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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/16

10:00 a.m., February 15, 1989

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	C. J. Jarvis, Temporary
Dai Q.	Zhang Z.
	C. S. Warner
	D. C. Templeman, Temporary
	M. E. Hansen, Temporary
J. de Groote	J. Prader
E. T. El Kogali	
E. V. Feldman	R. J. Lombardo
	M. A. Fernández Ordóñez
	G. Montiel, Temporary
R. Filosa	
M. Finaish	M. Othman
M. R. Ghasimi	O. Kabbaj
	B. Goos
	Hon C.-W., Temporary
B. Jalan	
A. Kafka	J. R. N. Almeida, Temporary
	D. McCormack
	W. N. Engert, Temporary
	C. V. Santos
	M. Al-Jasser, Temporary
	M. Fogelholm
H. Ploix	
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
	M. J. Shaffrey, Temporary
K. Yamazaki	S. Yoshikuni
	N. Adachi, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant
C. Wahlstrom, Assistant

Also Present

IBRD: C. I. Wallich, Asia Regional Office. Asian Department: H. Neiss, Deputy Director; S. V. Dunaway, S. Ichii, D. A. Scott, G. Szapary, H. Vittas. Central Banking Department: R. B. Johnston. European Department: M. Russo, Director; M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; A. Basu, H. Hino, S. Kanesa-Thasan, R. G. Kincaid, C. Puckahtikom. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: M. I. Blejer, Zhang E. IMF Institute: L. Lijon, Participant. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; P. L. Francotte, J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; J. M. Boughton, E. Hernández-Catá, M. Schulze-Ghattas. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; B. R. Hughes. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, M. P. Blackwell, J. E. Blalock, D. Gupta, P. S. Ross, A. J. Tweedie. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; G. Garcia-Osio, O. Gronlie, C. M. Loser, L. F. Weniger. Special Advisor to the Managing Director: A. K. Sengupta. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, F. E. R. Alfiler, M. B. Chatah, M. Eran, A. R. Ismael, P. D. Péroz, P. Péterfalvy, G. Pineau, B. A. Sarr, S. P. Shrestha, N. Toé, A. Vasudevan, R. Wenzel. Assistants to Executive Directors: B. A. Christiansen, Di W., B. R. Fuleihan, S. Guribye, M. A. Hammoudi, M. Hepp, J. Heywood, P. Kapetanović, T. Morita, N. Morshed, W. K. Parmena, C. Schioppa, G. Serre, Shao Z., Yang J.

1. PEOPLE'S REPUBLIC OF CHINA - 1988 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/89/15, 2/13/89) their consideration of the staff report for the 1988 Article IV consultation with the People's Republic of China (SM/89/6, 1/10/89; and Cor. 1, 1/11/89). They also had before them a background paper on recent economic developments in the People's Republic of China (SM/89/17, 1/30/89).

Mrs. Ploix made the following statement:

> I am very impressed by China's economic performance over the last ten years. The current Chinese economic situation is a rather familiar one; continued strong performance coupled with persistent problems of stabilization. As the staff notes, this recurrent stop-go problem is partly attributable to the ongoing reform process, but may at the same time hamper the process itself.
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> Overheating and inflation are clearly pressing problems for which excessive demand is undoubtedly to be blamed, but inflationary tensions are also compounded by the existence of serious structural distortions in the economy. The bottlenecks in the agricultural sector are good illustrations of these sectoral strains. In addition, the fact that the current episode of overheating has not been accompanied by a sharp deterioration of the external position seems to point to the significant role played by structural distortions. Given the present circumstances, the authorities should refrain from reimposing too many administrative controls, as they would only suppress inflationary symptoms, without addressing the problem at its roots. Furthermore, a return to instruments of direct control would only complicate the transition to a more market-oriented economy; a strong commitment to develop more efficient tools of macroeconomic management is of the utmost importance at the present juncture.
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> In the fiscal area, broader autonomy and financial responsibility granted to enterprises through the contract responsibility system is the main factor behind the Government's declining involvement in the economy. However, fiscal revenue has been falling more rapidly than public expenditure, and revenue enhancement measures should therefore be considered. One approach could be to adjust for inflation the profit ceilings on which a reduced tax rate is applied. A more radical approach would be to introduce a homogeneous tax rate on enterprises' profits. The latter approach seems to be the most warranted, as the present system of progressive taxation is not fully convincing. A tighter credit policy for investment financing would give enterprises a much stronger incentive to

become more efficient and generate higher profits. I would appreciate Mr. Dai's or the staff's comments on this point.

On expenditure, a worrisome development relates to the growing importance of subsidies, which seems to indicate the difficulty in shifting to macroeconomic management instruments based on price signals. In the near future, the price reform should have a decisive impact, and the authorities must then remain vigilant, so that the progress already accomplished in making the economy more responsive to price mechanisms does not become ineffective as a result of too heavy subsidization. I would also like to reiterate our concern about the relative lack of financial discipline at the local government level, which remains a major obstacle in promoting a more intensive and efficient public investment policy. Greater involvement of the Central Government in the development of larger-scale infrastructure projects is clearly needed.

On monetary policy, the importance of maintaining a stable financial environment that promotes a smooth transition to a more market-oriented economy can hardly be exaggerated. Steady monetary control will be essential for a successful phasing in of the price and exchange system reforms. Despite all the progress made in developing indirect monetary management mechanisms, serious weaknesses remain. Monetary control has to be global in order to be effective, which means that the central bank should exert tighter control over its local branches, whose autonomy should be reduced. Another way for the monetary authorities to tighten their grip on financial developments is obviously through more indirect instruments of monetary regulation, which would have a more pervasive impact on global economic conditions. The authorities have already taken some steps in the right direction, as emphasized in Mr. Dai's statement, but more remains to be done. In particular, a more active use of interest rate policy would be appropriate, as real interest rates remain negative for shorter maturities.

In contrast to previous overheating episodes, the external position has remained broadly satisfactory in 1988. This favorable outcome is certainly due to the growing share of external transactions conducted at a market-related exchange rate. However, with the subsequent widening of the spread between the official and free-market rates, unification of the exchange rates, has become a matter of urgency. It is encouraging to see that the authorities will implement exchange rate unification in parallel with price reform. However, the five-year period currently envisaged for the implementation appears rather long, and the authorities should envisage speeding up the process, as circumstances permit.

Finally, I note that the balance of payments capital account was particularly strong in 1988 and led to an overfinancing of the current deficit. I would like Mr. Dai or the staff to confirm that it is the authorities' deliberate choice to strengthen the international reserves, which are already at a rather comfortable level.

Mr. Yoshikuni made the following statement:

During the past ten years, economic management in China has undergone a significant change--both in terms of macroeconomic policies and structural adjustments. With the steady and determined efforts by the authorities, the Chinese economy has been gradually transformed from a centrally planned economy to a market-oriented, decentralized economy. The reform has already brought about favorable results, such as the remarkably high economic growth in the industrial sector, and the ensuing improvement in the quality of life.

Notwithstanding these favorable achievements, the Chinese authorities are faced with difficult challenges in the years ahead, the most serious of which is the overheating of the economy. I agree with the staff that direct administrative controls are necessary to contain the inflationary pressures already under way, but they should not lead to a reversal of the economic reforms. Naturally, these radical reforms are not without negative consequences, but the overheating resulted not so much from the reforms implemented as from their insufficiency. As the staff rightly points out, the lack of an indirect control mechanism of monetary policy prevented the central bank from effectively containing the money supply through precautionary tightening measures. Furthermore, the price system, still dominated by administered prices, failed to remove the excess demand resulting from excessive liquidity. A certain delay in the implementation of the economic reforms is inevitable, given the price stability in the short term; however, price stability should be predicated upon the completion of the reforms. I very much welcome the Chinese authorities' strong political will to proceed with the task of reconstructing the economy, as evidenced by Mr. Dai's opening statement.

While generally endorsing the thrust of the staff report, I would like to touch upon some policy issues for emphasis. As to fiscal policy, I generally support the ongoing efforts aimed at reducing the deficits as a percentage of GNP. The contract responsibility system of state enterprises and the revenue-sharing system of central and local governments, in particular, should be reviewed immediately to lay the foundation for stable tax revenues. As described in the background paper, the current tax system is complex and virtually permits tax evasion, especially in light of the high rate of inflation. However, there is a risk that such a review would result in a tax structure with excessive income elasticity, which might lead to a loss of financial discipline. The broadening of the tax base should be accompanied by a reduction in the tax rate and further control of fiscal expenditure.

I fully agree with the staff that monetary policy should play a central role in removing excess demand from the economy. But, as I pointed out earlier, the central bank is not equipped with the sophisticated indirect control mechanism needed to address the problem of excess liquidity. Accordingly, while I appreciate the series of indirect measures taken by the People's Bank of China, including the increase in various interest rates and in the reserve requirement ratio, complementary administrative measures are needed. Given the need for efficient conduct of monetary policy, it is of paramount importance that the central bank acquires sufficient control mechanisms through various kinds of technical assistance. On the other hand, the pressure for an accommodative monetary policy by the local branches of the central bank is a cause for concern and should be prevented by limiting the discretionary power of those branch offices. The central bank is one of the few institutions whose effectiveness cannot be enhanced by decentralizing decision making.

