markets. Moreover, consumer subsidies to offset the impact of price adjustments have also been a substantial burden on the budget and should be made uniform or eliminated. On the whole, fiscal policy should be used as an effective instrument of macroeconomic stabilization.

Turning to exchange rate policy, China has a dual exchange rate system with an official administered exchange rate and a floating exchange rate determined in foreign exchange adjustment centers. Since the authorities affirm that the existing dual rate system is only transitional and that they want to move eventually to a unified system, I believe that this could be the right moment for unification. In fact, the spread between the two exchange rates has narrowed substantially and inflation seems to be more under control. The greater access to the foreign exchange adjustment centers provided to domestic enterprises has served, in fact, partly to mitigate the effects of a deterioration in the competitiveness of China's exporters stemming from the pickup of inflation.

Clearly the policy changes I have indicated so far are going to be successful in developing a system of indirect controls only if adequate steps are taken with regard to price reform. It is therefore desirable that the authorities take advantage of the slowdown in economic growth and inflation to remove the distortions and irrationalities that still characterize the price system. In fact, in view of the rise in inflation during 1987-88, there has been some retrenchment in the area of price reform, as the authorities have focused on bringing inflation under control.

In conclusion, sustained excess demand fueled by an expansionary monetary and fiscal policy has resulted in an escalation of inflation, negative real interest rates, and current account imbalances. The stabilization program implemented by the authorities has so far been successful, although I share the staff's concern about its heavy reliance on administrative controls and the limited progress with reforms envisaged under the program. Indeed, I tried to emphasize in my comments the importance of continuing the reform process, not only to strengthen the efficacy of the reforms, but also to eliminate some inconsistencies in the system. A fully independent central bank needs to be established. Monetary policy needs to have a more coherent framework, as it cannot rely simultaneously on setting quantities and interest rates. Reliance on direct controls should be phased out. The fiscal system is in need of pervasive reform, both on the revenue and on the expenditure side, and not only because the budget is placing an undue burden on monetary policy, but mainly to make use of fiscal policy as an instrument of macroeconomic stabilization instead of primarily as an instrument for the allocation of resources. Finally, it is necessary to increase the flexibility of the price system. The persistence of price controls would inevitably undermine the possibility of achieving efficient resource allocation.

I can support the proposed decision.

Mr. Hammoudi made the following statement:

The comprehensive economic reforms that China had implemented for a decade have had a tremendous impact on the performance of the whole country's economy. In addition, the decentralization policy has granted local governments and public enterprises autonomy in decision making. All this has produced rapid growth and better living conditions. Nevertheless, an overheating economy which fueled inflationary pressures and led to bottlenecks in key sectors has forced the authorities to react promptly. To this end, they have adopted tight administrative controls to monitor more closely credit policy and prices. In the short run, these instruments seem to be working successfully since inflation has been reduced substantially, as reported in Mr. Dai's informative statement. While we sympathize with the authorities' efforts to fight inflation, we share the staff's concerns about the efficiency of the instruments adopted in the long run.

In this context, we are pleased to note from Mr. Dai's statement and the staff report that the authorities have stated that the reforms are irreversible and will be pursued. Since we are in broad agreement with the thrust of the staff report, our comments will cover only a few areas.

In our view, given the success of the stabilization program, the authorities should definitely consider promoting macroeconomic instruments to bring the economy back on track. Indeed, to halt the weakening of industrial production, reinforce the distribution sector, and foster the agricultural sector, it would be advisable to initiate appropriate pricing, interest, and exchange rate policies instead of continuing to rely heavily on administrative controls. In addition, we believe that adequate fiscal and monetary policies are necessary at this stage to reduce the inflation rate and raise savings. Needless to say, renouncing the stop-go policy in carrying out the reform would be best for the efficient functioning of the Chinese economy, even if we understand the authorities' position choice of policies for the time being, given the complexity of the economic and financial situation. In this context, we cannot ignore what has been done in the past decade and the achievements reached by China, which merits praise for what has been accomplished.