On external policy, I welcome the authorities' efforts aimed at a more flexible exchange rate system, but I am tempted to add that there is room for further improvement toward a unification of the exchange rates by gradually devaluing the administered exchange rate, as suggested by the staff. To prevent an undue depreciation of the exchange rate in the adjustment centers, intervention by the central bank might be useful to supplement tight financial policies, given the relatively high level of official reserves.

Finally, with respect to the medium-term outlook, I fully support the Chinese authorities' prudence in setting the target growth rate at 7.5 percent, which is lower than the past several years' average growth rate. However, in the short run I wonder whether this rate of growth is compatible with the need to remove excess demand from the economy; it is not advisable to stick to this growth target at the expense of containing inflationary pressures. I would like to stress, once again, the importance of implementing promptly the economic reforms.

Mr. Lombardo said that China's outstanding economic performance had a strong internal political component that was very difficult to analyze from an external point of view. He felt that the pace of economic reform was the result of a complex relationship between the ideal and the real. There seemed to be a choice between either slowing the pace of the reforms and strengthening the macroeconomic tools, or implementing the reforms at the expense of the control of inflationary pressures and jeopardizing the whole process. He fully supported the authorities' decision to give top priority to reducing the rate of inflation. Owing to the absence of some monetary tools, it was important to coordinate the different parts of the economic reform to avoid dangerous time lags.

Money and credit growth had been excessive during the first eight months of 1988, and although he recognized the utility of some administrative controls, it was necessary to encourage a more active use of indirect instruments, such as central bank credit, interest rates, and reserve requirements to control money and credit expansion, Mr. Lombardo noted. He appreciated the staff's comments on the difficulties in firmly implementing monetary policy. In particular, it was important to identify the linkages among the enterprises, the financial institutions, and the public enterprises in order to improve monetary performance. These linkages had made it difficult to sustain monetary restraint when the availability of credit to enterprises had been significantly affected, or when regional economic growth had been threatened. Nevertheless, despite some reliance on administrative controls, it was important to strengthen the macroeconomic policies by improving the indirect controls that could determine the actual speed of the reform.

In sum, he supported the proposed decision, but emphasized that the main issue was to ensure successful reforms; to attain excellence in macroeconomic tools seemed to be the first step in that process, Mr. Lombardo concluded. In that connection, the colossal transition of the Chinese economy did not have to be jeopardized by the pace of reform.

Mr. Hon made the following statement:

> I note with satisfaction China's remarkable economic performance in the past decade, which reflects the powerful economic forces unleashed by the economic reforms undertaken by the authorities. To transform the vast, centrally planned Chinese economy to a more market-oriented one is an endeavor of historical proportions, and the lack of similar and successful experiences elsewhere has not made the task less formidable. Therefore, it is expected that the economic reform process will be uneven and plagued by stop and go cycles. The high degree of flexibility in adjusting policies to unexpected developments and challenges has been the major ingredient of the Chinese success story. The trial and error approach seems to have served the country and its people well.
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> During the past two years, the economic reform has reached an important juncture. The desire for rapid economic development and enthusiasm for investment at all government levels have led to a large imbalance between aggregate demand and aggregate

supply that, together with the accommodative monetary policy, have created an overheated economy characterized by a high rate of inflation. The ensuing financial instability has disrupted the progress of economic reform, and is now threatening past achievements. There are signs that inflationary expectations are being entrenched, and that the inflationary process is becoming self-generating. In this connection, I welcome the authorities' decision to assign top priority to controlling inflation.

I would like to commend the authorities for quickly drawing up a two-year stabilization plan and putting it into place promptly. The adoption of administrative measures to review and control the growth of investment should help to cool the economy, and I can support the temporary reimposition of price controls to alleviate inflationary pressures. To prevent the overheating problem from recurring, I agree with the staff's recommendations to extend and deepen the use of indirect levers for macroeconomic control in the monetary, fiscal, and exchange rate areas; in particular, the overly accommodative monetary policy, which has been the catalytic factor in the acceleration of the rate of inflation, has to be corrected. I also agree with the staff that the formulation and implementation of a credit ceiling plan are necessary to successfully arrest the rise in the rate of inflation. The authorities' decision to closely monitor and regulate the extension of credit by nonbank financial institutions, and to index the interest rate for long-term savings deposits, are moves in the right direction. In this connection, I welcome the proposed strengthening of the role and function of the People's Bank of China, and the introduction of specific regulations to prevent interference from provincial and local governments in the area of monetary policy.

The last few years' developments have reduced the flexibility and role of fiscal policy as a major macroeconomic lever. Therefore, I welcome the authorities' decision to re-evaluate the contract responsibility system of state enterprises and the revenue-sharing scheme with local governments.

Despite the problem of domestic imbalance, significant progress has been made in the external sector. I agree with the authorities that an increased volume of transactions at the foreign exchange adjustment centers would serve to speed up the process toward a unification of the exchange rates. The authorities' decision to closely monitor the accumulation of external debt to ensure timely servicing is also to be commended. I welcome the authorities' commitment to, and recognition of, the crucial role of economic reform in sustaining a high rate of economic growth. I would also like to express my support for the authorities' decision to temporarily suspend further implementation of price reforms, as long as inflation remains a threat to the well-being of the nation.

Mr. Fernández Ordóñez commented that both Mr. Dai and the staff were right in highlighting the economic results achieved by China in the past ten years. It was fair to state that those results stemmed from the courageous, pragmatic, sound, and wise policies implemented since 1978. However, he also agreed with the staff that the Chinese economy was currently going through a delicate transitional stage. The main threat to China's well-being was the high rate of inflation and, in that connection, the reforms could be questioned owing to their supposed negative effects on inflation. He was very pleased to note that the Chinese authorities were well aware of those threats, and that they had given top priority to reducing the rate of inflation, or as Mr. Dai had stated, "the reform will not be revoked."

In the monetary area, he supported the market-oriented measures that had been adopted, such as increases in interest rates and the reserve requirements, but he understood the need to retain some administrative controls, such as the use of credit quotas, since the country had not developed other regulatory instruments, Mr. Fernández Ordóñez said. The staff was nevertheless right in underscoring the cost associated with the use of credit quotas and other direct controls.

He welcomed the reforms in the area of fiscal policy, especially the revision of the contract responsibility system, and wished the authorities success in dealing with one of the most difficult tasks a government could face: the reform of revenue-sharing mechanisms between the central and local governments, Mr. Fernández Ordóñez remarked. The proposed reforms in the areas of pensions and housing were consistent with the inevitable decentralization of decisions on investment that some day would have to take place to give a clear signal about the commitment of the Chinese Government in continuing to introduce market mechanisms.

On the external side, he welcomed the major foreign trade reforms and the expansion of the number of transactions and participants in the adjustment centers; a continuation of that policy was clearly needed, Mr. Fernández Ordóñez stated. He agreed with the staff that a modification of the administrative exchange rate would have a limited effect on the retail price index. To appreciate the exchange rate might be helpful in the short term, but could harm the Chinese economy in the longer run, as it would likely impinge on the process of integrating the Chinese economy in the world economy, which had been one of the most important achievements of the reform. The Chinese Government now had the opportunity to avoid adding to the Fund's long experience one more example of distortions created by overvaluation of the exchange rate.

Mr. Hogeweg made the following statement:

China is large and impressive in a number of ways--its sheer size, its courageous policy reforms and growth performance in the last decade, and, not least, the challenges it now faces. These challenges might be characteristic for the transitional stage in the development of socialist economies, but China's size certainly adds another dimension to their complexity.

The Chinese economy has a dual character; central planning remains important, but the market sector is rapidly growing. Mr. Dai gave a striking illustration of this dual character; as new policy measures he listed side by side more efficient regulation of the economy by the People's Bank of China by means of indirect levers, and the idea that each branch bank, in consultation with the relevant government agencies, establishes---in light of the national industrial policy--specific credit policies for different enterprises or products.

If the economy is dual in character so are the instruments of economic management. I believe that it is important for the authorities to be very much aware, when formulating their policies, of how policy measures affect the different parts of the economy. Probably, the centrally planned sectors still constitute the solid tradition, while the market is relatively new territory. Therefore, it is hard not only to set up policies when there is no record of previous market reactions, but the market may also respond in unexpected ways. The adverse allocative consequences of price distortions get worse and more obvious when market signals become increasingly important in the guidance of economic decisions. Markets can only function if prices are allowed to reflect supply and demand, and enterprises can only be held responsible for their results and be subject to stringent budget constraints if they are responsible also for the prices of their products; indeed, price reform is most essential at the present. At the same time, experience shows that correction of price rigidities may result in upward movements of the general price level, which most certainly was the case when excess demand was allowed to develop in China in 1988.

Obviously, the development and use of macroeconomic policy instruments should keep pace with the importance of the market sector, as there is otherwise a risk that the authorities will feel forced to resort to administrative controls that run counter to the general direction of policies. However, as temporary as these measures might be, which clearly seems to be the case in China, the loss may be a lot more than time because so much depends on the removal of price distortions. In light of this development, it is regrettable that the authorities did not reach a consensus on the need for a restrictive macroeconomic policy stance until the third quarter of 1988--a policy stance the Board clearly advocated at the 1987 Article IV consultation discussion. In addition, it is worrisome that there seem to be impediments to a firm implementation of restrictive monetary policies. The report mentions an increase in the role of nonbank financial institutions, as well as the close relationships among enterprises, branches of the People's Bank of China, and local governments. Such relationships are dangerous, as they imply political interference with monetary policy at a local level, which reinforces the case for a strong and independent People's Bank of China, as well as for truly market-oriented monetary policies, as opposed to a credit allocation device. Policies that work through market prices are far less vulnerable to collusion on the part of local interests.

Positive real interest rates--not only for savings deposits--certainly belong in such a market-oriented policy. Domestic savings are high, but so is investment, and it is therefore crucial that capital is put to its most productive use. On savings, it was interesting to read the reference in the staff report to the establishment of a nationwide pension fund, as opposed to enterprises paying their own retired employees from current income. Apart from stimulating labor mobility, such a fund--depending on the way it would operate--could have far-reaching consequences for the savings ratio, as well as for the management of the economy in general. Indeed, a nationwide pension fund for China's large population would have to be enormous, and it might prove risky to create such a massive pooling of savings and to concentrate economic power in such a way. Could not, for example, the Government be tempted to use such a fund to provide easy financing of its deficit?

Finally, on exchange rate policy, Mr. Dai's opening statement indicates that the policy philosophy of the authorities is not entirely clear, as they believe that a relatively stable and flexible exchange rate should be maintained. I note that the constant nominal official rate implied a substantial real effective appreciation in 1988. At the same time, the importance placed on the foreign exchange adjustment centers--where rates showed a rapid depreciation, illustrating the monetary stance--was considered to support China's competitiveness. This depreciation must have exerted the inflationary influence that the authorities rightly fear from depreciating the official rate. I was fascinated by the footnote on page 14 of the staff report, implying that import pricing was based on the adjustment center rate in cases where the foreign exchange was retained at the official rate. This practice reflects, according to the staff, the greater responsibility of foreign trade corporations to achieve profitability, but I do not think that that is the most desirable kind of profitability. I wonder in what way these corporations would maintain their profitability if the two rates were to come closer together--I hope by appreciation of the free exchange rate, rather than the other way around. Furthermore, I believe these phenomena reinforce the need for a unification of the exchange rates.

Mr. Al-Jasser made the following statement:

The Chinese experience in economic and structural transformation during the last ten years is so grand in scale and impact that the whole world is watching to learn from it. Thanks to Chinese ingenuity, the learning experience has been exciting and the results impressive. The Chinese economic reforms are unique in many ways: China itself is not comparable with any other country, in light of its size, history, and resource endowments; the Chinese economy prior to 1978 was poised, though shackled, for a take-off; social indicators in China were already higher than in most other developing countries; and the reforms were to be implemented with social welfare in mind. This latter point was evident from the 65 percent decline in the number of poor during the past ten years. I assume that I can safely conclude that structural adjustment and social welfare are not mutually exclusive.

I cannot help being impressed by Chinese ingenuity in devising the enterprise contract responsibility system and the revenue-sharing arrangements among the Central Government, the state-owned enterprises, and the local governments. Obviously, these important institutional developments have improved the operational efficiency of these economic agents at the expense of the Central Government's revenues. However, it should not be too difficult, in a second round of institutional fine-tuning, to rectify these misalignments and to enhance government revenues through the introduction of a reasonable element of variability in the Government's share of revenues accruing to state enterprises and local governments.

I commend the authorities for their efforts to expand the number and the role of the foreign exchange adjustment centers. However, since only about 13 percent of foreign exchange transactions were channeled through these centers in the first half of 1988, I tend to believe that a unification of the exchange rates through the devaluation of the administered rate may not be advisable this early in the process. It may create more dislocations in the economy, especially since the unification has to be consistent with the overall policy of price liberalization, including control over subsidies. I think it would be worthwhile to monitor the impact of the authorities' own efforts to stabilize the exchange rate in the adjustment centers, before embarking on the ambitious goal of unification. I believe that a middle-ground solution may prove to be more prudent once the stabilization process--resulting from a tightening of financial policies--takes effect throughout the system.

With the easing of centralized planning and the unleashing of market forces in the real and financial spheres of the economy, growth increased tremendously, producing signs of overheating. Laxness in fiscal and monetary policies has in all probability contributed to that development. Inflationary pressures seem to have become, rightly, the major concern of the authorities and the people in general.

How to control inflation without compromising the growth possibilities of the economy is a great challenge. I believe that, owing to the size and the stage of development of the Chinese economy, a different policy recipe than that appropriate to other countries with smaller economies is needed. Economic growth should not be slowed down measurably in order to dampen the overheating but, rather, the emphasis should be placed on removing the physical bottlenecks that have emerged in certain sectors, such as energy, transportation, and raw materials. Paradoxically, increased investment in these sectors to eliminate the bottlenecks, or simply removal of certain distortions and barriers to efficiency, might be necessary. The great potential of China's economy in size and in forward and backward linkages might have the net result of more rather than less growth. A lowering of the growth target may provide a necessary short-term respite, but it should only be accepted as a last resort, since it may prove to be a costly compromise. Notwithstanding the major differences between the Saudi Arabian and Chinese economies, experience in Saudi Arabia in the inflationary period of the mid-1970s showed that the policy of removal of physical bottlenecks could be implemented successfully without compromising potentially possible and socially beneficial economic growth.

According to the Financial Times of February 9, 1989, the Xinhua News Agency reported that China's "industrial output fell in January by nearly 11 percent because of the current austerity program." Moreover, the paper suggested that "Beijing is braking the economy too hard." Any comments on these remarks from the staff or Mr. Dai would be appreciated, especially with regard to the projected lowering of the economic growth target by 3.7 percent in 1989.

To decentralize an economy and liberalize its markets is a challenge given the size of China. But, as Mr. Dai has explained in his opening statement, the process that is under way of deepening the reforms and the stabilization program is impressive. The problems that are facing the authorities are immense. For example, grain production has been adversely affected by the liberalization of input prices, while output prices are lagging. Since this dilemma is not unique to China, I would appreciate any comments on this phenomenon from the staff or Mr. Dai.

Mr. El Kogali made the following statement:

It is encouraging to note the Chinese authorities' persistence in their economic reform policies and the progress being made in that direction. It should be stressed that this is a difficult and time-consuming process that has to be gradual in nature. The authorities are well advised to persevere with their efforts to further consolidate and build on the remarkable achievements of the past decade.

An interesting aspect of the Chinese experience is that the reform process has been accompanied by a rapid reduction in poverty and improvement in the quality of life of the majority of the people, as manifested by major indicators of social welfare. In our part of the world, we have a lot to learn from this experience since adjustment in most of our countries has been accompanied by a steady deterioration in the standard of living--particularly for the relatively poorer segments of the population.

In 1988, I note that the performance of the Chinese economy was mixed; while the last decade's rapid growth in real GNP was maintained, inflationary pressures continued to mount, reaching the highest rate of inflation since 1950. Cost-push elements, which resulted from some reform measures and pressures arising from supply bottlenecks, as well as accommodative monetary policies and the relaxation of fiscal controls have been important factors contributing to the overheating of the economy through continuous building up of excess demand. The staff report and Mr. Dai's opening statement show that the immediate challenge facing the Chinese authorities is how to control inflation and stabilize the economy, while not endangering the progress of economic reform and the gains achieved so far. I welcome the authorities' two-year stabilization program adopted in September 1988, with the objectives of improving the economic environment, rectifying economic order, and deepening the reform. I fully support the authorities' policy priority of reducing the rate of inflation and stabilizing the economy to ensure smoother reform.

At this difficult transitional stage, I understand the authorities' resort to direct administrative controls in combination with indirect macroeconomic policy tools to contain growth in demand. In this context, the administrative measures taken to restrain the rapid growth in investment should help to dampen excess demand. The move to strengthen price controls, although it may temporarily slow the pace of price reform, has been warranted by the urgency to ease inflationary pressures and stabilize prices.

A central element in the authorities' stabilization program is to maintain a tight control over monetary policy. In this regard, I note that a number of measures, including substantial increases in deposit and lending rates, indexing of longer-term savings deposit rates, higher redeposit requirement for banks, and firmer control on nonbank financial institutions have already been put in place. I agree with the staff that to ensure rapid progress toward the objective of reducing the rate of inflation, the authorities would need to establish the credit plan for 1989 within an overall financial framework--including a target for broad money growth that is consistent with the objective sought. The steps taken to strengthen the People's Bank of China, and to give it greater autonomy in managing monetary policy with adequate flexibility, as indicated in Mr. Dai's statement, is an important step in the right direction.

The authorities' 1989 budget objective of reducing the fiscal deficit as a percentage of GDP, as well as their intention to use fiscal restraint, will help to contain the growth in aggregate demand. Other important steps in maintaining fiscal discipline are the streamlining of expenditure, bringing extra-budgetary expenditure under control, and improving the presentation of the budget. However, it appears that measures will be needed on the revenue side to prevent further erosion of tax revenues as a percentage of GNP. In this respect, the steps being taken to rectify and consolidate the contract responsibility system, the profit sharing arrangements, and the system of revenue sharing between the different governmental levels are most welcome.

Finally, I appreciate the Chinese authorities' continued assistance to many developing countries.