For the future, we have to say that the most important challenge remains for the authorities to bring inflation and domestic demand under firm control. In this regard, we are pleased with the measures planned--as explained in Mr. Dai's statement--in order to contain the fiscal deficit and to tighten credit policy. In our view, further reforms are needed in the tax field so as to rationalize the system and increase revenues. Appropriate expenditure measures should be introduced with the objective of first rendering the public enterprises less dependent on subsidies, then more autonomous financially and accountable for their management. This would certainly increase the efficiency in the functioning of the economy, as stated by Mr. Dai. Furthermore, in the credit area, it is of the utmost importance to introduce measures allowing banks to lend money on a commercial basis in order to encourage the most productive public enterprises and the most profitable sectors of the economy.

In this context, the banking system needs to be improved to foster sound development of the economy. Therefore, it is advisable to strengthen the central bank's monetary and supervisory functions. Interest rates should be set in real terms so as to initiate better resource allocation and to attract savings. Positive real interest rates on deposits would be also an efficient means of absorbing excess liquidity and reducing inflationary pressures.

We have noted from the staff report that the external sector has not improved as expected, due certainly to measures taken under the stabilization program. Indeed, the results show that the current account position weakened somewhat, the export performance has been stable, and reserves remain steady. Thus, improvement of the situation requires further modifications of the exchange and trade system. In this respect, the authorities are to be commended for the measures already taken, which are in the right direction, in particular with the depreciation of the currency. However, in our view the authorities' objective should be the unification of the exchange rates, to give an encouraging signal to exporters and foreign investors. The authorities are to be commended for their prudent external debt management policy.

In conclusion, it is heartening to note the authorities' intention to pursue the reforms. We believe that resuming the implementation of comprehensive reforms could trigger the sustainable economic growth so necessary for China. In this respect, while we support the authorities' efforts to reform the economy, we share the staff's view that macroeconomic instruments would be more efficient than administrative controls in order to achieve the authorities' objective, namely, to put the economy definitely back on track. In the long run, China would draw benefits from adopting such instruments, which could help the economy to adjust automatically to possible shocks. We can support the proposed decision.

Mr. El Kogali said that there was no question that China's economy had benefited from the sustained implementation of reform measures over the past several years. Output had expanded significantly, and the standard of living had improved. The Chinese experience was a case of growth with development, a statement that was not as trite as it might seem, because there was a body of literature in development economics that attempted to show that high rates of economic growth were not necessarily accompanied by development, among other things, in terms of institutional reform and an enhancement of living standards. The Chinese authorities should therefore be commended for their achievement.

However, the rapid pace of growth in China had not been without problems, Mr. El Kogali noted. Inflation and some sectoral imbalances had become areas of concern. The authorities, as Mr. Dai had pointed out, had responded in a timely manner to those problems with what he considered to be a balanced approach: a cautious fiscal and monetary stance, on the one hand, and appropriate steps to expand productive capacity, on the other. They had also applied administrative controls in a measured fashion in situations where the absence of market instruments might have made an indirect approach less effective. It was useful to note in that respect the point made by Mr. Dai in the last paragraph of his statement that it was very important that policy measures be based on the specific circumstances and conditions of an economy, taking into account not only what needed to be done but also what was possible.

In the light of that note of caution from Mr. Dai, it was pertinent to ask whether a more rapid approach to price liberalization, as suggested by the staff, would have yielded better results, Mr. El Kogali remarked. The stabilization exercise in China had so far proved to be successful in restraining demand and curbing inflation. The outcome of the Polish experience, and that of other centrally planned economies now adopting market-oriented policies, would enrich the Fund's knowledge of the strengths and weaknesses of accelerated reforms.

In the section of its report on prospects for reform, the staff made the point that stabilization and longer-term reform were mutually reinforcing, Mr. El Kogali observed. One could hardly disagree with that view, and, in fact, Mr. Dai had indicated his authorities' commitment to stabilization measures as well as to the deepening of structural reform. Perhaps the issue had to do with the sequencing of policies. Should stabilization be the immediate goal before massive structural reform? The Chinese seemed to be stressing that stabilization was a necessary condition for the successful implementation of comprehensive structural reform, and, indeed, some studies had tried to establish that the adjustment process might be helped if stabilization preceded liberalization. The main point to note was that the case for structural reform must take account of the particular circumstances of the country concerned.