Mr. Othman made the following statement:

At the outset, I would like to compliment the Chinese authorities for having successfully implemented wide-ranging economic reforms over the past decade. Substantial progress has been achieved in the reduction of poverty and improvement in the quality of life. Furthermore, the advantages associated with a greater role for market forces and the relaxation of planning controls have had to be carefully balanced against the need to maintain a stable external position, as well as the need to allow economic agents time to adjust to the changing environment during this transitional stage.

While the rapid economic growth in 1988, particularly within the industrial sector, was encouraging, the marked acceleration in the rate of inflation is an important cause for concern; to some extent, price rises reflect adjustments associated with price and trade-related reforms. Nevertheless, inflation appears primarily to have received an impetus from rapid monetary growth, and I therefore welcome Mr. Dai's assurance that his authorities have made it a matter of top priority to bring the inflationary situation under control. Particularly noteworthy are the decisions to stop or delay less productive projects, to tighten fiscal policy through improvements in the contract responsibility system, and adopt a more conservative monetary policy.

An appropriate regulatory framework for controlling monetary growth is essential to consolidate the benefits accumulated as a result of past reforms; such a framework is also a prerequisite for the initiation of further reform. In this connection, the use of indirect mechanisms for monetary control, the strict implementation of a comprehensive credit plan, as well as other administrative measures outlined in Mr. Dai's statement, represent a substantial effort that should provide the necessary monetary restraint. I note that the staff agrees with the authorities that some reliance on control of certain key prices is necessary, even though price controls may exacerbate existing distortions and create uncertainty. I am confident that the authorities will continue to monitor price developments closely, and will undertake selective changes in controlled prices to ensure that distortions are not excessive or hinder the effectiveness of monetary and exchange rate policies. In addition, I hope that the authorities will give due consideration to agricultural producer price adjustments to encourage continued rapid growth in food supply.

The increase in foreign exchange transactions at the foreign exchange adjustment centers is a reflection of the significant progress in trade reforms that has taken place during 1988. I welcome the authorities' intention to carry out further trade-related reforms. A policy of shifting transactions to the centers, coupled with efforts to stabilize exchange rates through the tightening of financial policies, should help to reduce the effective spread between the official exchange rate and the one prevailing at the centers. While the pace of overall reform may be adjusted over time, depending on the need for stabilization of the economy, I would like to emphasize that the unification of the two exchange rates needs to be closely coordinated with price reform. Despite the relatively small size of the external sector, an increase in prices of goods--particularly investment goods--could create significant distortions unless a series of corresponding output and retail price adjustments were made. The pace of foreign trade reform remains contingent on the continued rapid growth in exports, and I note with concern the staff's assessment that Chinese exports are likely to encounter increasing protectionist constraints in the medium term.

I welcome the authorities' intention to maintain a rational structure for foreign borrowing and to set aside the appropriate portion of foreign exchange in order to ensure scheduled and timely repayment of accumulated debt. The substantial progress achieved by China has been possible largely owing to the high level of domestic savings and the rapid increase in investment in recent years. As the economy grows and reforms are extended, the increasing availability of consumer goods may dampen the rise of household savings, which has been a major factor contributing to increased domestic savings. The adoption of an active interest rate policy through the maintenance of positive real returns could then become an increasingly important issue.

In conclusion, I note that it is easy to underestimate the difficulties associated with the economic management of the most populous country in the world--especially during a period of transition in overall economic orientation.

Mr. Shaffrey made the following statement:

The recent developments in the People's Republic of China illustrate many of the benefits and tensions that confront an economy in transition from a long history of extensive regulations, to one in which market forces are allowed to play a far larger role in price determination and resource allocation. While the recent reforms have allowed the economy to experience sustained and high growth rates and improve the general welfare of the population, the uneven pace of development of market-oriented policy tools has resulted in serious imbalances that are reflected in an unprecedented rise in the rate of inflation. Nevertheless, the Chinese authorities deserve to be congratulated for the progress made in deregulating the economy, and should be given every encouragement to continue this process of change.

The Chinese economy is in a delicate transitional phase, and the temptation for the authorities to occasionally revert to direct controls to correct evident imbalances at this stage is quite understandable. In an effort to bring inflation under control, the authorities have reimposed administrative measures to curtail investment growth and strengthen the role of price control. In that connection, I welcome the authorities' assurances that the reintroduction of the direct controls is a short-term measure. The reform program's impact on economic performance provides a powerful illustration of the full benefits of persevering with the shift toward a market-oriented economy.

Monetary policy appears particularly critical at the current juncture, given the role of excessive money and credit growth in accommodating inflationary pressures, and the importance attached by the authorities to controlling inflation. Accordingly, I very much welcome the authorities' move in late 1988 to increase interest rates and reserve requirements for banks, although the persistence of negative real interest rates suggests that more and sustained efforts are needed to bring down the rate of inflation to its historical single digit level. I note that the long-run success of these efforts depends on the greater use of market-oriented tools.

I would urge the authorities to implement quickly their intention to strengthen the autonomy of the central bank and make it less prone to pressures from local branches for credit expansion. On direct controls, I urge the authorities to ensure that administrative measures to restrain the rapid growth in investment do not impart an impression of uncertainty toward investment in future policies. Any measures relating to the suspension of construction projects should consider the extent of private and foreign sector participation.

The decline in revenue and expenditure in relation to national income may be related to the increasingly important role of private enterprises. In this context, the increasing trend of the budget deficit needs to be tackled, and I therefore welcome Mr. Dai's statements on the general direction of his authorities' fiscal policy reforms. Many areas of fiscal reform need to be addressed by the authorities, particularly on the revenue side, although the expenditure side should not be ignored. I agree with the staff that expenditure on subsidies should be addressed, even though it has not shown a tendency to increase as a proportion of total expenditure; expenditure subsidies might have been expected to fall, at least as a proportion of total expenditure, given the substantial reduction in the number of absolute poor over the last ten years--a truly significant achievement in itself.

In respect to taxes, the arrangements among the Central Government, local governments, and state enterprises need to be reviewed. I would urge the authorities to further develop the income tax system for the private enterprise sector, which would appear to be a particularly promising source of revenue, given the sector's rapid growth under the economic reform program.

The substantial increase in the proportion of foreign exchange transactions in the foreign exchange adjustment centers is a most welcome development. However, I would urge the authorities to consider the widening discrepancy between the official and the free market rates as an important indicator of the need to accelerate the process of exchange rate unification. I agree with the staff that appropriately tight financial policy can prevent the adverse effect of a more rapid exchange rate reform spilling over to domestic inflation.

In conclusion, I welcome the authorities' commitment to continue with the economic reform program, and their apparent recognition of the essential elements of the reform process. I support the proposed decision.

Mr. Enoch made the following statement:

As noted by Directors, the Chinese authorities' far-reaching economic reform program has already brought significant gains to the population. With output growth averaging nearly 10 percent a year since 1978, living standards in China have increased sharply. Moreover, the growing market orientation of the Chinese economy and its increasing integration with the rest of the world provide considerable reassurance that the recent economic and social gains can be consolidated and extended over the medium term.

Nevertheless, in the short term, China remains in a delicate transitional phase; it is no longer a highly centrally planned economy, but not yet a mature market-based economy. This transitional stage makes the process of macroeconomic control both more complicated and more urgent in China than in most other countries. Confronting the need to stabilize the economy, the authorities are with the one hand instinctively reaching back for the old tools of direct controls, yet, with the other hand, reaching forward to the new levers of indirect macroeconomic policies.

Over the past year it has become clear that the economy is showing serious signs of overheating: bottlenecks in key sectors, rapid investment growth, a very sharp fall in urban savings, and above all, a steep rise in price inflation. After some initial hesitation, the authorities have not accepted that inflation is the central economic problem facing China in the short term. An entrenchment of inflationary expectations would considerably hamper further economic liberalization; the economy is clearly not geared to cope with inflation. As a result, the past few months have seen bouts of panic buying, an erosion of the corporate tax base, a sharp growth in spending on consumer subsidies, the first signs of a wage-price spiral, and a return to negative real interest rates. These factors will all tend to exacerbate the inflationary pressures within the economy unless firm action is taken to restore stability.

The authorities' response to the deteriorating position has been to use a mix of controls and indirect financial policies. I have some sympathy for the staff's view that some reliance on administrative controls is necessary, given the overriding need to curb inflation. In particular, since investment growth has proved fairly unresponsive to changes in interest rates or tax rates in recent years, the steps taken by the authorities to set priorities for investment programs seem appropriate. In addition, it is clear that direct credit controls--if strictly enforced--should make an important contribution to keeping monetary conditions under control in 1989.

While the resort to direct controls may help the authorities to regain control over inflation, there are clearly both risks and costs with this approach. One important concern relates to the credibility of the reform program; uncertainties caused by the sudden reimposition of some price controls may well reduce agents' willingness to create the markets and economic structures upon which the success of the authorities' reform effort will ultimately depend. In the area of rural reform, for example, continued uncertainties about the long-term fate of the reforms appear to have inhibited private investment. Credibility is a fragile asset, and once lost it can take a long time to recover; thus, even controls that are imposed for only a short period may incur costs to the economy over the long run.

A further consideration is that direct controls tend to be multiplied in the attempt to offset the distortions and rigidities that result from the initial controls. Thus, the staff notes that credit was tightened to prevent the burden of restraint from falling disproportionately on sectors that lacked the ability to maintain access to credit, or had limited access to budgetary subsidies. Moreover, the persistence of existing distortions, and the creation of new ones, tend to weaken the impact of more conventional fiscal and monetary policies at a time when their efficacy is most important. The leverage of interest rate policy in China is considerably diminished by the ability of many enterprises to obtain loans and subsidies to cover increased costs deriving from higher interest rates. The maintenance of artificially low prices in some sectors, to take another example, may come in conflict with fiscal objectives, if losses need to be covered.

Relative price distortions may have actually contributed to the current inflationary pressures. Despite recent increases in procurement prices, agricultural production in China continues to flag; in 1987, the free market price for grain was 93 percent above the state-fixed price. The authorities need urgently to restore adequate price incentives for farmers to expand grain production. To improve the supply will be a critical factor in reducing inflation, and an increase in fuel prices would lead to a reduction in the energy intensity of production over the medium term, easing both supply bottlenecks and inflationary pressures.

I strongly agree with the staff view that the authorities should continue to look for ways of strengthening fiscal and monetary policies. On fiscal policy, the authorities' intention to reduce the 1989 deficit, as a proportion of GNP, is welcome. To achieve further progress in this area it will be necessary to enhance elasticity of the tax system and exercise firmer control over subsidy expenditures. There is an urgent need to broaden the tax base by extending the coverage of the value-added tax, eliminating the tax deductibility of loan repayments, and increasing the revenue from the personal income tax.

On monetary policy, I was encouraged to learn that interest rates recently were increased again in line with the staff's recommendations. However, given the relative ineffectiveness of interest rate policy over recent years, the authorities should consider additional indirect measures to improve monetary control, including a further increase in reserve requirements and a strengthening of the authority of the People's Bank of China. Greater attention should also be given to developing new financial instruments, in order to absorb the high level of household savings; at present, $80 billion of deposits are held with the banks, and any loss of confidence could quickly trigger a further bout of demand-led inflation. In this context, attempts to broaden shareholding in China, to commercialize the housing market, and to establish a national pension fund system should all be helpful contributions. However, I do share Mr. Hogeweg's concern that the establishment of a national pension fund system might lead to a dangerous economic concentration of power.

In conclusion, it is clear that the authorities remain committed to the cause of fundamental and radical economic reform. However, in the short term, stabilization has taken precedence, and the authorities have introduced a package of measures to bring inflation down to more acceptable levels. They should be cautious about relying excessively on the reimposition of direct controls, which could hamper their broader reform objectives over the medium term. They need resolutely to strengthen the more indirect policy instruments at their disposal. The authorities have set themselves an immense and complex task, but we remain confident that they have the commitment and the determination to carry it through.

Mr. Ghasimi made the following statement:

We commend the Chinese authorities for the progress made in implementing far-reaching economic and financial reforms aimed at substantially transforming and modernizing their centrally planned economy. The new framework of economic management has been helpful in sustaining output growth, improving standards of living, and reducing some of the macroeconomic imbalances. We particularly note the successful achievements in the external sector, where a sharp increase in exports contributed to the external current account surplus in 1987. These achievements have been made possible owing to the authorities' commitment to implement structural reforms. In this respect, we are pleased to note that macroeconomic instruments are more and commonly used, while administrative and direct controls have been replaced gradually by indirect interventions.

The Central Government is promoting decentralization; thus, local and provincial authorities, public enterprises and agencies, and foreign exchange adjustment centers are increasingly involved in macroeconomic management. In addition, the private sector is booming in many areas, and foreign direct investment has become an active part of the Chinese economy. Some constraints have hampered the pace of economic reform, but it is encouraging to note that the authorities are determined to pursue and implement measures to ensure better prospects for the Chinese economy.

As the staff acknowledges, despite the remarkable progress with reforms, the Chinese economy remains in a delicate transitional stage. Huge investment and rapid development have provoked expansionary pressures. With the emergence of inflation and shortages in inputs and basic commodities, problems and constraints occurred in macroeconomic management, and difficulties appeared in organizing relations between the Central Government and provincial and local governments. The decentralization of management induced a widening of the fiscal deficit, which was compounded by higher subsidies and lower revenues. In order to finance this expansion, monetary policy and credit policy were relaxed, leading to an acceleration in inflationary pressures.

We share the staff's concern about the problem of overheating, and we encourage the authorities to take the necessary actions to tackle some of the serious challenges associated with a transition to a more market-oriented economy. In September 1988, the authorities adopted a two-year stabilization program to overcome the current difficulties and to bring down the rate of inflation--the details of which were outlined in Mr. Dai's opening statement. Fiscal policy will be invigorated through expenditure reduction, limitation of subsidies, and reform of the tax system; in this respect, we encourage the authorities to broaden the tax base and improve tax collection.

On monetary policy, access to credit is expected to be contained through an increase in the reserve requirement, and growth of broad money is intended to be limited in order to bring down inflationary pressures. In addition, the authorities will pay particular attention to developments in prices and will monitor carefully the level of salaries and bonuses.

As to the external sector, the authorities contemplate continuing to adjust the exchange rate, and will pursue a floating exchange rate policy in order to reduce the gap between the two exchange rates. These policies would be complemented with structural reforms to enhance the supervisory functions of the central bank and to augment the autonomy of public enterprises in order to stimulate competitiveness. The reform process will also be pursued in the areas of trade and external borrowing, where rationalization and efficiency will be further encouraged.

China, a country rich in resources and with a large market, could play a greater and more important role in the world economy, if the authorities succeed in the transition toward a more market-oriented economy in order to ensure rapid growth and sustained exports. We also encourage the authorities to increase production of staple goods and inputs for the agricultural and industrial sectors, as well as to promote housing. Macroeconomic instruments will be more efficient than administrative controls, and we are pleased, therefore, to note that the authorities are in general agreement with this view.

In the light of China's geographical size, massive population, and the gigantic scale of the economy, which is undergoing a process of courageous economic and social reforms, we commend the people and the authorities for their great efforts and initiatives in changing the image and structure of their economy.

We support the proposed decision.

Mr. Almeida commented that not only China's economic performance had been impressive, but social indicators had improved tremendously, with life expectancy and infant mortality rates having reached a level comparable to that of middle-income countries. The economy had experienced a fast modernization process that might be unique in modern economic history. However, the transitional costs associated with economic reforms, particularly excess demand and bottlenecks in specific sectors, might be increasing too fast, and subsequently prompt stagnation of further progress in economic reforms; that was particularly true in regard to inflation. The effects of inflation on China's income distribution might be more damaging than in countries with a long history of high and persistent inflation, that had developed special defense mechanisms, whereas China had a very limited experience with inflation.

It was reassuring that, according to Mr. Dai's statement, the authorities had announced recently a two-year stabilization plan to reduce inflation and cool down the economy, Mr. Almeida noted. It would not be easy for the authorities to meet their target of a 3.7 percentage point reduction in the growth rate in 1989--even though they had, in fact, increased the target for agricultural growth--but that was the price they would have to pay to assure moderate inflation and continued and sustained growth in the long run. In particular, it was impressive to note the increasing role the authorities had placed on monetary policies in macroeconomic adjustment.

As to the problems associated with a dual exchange rate system, he believed that only limited benefits would be gained from having a unified exchange market at the present juncture, as there would be another five years until the price reform would be completed, Mr. Almeida said. The key issue should be to stabilize the exchange rate in the adjustment centers and to reduce the spread between the official and floating exchange rates. In that connection, the planned tightening in fiscal policy was a step in the right direction.

The decline in revenue and expenditure, as a ratio to GNP, was a natural consequence of the very fast growth and restructuring of the economy, Mr. Almeida continued. However, the authorities were right in noting that it was time to improve the current contract responsibility system adopted by businesses, under which the tax rate was determined on a case-by-case basis. The tax system was currently too discretionary and, as a result, fiscal policies were difficult to implement. However, despite the problems with the tax system, the key indicator of fiscal policy--the public sector deficit--had been kept at a moderate level in 1988, of 2.2 percent of GNP in 1987/88.

The Chinese economy would require huge investments for many years to come, Mr. Almeida commented. It was remarkable that the household savings rate had not decreased during the last four years, especially since the savings deposit rate had been negative in real terms. However, he had doubts that the indexation of interest rates would increase long-term savings deposits, since the nominal interest rate was expected to be in line with inflation.

Mr. Fogelholm made the following statement:

> In his opening statement, Mr. Dai captured in a nutshell one of the fundamental and still unresolved problems that the Chinese authorities are facing: "In the final analysis, the

imbalances between aggregate demand and aggregate supply have been due to the lack of an effective macroeconomic regulatory system, such as the lack of sound fiscal and monetary policies and relevant instruments to go hand in hand with these policies."

Is it possible to conduct sound fiscal and monetary policies if no appropriate instruments are accessible, or if the instruments available are not adequate or suitable for the particular purpose? To create appropriate and effective instruments, one needs to rely on the availability of price signals from the markets that reflect actual demand and supply. However, market prices are available only to a limited extent in China, which severely distorts the proper functioning of enterprises; the enterprises are, of course, also targets for demand-management policies. The conclusion is that the ineffective demand management policies can be attributed not only to weaknesses in the design of these policies, but also to the lack of sufficient market prices, through which the policies should be executed.