Lastly, Mr. El Kogali said that he wished to commend the Chinese authorities for their assistance to other developing countries, notwithstanding the economic difficulties they were facing.

Mr. Arora said that he had been struck by Mr. Grosche's observation that many valuable lessons could be drawn from the Chinese case, including the need for greater resolve in the face of difficulties that had appeared following the initial phase of the reform. But before turning to that argument in more detail, he wished to make two brief points, for comment by the staff. The first concerned Mr. Finaish's question about the liquidity overhang and the implications for price liberalization and economic growth in China; and the second concerned the medium-term scenario, in which investment rate continued to be relatively high, with some slowing down in the growth rate. The question was to know what incremental output ratios were assumed in the scenario, and how they compared with what they might have been in the previous period of very rapid growth.

In enumerating in his statement the goals of macroeconomic and structural policies, Mr. Dai had observed that "continuous efforts should be made to straighten out the economic order so as to overcome the serious confusion in the spheres of production, construction, circulation, and distribution," Mr. Arora noted. It would be helpful to know precisely what that statement meant. As for the relationship between the process of economic reform and certain political arrangements, which had been described as democratic pluralism, there was no evidence in the past 45 years of any necessary relationship between any particular kind of political arrangement and economic reform. The lesson that could be drawn from China's case was not the applicability of reform in a set of world economic conditions, but rather the limits placed on countries with large populations at different stages of economic and social development in terms of the flexibility and maneuverability that they had for achieving their goals. One aspect of the problem, to which insufficient attention had been paid in the staff analysis, might in fact be to know exactly what those limits were. Not all countries were similarly placed to deal with the various parameters of such a situation.

In the case of China, there was no serious divergence of views between the staff and the Chinese authorities regarding the process of reform or specific action to be taken, Mr. Arora considered. The only issue was the Chinese authorities' view of what action could be taken at present and what could not be done until later. The process of economic reform was not a linear one, historically, without setbacks and interruptions, or without the need to look at developments and consider whether the process or the results should have been different. Economic reform was a process that could not be isolated from a state's other objectives. The Chinese state might have many other objectives that it wished to pursue simultaneously with the process of economic reform, and that were bound to have effects that could not be predicted in simple statistical scenarios. Therefore, the important goal was to bring into alignment not perhaps relative prices as much as the entire process of economic reform with the moral, intellectual, and political structure. In the absence of the proper organic relationship, existing problems would remain.

There were certain institutional weaknesses to be taken into account, Mr. Arora added, as had been pointed out by Mr. Grosche. As Mr. Dai himself had recognized in his statement, the People's Bank of China should become an independent institution in charge of monetary affairs and should not have to carry out a monetary policy based on administrative orders from the Government. The extent to which, and in what way that could be done, was a matter for consideration. Obviously, if a market-oriented direction was to be pursued, the institutional structures would have to be adjusted accordingly. If the Chinese economy was to rely predominantly, as he believed it would, on public enterprise reform, that reform would be a vital prerequisite for resolving problems with the budget, public savings, and the modernization of the Chinese economy.

Reference had been made to the response of the economy to market signals, Mr. Arora noted. In the beginning, particularly in the agricultural sector, where individuals had responded readily, the impact on production had been tremendous. But in the large area that was dominated by public enterprises, the responsiveness to market signals would not be forthcoming without basic reform of the public enterprise system, which the Chinese authorities had been considering but which was taking a little longer to carry out than had been thought.

In terms of the medium-term scenario, he would place much greater emphasis on the reform of fiscal/monetary structures and on the public enterprise system, Mr. Arora observed. That did not mean that he disagreed with the staff about the need, for instance, for price reform, for the unification of the exchange rate, and for a flexible interest rate policy. But those aspects of reform were a question of timing, which the Chinese authorities were perhaps most competent to judge, given the fact that market mechanisms were imperfect and could lead to serious problems in terms of social discontent if certain administrative controls were not applied.

Whether the stabilization program had gone far enough for China to make yet another effort to undertake such steps as a more rapid price reform was a matter for the Chinese authorities to consider very carefully, Mr. Arora stated. But there might be merit in carrying price reform somewhat further; what was important, at least as he saw it, was to determine whether some fundamental measures could not be taken to reform the public enterprise system. He supported the proposed decision.

Mr. García said that the positive effects of the reforms implemented in China in the past ten years were evident. The rate of growth had increased substantially and living standards had been significantly improved. However, the fear of inflation since 1988 had induced the authorities to rely again on administrative controls and to slow down the process of change toward a more market-oriented economy. The high inflation rates of the previous two years had been induced by excess demand, which the authorities had attacked successfully with both fiscal and monetary policies. However, some of the pressure in the price system was the result of structural bottlenecks created by the serious distortions that developed during a long period of state intervention and controls and that were exacerbated as the economy overheated. That process had induced major changes in relative prices as the economy responded to market forces and moved toward a new equilibrium.

Relying on administrative controls and state intervention to control inflation would have a negative effect on the rate of economic growth, Mr. García commented, which had to be a cause for serious concern to the authorities, given the low level of GDP per capita and the high rate of population growth. In that sense, he concurred with the staff that the Chinese authorities faced a clear dilemma: low levels of inflation based on demand restraint might be reached relatively soon but at the cost of losing some of the achievements already reached during the reform process, particularly on the supply side of the economy. The alternative was growth, based on increasing internal and external competitiveness, and the only way to achieve that objective on a sustainable basis was through market mechanisms, even at the cost of temporary inflationary pressure as market forces corrected the disequilibria and the effects of distortions. State intervention was justified only in order to remove those distortions and to help the market work.

Demand management policies were called upon to play an important role in containing inflation and helping the economy to reach a stable equilibrium, Mr. García stated. However, market forces should also guide macroeconomic policies which, in the long run, should allow interest rates to reflect the effective cost of capital and exchange rates to reflect inflation and productivity differentials with respect to China's main trading partners. Otherwise, if macroeconomic policies were carried out by means of administrative controls, the distortions would increase and would limit the scope of supply-side policies.

The assurance of the Chinese authorities about the irreversibility of the reforms already implemented was welcome, Mr. García concluded. However, a stop-and-go process and excessive gradualism should be avoided in order to send clear signals to the market. He fully concurred with the staff that structural reforms, aimed at introducing market mechanisms, were the most efficient way for China to achieve rapid growth with low inflation and balance of payments viability. His chair encouraged the authorities to resume and accelerate the process of market-oriented reform, and supported the proposed decision.

The staff representative from the Asian Department, referring to the issue that had been raised regarding the existence or nonexistence of a liquidity overhang in the broader context of knowing whether it was appropriate for China to resume a somewhat more rapid process of economic reform than in the past two years, observed that the demand for money analysis performed by the staff indicated that there was little or no liquidity overhang in China. Over time, money could be tracked very well by changes in output and inflationary expectations, and that econometric evidence was bolstered by more empirical facts, such as the absence over time of serious shortages of goods in the Chinese economy compared with the experience of other planned economies, particularly in Eastern Europe. Shortages had emerged only during the period of high inflationary expectations in the summer of 1988. At the present time, if anything, stocks of consumer and intermediate goods in China were at record levels and a source of concern to the authorities.

Over half the content of the consumer price index represented goods whose prices were freely determined in the market place, the staff representative added. Some theoretical work done by the staff pointed to the possibility that, in a dual price system such as China's, prices in the free market were above market clearing levels; thus, in the context of accelerated price reform, some corrective price increases might be offset by the diminution of prices in part of the market. Such a phenomenon did not mean that there would not be some corrective inflation in the context of price reform, hopefully very minor, given the continued pursuit of strict monetary and fiscal policies.