The staff believes that carefully selected steps in price reform should be undertaken to increase the effectiveness of monetary and exchange rate policies, and to reduce distortions in the pattern of profitability. However, the question is whether or not the planned steps in price reform will be enough to make fiscal and monetary policies effective, or at least effective enough to facilitate the creation of necessary instruments and adherence to policies, without time after time having to resort to regulations and controls. I do not have an answer to this problem, but I certainly hope that a gradual transformation of prices will provide the answer. Politically, it tends to be much easier to accept a gradual transformation, rather than radical and abrupt changes in the price system. In this connection, I was interested in Mr. Goos's slightly skeptical view of the effectiveness of a gradualist approach in the area of price liberalization. The pace of price reform is worth studying further, and I am therefore pleased to note that the staff is presently involved in a comparative analysis of market-oriented reforms and their implementation in centrally planned economies.

The acceleration in the rate of inflation is doubtlessly a major concern; it threatens macroeconomic stability and the pace of further reforms. Thus, I am pleased to note from Mr. Dai's opening statement that the authorities are giving top priority to the matter of inflation.

Because rapid money and credit growth has been one of the major reasons behind the significant increase in the rate of inflation, a tightening of the monetary policy stance is needed.

While recognizing the various steps already taken to this end by the Chinese authorities, it is most important that the influence of the People's Bank be strengthened. Furthermore, it is essential that the People's Bank of China be given a mandate to tighten policy further if necessary. It would seem preferable if the authorities--in line with the longer-term objectives of reform--relied more on the use of indirect instruments, such as central bank credit, interest rates, and reserve requirement to control money and credit expansion rather than on direct credit controls. The foreign currency operations of the domestic banks have increased sharply, which should also be taken into account when evaluating monetary policy.

On fiscal policy, the authorities' intention to reduce the deficit is most welcome. In the present circumstances, a tight fiscal stance is undoubtedly required. To increase the potential ability to use fiscal policy in macroeconomic management it would be necessary to broaden the tax base, since the various schemes with respect to both the state enterprise sector and the local governments tend to reduce the elasticity of tax revenue. On the expenditure side, strict control over subsidies and fixed investment is required, especially in sectors that do not themselves correct emerging bottlenecks.

With respect to external policy, I encourage the Chinese authorities to continue the reforms of the exchange and trade system. The present dual exchange rate system gives rise to price distortions and, by fueling speculations, complicates the task of reforming the price system. Decentralization of the price formation system must proceed simultaneously with reforms on the external front, in order to be successful.

In conclusion, while applauding the results reached to date, and acknowledging the complicated task of transforming the economy to a more market-oriented one, I believe that the Chinese authorities have to make additional efforts, especially in the area of price reform and in strengthening the tools of macroeconomic management. These efforts are particularly important in order to safeguard public confidence in the reform process. Finally, I support the proposed decision.

Mr. Engert said that the reform process in China had been remarkable and had brought very impressive benefits. He welcomed the Chinese authorities' commitment to persevere with their ambitious efforts to continue that process. In order to avoid a recurrence of overheating in the economy, as administrative controls continued to be removed, it was essential to strengthen monetary, fiscal, and exchange rate policies, and to persevere with reforms that increased responsiveness to market signals. He endorsed the staff appraisal.

Top priority had to be given to lowering the high rate of inflation, Mr. Engert commented. He agreed with the authorities that in the current transitional stage to a more market-oriented economy, it might not be possible to avoid reliance on administrative means to bring down the rate of inflation. However, the re-introduction of price controls should be only a short-term measure. The focus should instead be on tightening monetary policy and improving monetary and financial policy procedures, for example, by ensuring that the People's Bank of China could respond in a flexible and timely manner to developments in China's rapidly changing economy. In that connection, it was regrettable that most interest rates appeared to remain negative in real terms. It was preferable not to use the interest rate structure to provide subsidies to particular enterprises, as the associated resource misallocations could generate significant costs to the reform effort. He agreed with staff on the need to consolidate the contract responsibility system undertaken by state enterprises, as well as the profit sharing system among state enterprises, various levels of government functions, and financial institutions.

With respect to the acceleration in the rate of inflation, fiscal improvement was warranted, particularly in view of the sharp decline in the fiscal position since 1985, Mr. Engert remarked. His authorities were pleased to see that the staff and the authorities agreed on many of the policy issues, and he noted the important contribution that technical assistance had made in the case of China.

The staff representative from the Asian Department said that the broad objective of China's economic reform was the dismantling of the command economy with its associated administrative directives that determined the level of investment, wages, prices, and the allocation of output. In addition, the Chinese authorities had decided, as part of their strategy, to open their economy to a much broader range of transactions with the outside world. There was broad agreement between the staff and the authorities on the need to reform the instruments of macroeconomic management. To remove the reliance on administrative controls, more active use of indirect instruments, such as interest rates and the exchange rate would be important. While recognizing the need for some administrative steps to curtail investment, with the decentralization of decision making and the growing share of investment outside the state plan, administrative control over investment had probably become less effective. He noted that all capital construction projects that had been less than 50 percent completed in October 1988 were to be reviewed to establish whether or not they should be continued.

The main underlying motivation for the foreign trade reforms in 1988 had been to give the floating exchange rate in the foreign exchange adjustment centers a much broader role in guiding China's foreign exchange transactions and in providing a new set of signals for the continuation of price reforms, the staff representative remarked. As to the footnote on page 13 of the staff report (SM/89/6, 1/10/89), about 13 percent of foreign exchange transactions had been channeled through the adjustment centers in the first half of 1988; obviously, a large part of foreign trade transactions, which utilized foreign exchange, were not channeled through the adjustment centers. The control over the Foreign Trade Corporations (FTC) had been decentralized to make most of the independent entities responsible for their own profits and losses, which had encouraged a more widespread pricing of imports in relation to the adjustment center rate, regardless of whether the corporations retained foreign exchange from export proceeds, or bought it in an adjustment center. Unfortunately, in the rapidly changing economic structure of China, data to measure the influence on pricing of the administered rate versus the market rate were not yet available.

The staff did not believe that China's balance of payments in 1988 had been overfinanced, the staff representative commented. Although in October 1988, reserves had been in excess of the equivalent of five months of imports, while the reserve target had been set at the equivalent of three to four months of imports, the authorities stated that they were not in a position to fine-tune and regulate capital transactions at the current stage. However, another source of concern was the rising and unintended external borrowing that had taken place in 1988--especially by entities at the regional level.

The staff had urged the authorities to dampen investment expenditure, not through administrative means, but through interest rate and credit policies that were consistent with the broader objectives of economic reform, the staff representative said. However, the current mix of policies to contain inflation was not surprising; the authorities had experience and confidence in administrative measures, but recognized, at the same time, that interest rate and credit policies would be more appropriate in the long run. That current mix of policies might be part of the reason why industrial production had slowed down in January 1989, but it was also worth noting that there was always a seasonal slowdown in production during the first quarter of each year, reflecting the robust activity of the previous year's last quarter.

With respect to the right pace of reform, the staff emphasized the need to implement the longer-term process of total price reform, the staff representative commented. Top priority had to be given to bringing down the rate of inflation before unifying the two exchange rates and correcting the interest rate to an appropriate level. The Chinese authorities were, however, urged to unify the two exchange rates as soon as feasible. The staff had not felt compelled to argue for positive real interest rates in the fourth quarter of 1988, but rather urged a substantial increase in interest rates. That, in conjunction with other measures to reduce inflation, should enable positive real interest rates to emerge during 1989. On the lending side, there was still a need for further increases in interest rates.

The staff had not yet received any data on the Chinese budget, which was to be presented in March, or details of the credit plan, the staff representative from the Asian Department noted. He understood that the credit plan would aim at a lower rate of expansion in 1989, compared with what the authorities had anticipated in November 1988.

Mr. Dai noted that since mid-1988 the Chinese economy had been overheating, and that inflationary pressures and price rises had been evident. However, his authorities had taken timely measures to improve the macroeconomic management of the economy. The international community had expressed concern about the problems confronting China, and he would therefore like to reaffirm his authorities' determination to stabilize the economic situation while continuing to carry out economic reforms. However, his authorities realized that it might take two years or more to reach the goals of the stabilization program. Certainly, the economic reform would be carried out more smoothly once the economy had stabilized, but the authorities remained steadfast in their belief that the fundamental solution to China's economic development was through reform. They had continued to open up the economy and carry out economic reforms, for instance, reform in the areas of taxation, labor management, and foreign trade. Given that the authorities had assigned top priority to cooling down the economy and correcting inflationary pressures, it had been necessary to make certain adjustments of those reform measures that had a direct bearing on inflationary pressure. The authorities realized that price reform was a crucial issue for economic reform, but in light of its direct bearing on inflation, price reform would have to be implemented over a longer period of time. He agreed with Directors that direct administrative controls could have adverse effects, but the costs would be even larger and the consequences even worse if people lost faith in the Government's ability to control inflation.

While top priority had been given to controlling the rate of inflation, special attention had also been paid to the deepening of reforms, with particular emphasis on the relationship between the ownership and managerial arrangements of enterprises, in order to raise economic efficiency and productivity, Mr. Dai said. Various types of reforms in the ownership of enterprises had been explored; shareholding and leasing aspects had also been investigated to explicitly define profit sharing, decision making power, and responsibilities for gains and losses. But, to succeed with those reforms, complementary reforms had to be implemented in other sectors as well. Obviously, it would take quite some time to transform China's centrally planned economy to a more market-oriented one. Given the size of the population and the complexities of the economic structure, the authorities were trying hard to avoid making abrupt and drastic changes in the country's economic life. The transformation of the economy had to be carried out in an orderly and gradual manner, as economic reform was a long-term process in China. However, his authorities were confident that they would achieve their goals if they persevered in the right direction.