As for the timeliness of a resumption of price reform, the staff representative continued, the price level in China had been virtually unchanged in the past six months. As the growth of industrial output had been negligible, and stocks were at a very high level, the staff felt that it would be appropriate, either at present or fairly soon, to move forward again in the process of price reform. More important, the staff would want to emphasize the considerable risks of not moving ahead with reform. Without an increased role for price signals in the allocation of resources, the continued pursuit of the necessary monetary and fiscal policies was likely to have a greater cost in terms of forgone output than would be the case if prices played a greater role in the economy. Furthermore, if output did not begin to recover substantially in the near future, serious pressures to relax demand policies would begin to make themselves felt. As noted in the staff report, cycles involving periods of low inflation and rapid growth followed by periods of loss of control over prices, seemed to have been occurring more and more frequently, and each time the cost of stabilization was greater. Happily, the authorities had moved quickly to correct the imbalances in 1988, with results that were evident. But the staff was concerned that pressures would again build up for a relaxation of policies if there were no early results on the output side. And the way to achieve those results was surely not by abandoning sound demand management.

Answering questions on the medium-term scenarios, the staff representative noted that a substantial increase in international reserves had not been the paramount goal in the higher-growth scenario. Rather, that scenario, which assumed substantial progress in reform over the period, was driven by the assumption that a substantial capital inflow would sustain a high level of investment and therefore of imports. In addition, the scenario was based on the maintenance of the real effective exchange rate that prevailed after the devaluation of mid-December 1989. The staff had chosen to be somewhat conservative about the potential for export volume growth, because, although China's export sector had great potential for development, its participation in export markets for certain types of products was by no means negligible. Indeed, according to an article that day in the Wall Street Journal, pressures were building up in one member country for reducing its trade deficit vis-à-vis China. The staff therefore felt that China's ability to increase the supply of exports very rapidly might be limited. Given the size of the country, its potential for import substitution might be even more important than its potential for export growth.

As for the rate of investment and the rate of increase in GNP under the high growth scenario, the staff had assumed that investment would become more efficient over time although not necessarily more efficient than it had been during the 1980s, the staff representative observed. Over time, there would be some reduction in the investment/GNP ratio, and the incremental capital output ratio, which had reached the extremely high level in 1989 of almost 8 percent of GNP, was assumed to decline gradually to under 5 percent. On the other hand, investment was projected to remain high as the reform process opened up opportunities for new domestic and foreign capital inflows.

Neither the Fund nor the World Bank had any reliable data on the distribution of income in China or its evolution, the staff representative from the Asian Department concluded. It was likely that the distribution of income had improved as a consequence of the reforms, particularly since they had been concentrated in the rural areas. The result had likely been a change in urban/rural income distribution in favor of the rural areas. It might be necessary, however, in the next stage of China's development, to create safety nets in the urban areas as the reform process continued and the ultimate social safety net--the absence of provisions for bankruptcy--disappeared.

Mr. Dai thanked Directors for their comments, which he would convey to his authorities for consideration. He had noted that some Directors were concerned about the process of China's economic reform. China had made tremendous achievements in its reform and policy of opening up its economy over the past decade. That policy had rapidly promoted social productivity, enhanced national economic strength, and increased benefits to the population at large. Experience had proved that the policy was good for the country and good for the people. For that reason, his authorities believed it to be the correct policy and reaffirmed that it was irreversible.

To better understand China's economic reform, Mr. Dai considered that a few additional words of explanation of the policy might be helpful. First, China's reform consisted in essence of making unfailing efforts to perfect the economic system, maintaining the readjustment and improving those elements in economic life that appeared irrational and that had hampered the progress of economic development. Thus, China's economic reform would last for a fairly long period and would probably continue throughout the whole process of modernization of the economy.

Second, a fundamental principle of the economic reform was to achieve a better combination of a planned economy with market regulation, Mr. Dai added. The extent, method, and scope of that combination should constantly be adjusted in accordance with actual situations.

Third, the ultimate goal was to build a planned commodity economy with Chinese characteristics that was not only different from the economic system of market-economy countries, but also different from that of other countries with planned economy systems, Mr. Dai stated. China was in the process of transition not only from a planned economy system, but also from being a developing country. Although China had made significant progress in economic development since the founding of the People's Republic of China, it was still at an early stage of economic development. On the one hand, China's GNP has risen to the eighth largest in the world and the output of some important products had leapt into the front ranks in the world; on the other hand, in terms of per capita income, China was still one of the very low-income developing countries. With so huge a population, and so low a level of social productive forces, his authorities had to base themselves on Chinese reality and pursue a road of reform that best suited China's circumstances and conditions.

Fourth, the accomplishment or progress of the economic reform was to be judged only by its practical effects, Mr. Dai observed. Whether or not those reform measures were the correct ones should be judged by the facts, depending upon whether they promoted social productivity, brought about sustained, stable, and harmonious growth, and improved the living standards of the mass of the people. Those should be the primary measurements or criteria.

During the process of reform over the past years, while emphasizing relaxation of direct planning control, the necessity for centralization in certain important areas--for instance, the need for a centralized monetary policy--had been neglected, Mr. Dai remarked. While emphasizing autonomy and flexibility for purposes of micromanagement, the necessary aggregate equilibrium and macroeconomic control and regulation had been neglected. Those were the major shortcomings in the work done by China during the reform. To correct those problems at the present stage of rectification was, in itself, a continuation of the reform process in the sense that it would serve the purpose of perfecting and improving macroeconomic management in the Chinese system.

He fully agreed with the view that, while emphasizing the avoidance of an overly ambitious and unrealistic pace of growth, a reasonably high growth rate would be needed in China, Mr. Dai commented. China's long-term goal was to realize modernization as quickly as possible. After having firmly consolidated the achievements of stabilization, a more favorable environment would be created to permit bolder steps forward to be taken. China's strategic plan of modernization remained unchanged. The first step--to double the GNP of 1980--had been basically taken, and the second step was at hand--namely, to double GNP again by the end of the century. The third step was then, by the middle of the next century, to catch up to the stage of development of moderately developed countries. To realize that strategy would require long-term strenuous efforts. The goal would not be changed.

The Acting Chairman made the following summing up:

Directors recalled the impressive achievements of the Chinese economy in the decade from 1978 to 1988; the economic reforms implemented since 1978 had been remarkably successful in raising economic growth and improving living standards in China. Difficulties had been encountered, however, in maintaining control over macroeconomic conditions. This was reflected in the most recent sharp rise in inflation and the deterioration in the external current account in 1988.

Directors supported the priority the authorities had given to reducing inflation. The decisive action to curb aggregate demand had led to a rapid deceleration of inflation and to an improvement in the balance of payments; and indications were that by early 1990, domestic demand pressures had clearly abated. At the same time, Directors expressed concern over the heavy reliance that the stabilization program has placed on the use of administrative controls. This was viewed as potentially exacerbating the adverse effects of stabilization on output, and as weakening the ability of the Government to maintain stability. In particular, continued reliance on price controls and the increase in the extent of controls over the direction of bank credit were likely to stifle the most productive sectors of the economy and especially to have counterproductive effects on aggregate supply and on the level of unemployment, which was already high. The very marked weakening of industrial production in recent months was seen as partly the result of the intensification of administrative controls over the past year.

Directors also felt that the strengthening of administrative controls would tend to undermine confidence in the durability of reforms and that this could damage future investment and growth performance. There was a broadly held view among Directors that economic reform and the dismantling of price controls should go hand in hand with the development of indirect instruments of monetary and fiscal control, and that these should be supported by an appropriate and unified exchange rate and a move toward a more open and unrestricted exchange and trade system. Directors observed that the emergence of severe inflationary pressures in 1988 had been fueled by rapid credit growth over a prolonged period, and that the tightening of credit since late 1988 had been instrumental in producing a marked slowdown in inflation. Speakers agreed that to consolidate control over inflation, monetary policy should remain cautious while paying due regard to the weakening of economic activity in recent months. A relaxation of controls over the direction of credit was seen as essential for a more efficient allocation of financial resources and a recovery of economic growth.