He agreed with Directors on the need to strengthen the role of the People's Bank of China in macroeconomic management, Mr. Dai said. The authorities intended to shift from direct administrative controls to indirect controls, but recognized that the economy was currently in a transitional stage in which the old and the new systems coexisted. Therefore, for the returns to succeed the special characteristics existing in the Chinese economy had to be considered; for example, interest rate policy needed to be implemented in accordance with the particular set of circumstances facing China. His authorities were fully aware that interest rate policy was one of the most important instruments in trying to stabilize the economy, and in addressing imbalances between aggregate demand and aggregate supply. The authorities had adjusted the interest rates twice within a five-month period, which they believed was in conformity with the realities in China. Only when a comprehensive economic reform was carried out and the enterprises had the means and mechanisms to absorb the costs induced by raising interest rates, could positive interest rates be reached. In addition, he noted that the negative interest rates had occurred in connection with the recent acceleration in the rate of inflation.

In carrying out the economic reforms, the authorities would like to learn from the experience of other countries, developed and developing, Mr. Dai noted. The People's Bank of China had established good working relationships with many central banks, and had benefited greatly from that cooperation.

The Chairman made the following summing up:

Executive Directors reiterated their strong support and admiration for the bold economic reforms undertaken by the Chinese authorities over the past decade. The relaxation of planning controls and the opening of China's economy to the outside world have already yielded great gains in terms of remarkably rapid growth and higher living standards. Nevertheless, Directors appreciated that China is at a delicate transitional phase in the process of reform. The overheating of the economy, and the emergence of sectoral bottlenecks alongside the decentralization in decision making and increased autonomy for localities and enterprises, have created major new challenges for macroeconomic management. In their interventions, Directors were unanimous in emphasizing that strengthening indirect levels of macroeconomic control would be essential for further progress toward a more market-oriented economy, and that top priority should be given by the authorities to reducing the rate of inflation. In this context, most speakers expressed concern about the use or tightening of administrative controls over prices, which appeared to be ineffective, and as running counter to the paramount need to eliminate distortions in prices and supply-demand patterns.

The strong inflationary pressures that had emerged were chiefly the result of rapid money and credit growth since late 1986, and speakers generally agreed on the need to strengthen monetary policy. They welcomed the steps already taken by the authorities to tighten monetary policy, and they emphasized that sharply reducing monetary growth in 1989 was essential if inflation was to be brought under control. They welcomed the increases in interest rates implemented in September 1988 and again in February 1989, and many Directors encouraged the authorities to implement further increases, since most rates remained negative in real terms.

Directors believed that strengthening the authority of the People's Bank of China, and the control of headquarters over credit creation by its branches, was essential if firm control over money and credit growth was to be sustained. The local authorities' pressures on financial institutions and the central bank to satisfy their credit demand were noted with some concern by a number of speakers. Closer regulation and monitoring of the operations of nonbank financial institutions would also be required to ensure that monetary conditions were adequately tightened. In addition, new monetary instruments should be developed to absorb the high level of household savings. Directors emphasized the importance of avoiding stop-go cycles in financial policies, which created uncertainty and could undermine confidence with reform.

A stronger monetary policy should be buttressed by a tighter fiscal policy. Directors expressed concern about the widening in the budget deficit since 1985, and welcomed the authorities' intention to reduce the deficit in relation to GNP. They believed that tax reform, a broadening of the tax base, and revisions to the revenue-sharing arrangements with local governments would be necessary to ensure a sustained improvement in the deficit. However, they recognized the difficulties that might arise in connection with the revenue-sharing arrangements. Tight control over growth in expenditure, especially subsidies, was also considered to be important.

Directors welcomed the foreign trade and exchange reforms implemented in 1988, which have resulted in a substantial increase in the proportion of transactions taking place at the floating exchange rate in the adjustment centers. This had helped to maintain external competitiveness during 1988. However, they noted with concern the appreciation of the administered exchange rate in real effective terms and the widening gap between the floating and administered exchange rates. Most speakers encouraged the authorities to move rapidly to unify the exchange system. Adequate progress with exchange and trade system reform would be important in encouraging sustained export diversification and in promoting sustained export growth.

Directors welcomed the progress in implementing a comprehensive system for registering and monitoring external debt. Noting the proliferation of entities at the provincial level with the authority to borrow abroad, as well as the sharp increase in their borrowing during the first half of 1988, some Directors emphasized that foreign borrowing would need to be restrained in line with the objective of reducing overheating and slowing inflation.

In sum, Executive Directors expressed their fullest support for China's far-reaching program of reforms. In such a complex undertaking it was inevitable that progress would not always be smooth. Directors were confident that the authorities would be able to bring inflation under control and keep the wheels of reform moving forward in an environment of financial stability.

It is expected that the next Article IV consultation with the People's Republic of China will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1988 Article XIV consultation with China, in the light of the 1988 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, as described in SM/89/17. In addition, the authorization for trading of foreign exchange in foreign 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 restrictive features of the bilateral payments agreements with Fund members.

Decision No. 9077-(89/16), adopted
February 15, 1989

2. HAITI - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

The Executive Directors gave substantive consideration to the Managing Director's report and complaint under Rule K-1 relating to Haiti's overdue financial obligations to the Fund (EBS/89/15, 2/17/89; and EBS/89/4, 1/13/89).

The staff representative from the Treasurer's Department said that Haiti had made payments to the Fund on February 6 and 10, 1989, in an amount equivalent to SDR 424,000, which had the effect of reducing Haiti's overdue financial obligations to the Fund from SDR 6.7 million to SDR 6.3 million.

Mr. Kafka remarked that Haiti had made extreme efforts to make the recent payments, which showed the Haitian authorities' commitment to cooperation with the Fund. He suggested that the period proposed for the review of Haiti's overdue financial obligations to the Fund should be extended from three to four months from February 15, 1989, in order to give Haiti some additional time to clear its arrears. Furthermore, he hoped that the Fund mission to Port-au-Prince in early March would provide new initiatives to assist Haiti to put in place not only a Fund program, but also--with the support of the Inter-American Development Bank and the World Bank--a major development program, which would of course also call for technical assistance. That was urgently necessary, given the tragic situation in Haiti, in which, inter alia, the basic livelihood of the people was being threatened by soil erosion.

Ms. Hansen said that she regretted the re-emergence of arrears with respect to Haiti's financial obligations to the Fund. However, she recognized that the Haitian authorities were facing serious economic difficulties and that their foreign reserves were at very low levels. She welcomed Haiti's recent payments to the Fund, and was pleased that the authorities were cooperating with the Fund. Nevertheless, she urged Haiti to give top priority to meeting its financial obligations to the Fund. In that respect, it was disappointing that there was no information in the staff paper on the degree to which Haiti was current with other creditors, that was a general point that her chair had made in the past.

Finally, she hoped that Haiti's arrears to the Fund would be cleared in the very near future, as had been the case following the Managing Director's report and complaint in 1988, Ms. Hansen commented. However, if the arrears had not been cleared by the time of the next review of Haiti's overdue obligations, and if it proved appropriate in light of upcoming discussions of the modalities of the collaborative approach to overdue financial obligations, she suggested that the staff should make proposals to the Board for communicating with Haiti's major creditors and donors. She supported the proposed decision.

Ms. Montiel remarked that Haiti's economic prospects had continuously worsened since the Board's discussion of the 1988 Article IV consultation. Indeed, the decline in capital inflows, owing to the curtailment of external aid, had led to severe restrictions in both the external and the internal areas--despite the authorities' efforts to improve tax collection and reduce government spending on several occasions, her chair had stated that the economic problems of Haiti needed to be solved, and that failure to act promptly would lead to a relapse to a condition of generalized impoverishment, lack of political will, and another difficult case of overdue obligations to the Fund. She realized that the acute problems currently facing the economy made it difficult for Haiti to clear its overdue obligations to the Fund in the very near future, and she noted the willingness of Haitian authorities to meet their obligations, despite severe foreign exchange constraints. In addition, she observed that Haiti would continue policy discussions with the Fund at the time of the 1989 Article IV consultation to be held in Port-au-Prince in early March.

As in the case of Guyana, the Fund strategy with respect to Haiti should be based on a collaborative approach where all parties involved--the Fund, the World Bank, the Inter-American Development Bank, and official donors--would participate to solve Haiti's problems in the medium term, especially taking into account the goodwill of the authorities in adopting appropriate measures, Ms. Montiel said. She urged the authorities to continue implementing policy measures to redress current imbalances, in order to induce the support of the international financial community. Furthermore, she called on external donors to resume flows of concessional lending and grants to Haiti. She supported Mr. Kafka's amendment of the decision.

Mr. Feldman said that despite the authorities' efforts to remain current with the Fund, he regretted Haiti's inability to meet all its financial obligations, which reflected its severe economic difficulties. He noted the estimated decline in real GDP, as well as the increase in the rate of inflation during 1987/88. In addition, the external position had deteriorated significantly, and net capital inflows, grants, and external assistance had fallen, resulting in a stock of international reserves equivalent to less than two weeks of imports at end-1988. The authorities had made efforts to adjust the budget by cutting expenditures and improving tax collection, but the situation was expected to remain difficult, particularly in the external sector.