Directors welcomed the increases in interest rates implemented since mid-1988 and believed that these had been effective in stemming deposit withdrawals and in curbing the demand for credit. With the decline in inflation, most interest rates were now positive in real terms. The authorities were encouraged to adjust interest rates flexibly in the future, particularly in light of developments in inflation. Directors strongly recommended that the recently introduced system of preferential interest rates for basic industries be phased out, because it weakened the effectiveness of monetary policy generally and also potentially misallocated credit, weakened financial discipline at the enterprise level, and promoted financial disintermediation. Several Directors emphasized the importance of strengthening the power and the autonomy of the central bank to improve its capacity to implement monetary policy, including firm control down to the regional levels of the central bank. A firm monetary policy would include the maintenance of appropriate interest rates and control over monetary growth.

There was general concern among Directors about the weakening of the budgetary position in recent years, which was seen as placing too much of the burden of stabilization on monetary policy. They stressed the urgency of comprehensive fiscal reform. To address structural weaknesses in the tax system, the authorities were encouraged to adopt on a nationwide basis the proposed reforms of the contract responsibility system and of the revenue-sharing arrangements with local governments. The renewed increase in budgetarysubsidies was deplored as counterproductive and the authorities were urged to reduce the burden of subsidies on the budget.

While Directors welcomed the depreciation of the administered exchange rate in December, they stressed that to be fully effective in curbing import demand and stimulating exports the depreciation would need to be fully passed on to domestic prices. It was also regarded as important that restrictions on access to the swap centers be relaxed so that the floating exchange rate would be more effective in allocating foreign exchange and in promoting exports. Many speakers encouraged the authorities to move swiftly to unify the exchange system at a competitive level through a combination of further adjustments to the administered rate and the transfer of additional transactions to the adjustment centers. Because of the distorting effects of an overvalued exchange rate, they saw no virtue in postponing exchange rate reform out of concern for its potential impact on the price level. Looking to the medium term, the strengthening of China's balance of payments and growth performance would also attract capital inflows, particularly nondebt-creating capital inflows. Thus, it was in China's interest to secure a positive climate for foreign direct investment. The improved supervision over external borrowing by Chinese entities was also welcomed.

Many Directors focused their comments on the outlook for reforms under the stabilization program and over the longer term. Directors were encouraged by the authorities' restatement of their commitment to reform, but at the same time most expressed concern about the recent slowdown of reforms in some areas, and about the limited progress with reform planned over the next two years while the stabilization program would be in effect. They stressed the importance of avoiding stop-go cycles in reform and felt that further substantial progress with reform was essential not only for rapid development to be sustained over the medium term, but also for the sustained success of the stabilization effort. This was particularly true of price reform, a continuation of which was seen as essential to strengthen the indirect instruments of monetary, fiscal, and exchange rate policy, and to eliminate bottlenecks in the economy. In the view of many Directors, the sharp decline in inflation provided the right environment in which to move boldly with price reform.

Directors also emphasized the central importance of establishing greater financial discipline in the state enterprise sector if price reforms were to be successful in improving the pattern of resource utilization and in making more effective use of indirect instruments of macroeconomic control. Directors believed that a cutback in subsidies and the elimination of negotiation over taxation were urgently called for. However, many speakers felt that a more fundamental reform of state enterprises, possibly through the introduction of share holding systems, would prove necessary to provide enterprises with adequate autonomy and an appropriate structure of incentives.

Again, many Directors emphasized the interdependence of economic reforms in many areas, of which the close interrelationship between price and enterprise reforms was just one example. These interdependencies made the task of sequencing reforms very complex and it was suggested that there may be little alternative to a comprehensive approach to reform; piecemeal approaches were likely to encounter unforeseen setbacks and also ran a risk of undermining the credibility of the reform process. The authorities were therefore encouraged to move ahead boldly with reforms across a broad front. Directors believed that this strategy would help the authorities to keep overall economic activity under firm control and also to lay the foundation for the resumption of strong and sustained economic growth.

It is expected that the next Article IV consultation will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the People's Republic of China's exchange measures subject to Article VIII, Sections 2(a) and 3, and 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/90/14. 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.

Decision No. 9375-(90/27), adopted
February 28, 1990

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/26 (2/26/90) and EBM/90/27 (2/28/90).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 89/92 (7/17/89) are approved.

Adopted February 26, 1990

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/90/51 (2/23/90) is approved.

APPROVED: November 30, 1990

LEO VAN HOUTVEN
Secretary