He noted that the authorities had maintained a close relationship with the Fund, and that a mission was scheduled to visit Haiti in early March, Mr. Feldman remarked. He welcomed the partial payments made by Haiti, and supported the proposed decision, although he believed that Haiti could be given some additional time to clear its arrears. Accordingly, he supported Mr. Kafka's proposed amendment of the decision, extending the proposed review period from three to four months.

Mr. Goos said that he shared the concern expressed by previous speakers about Haiti's overdue financial obligations to the Fund. The existence of arrears to the Fund since 1985, implied that the underlying problem was of a more permanent nature--the recent political difficulties were just part of the problem. In the forthcoming discussions between the staff and the authorities, the underlying problems should be looked into more thoroughly, in order to find a way to enable Haiti to settle the arrears promptly. He noted that the mission could be a success, given the fact that the authorities had recently taken a number of economic adjustment measures. In addition, the authorities' willingness to maintain a close relationship with the Fund was encouraging.

He could support Mr. Kafka's proposed amendment of the decision, if it could be agreed that the Board should hold an informal discussion on Haiti's overdue financial obligations soon after the return of the staff mission in March, Mr. Goos commented. That kind of meeting would serve the purpose of keeping Directors up to date on recent developments in the country.

Mr. Jarvis commented that Haiti was currently facing a very serious situation. The Government's control over the main economic instruments, particularly over revenue collection, appeared limited, and reserves were at a critically low level. Accordingly, further external debt payments would entail a decline in imports. In those circumstances, the first requirement was to re-establish economic stability. The authorities would have to regain control over fiscal policy and ensure that exports were maintained, as they were likely to become Haiti's lifeline. In the longer term, it was clear that to facilitate external financing that would be needed to promote further development, the authorities would have to make efforts to avoid falling further into arrears, especially to the Fund. In that context, he welcomed the recent payments made by Haiti.

Table 2 in the staff paper (EBS/89/4, 1/13/89) presented an interesting picture of payment indicators, which might offer a glimmer of encouragement to the authorities, Mr. Jarvis noted. Until end-1988, Haiti had made quite substantial payments over a two-year period; however, Attachment III of the staff paper showed that payments to the Fund would, in the normal course of events, be much lower in future years. He suggested that information on payments to other creditors by a member with arrears to the Fund should be provided in future staff papers. According to the staff paper, the Fund was the largest of Haiti's creditors and, accordingly, the fall-off in debt service payments to the Fund should be translated into a significant improvement in Haiti's external position. As Haiti's obligations in future years were relatively small compared with both exports and payments in previous years, it would be particularly unfortunate if Haiti ruined the prospect of future use of Fund resources by allowing arrears to build up. Therefore, he urged the authorities to remain current on charges and clear promptly their arrears to the Fund. The staff should keep open lines of discussion with the authorities, and explore the possibility of setting up a Fund-supported program once the arrears had been cleared.

Finally, Mr. Jarvis said that he supported the proposed amendment to the decision, extending the proposed review period from three to four months.

Mrs. Ploix said that she regretted Haiti's nonobservance of its financial obligations to the Fund. As a first step toward establishing a confident relationship with the international financial community, she urged the authorities to clear their arrears to the Fund. The recent developments in Haiti's external position were worrisome; further external debt payments would entail a decline in imports. Haiti should give top priority to meeting its obligations to the Fund, especially since the arrears were still relatively small. In addition, every effort to settle the arrears would convey positive signals to other potential donors, and Haiti would then be able to benefit from a comprehensive Fund-supported program. She supported Mr. Kafka's proposal to extend the next review period from three to four months.

Mr. Warner said that he wanted to emphasize that his chair had taken a very firm view on preventing the emergence of arrears. However, he could agree with the proposal to extend the review period from three to four months, given that the Board would hold an informal discussion on Haiti's overdue obligations soon after the return of the staff mission in March.

Mr. Adachi expressed understanding of the current situation in Haiti, which partly stemmed from its political instabilities in the country. He also recognized the serious efforts that the authorities had made to repay the Fund in October 1988. In addition, it was encouraging that the authorities seemed to be willing to cooperate with the Fund. However, Haiti had again been unable to meet its obligations to the Fund, and he urged the authorities to adopt swift and appropriate actions to improve the situation in the country. He supported the proposed decision, with Mr. Kafka's and Mr. Goos's proposed amendments.

Mr. McCormack noted Haiti's extremely difficult situation. The authorities had made a number of promising policy efforts, and they seemed willing to cooperate with the Fund. He welcomed the recent payments, as well as the fact that the arrears had been cleared after the Managing Director's report and complaint under Rule K-1 in October 1988. He supported Mr. Kafka's and Mr. Goos's proposed amendments of the decision.

Mr. Fogelholm said that in light of Mr. Kafka's proposed amendment to the draft decision, extending the proposed review period from three to four months, he wanted to remind Directors of their general agreement, at a previous discussion of overdue financial obligations to prevent new arrears cases from emerging. Haiti's arrears to the Fund were still relatively small, and could be cleared promptly. In that connection, had the staff studied any other formalized ways of dealing with arrears that were on a very small scale?

The staff representative from the Western Hemisphere Department said that Haiti had no overdue obligations to the World Bank or the Inter-American Development Bank. In addition to the overdue financial obligations to the Fund, Haiti was in arrears to bilateral creditors, including Argentina and the United States, as well as private creditors in an amount equivalent to about $16 million in December 1988.

A staff mission would visit Port-au-Prince in early March for the 1989 Article IV consultation discussion, and to help develop a strategy for solving the problem of arrears, as well as the problems with respect to the balance of payments and domestic imbalances the staff representative commented. In that context, the Fund staff had been in close contact with the World Bank staff, discussing the possible approach to be followed. Haiti was in a very difficult situation, especially since slippages in policy had occurred in the recent past.

As to the timing of the mission and the preparation of the staff report, it seemed appropriate to extend the proposed review period from three to four months, the staff representative from the Western Hemisphere Department remarked. In addition, it would certainly be possible for the staff to prepare an oral report on the current situation in Haiti soon after the return of the staff mission in March.

The Chairman remarked that prompt action would be needed to ensure that Haiti would meet its overdue financial obligations to the Fund. He recognized the difficult situation currently facing the Haitian authorities, but he was confident that the Fund, in collaboration with the World Bank, could develop an appropriate strategy to solve Haiti's arrears problems.

The Executive Board then took the following decision:

1. On January 13, 1989, the Managing Director submitted a report and complaint to the Executive Board (EBS/89/4), under Rule K-1 of the Fund's Rules and Regulations, setting out the facts on the basis of which it appeared to him as of the date of this report that Haiti was not fulfilling its obligations under the Articles of Agreement. The complaint under Rule K-1 was that as of January 9, 1989 Haiti was not fulfilling its obligations relating to repurchases and the payment of charges in the General Department in the total amount of SDR 4,225,569. These facts and the complaint of the Managing Director were noted by the Executive Board on January 23, 1989 and communicated to the authorities of Haiti on January 25, 1989.

2. Having considered the report and complaint of the Managing Director and the views of Haiti, the Fund finds that Haiti has failed to fulfill its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Department.

3. The Fund regrets the nonobservance by Haiti of its financial obligations, urges Haiti to give these obligations the highest priority and to resume their observance forthwith, and decides, pursuant to Rule K-2 of the Fund's Rules and Regulations, that Haiti shall not make use of the general resources of the Fund until such time as Haiti has become current in its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Department.

4. The Fund shall review the matter of Haiti's overdue financial obligations to the Fund at the time of the 1989 Article IV consultation with Haiti or within a period of four months from the date of this decision, whichever is earlier.

Decision No. 9078-(89/16), adopted
February 15, 1989

3. PROPOSAL FOR ADMINISTERED ACCOUNT - JAPAN

Mr. Yamazaki made the following statement:

I would like to share informally with you a proposal that my authorities would like to make to facilitate Japan's participation in the intensified collaborative approach to the resolution of arrears.

My authorities would like to request that the Fund establish an account for the administration of resources to be provided by Japan in order to assist countries with overdue obligations to the Fund in the context of the intensified collaborative approach. Japan would place resources in the account, which would be disbursed in the form of grants at Japan's instruction to help provide financing necessary for the implementation of adjustment policies under a program endorsed and monitored by the Fund.

As I stated on previous occasions, my authorities have strongly supported the intensified collaborative approach endorsed by the Interim Committee. In the communiqué of the Interim Committee, it was stated: "Intensified collaboration will need to involve coordinated assistance, provision of bilateral financing to members that undertake strong programs of economic reform...." However, as I have already noted on previous occasions, given the current Japanese institutional and budgetary arrangements, it is extremely difficult for Japan to extend bilateral assistance to countries with overdue obligations to the Fund. Thus, we have made every effort to find a way to extend financial assistance to the extent that it is necessary and desirable to support the adjustment effort of the countries in arrears to the Fund that are cooperating under the intensified collaborative approach. The only solution was to provide such assistance outside the existing channels for bilateral aid. Under Japan's current institutional arrangements, however, assistance outside the existing channels could not be directed to sovereign governments. Therefore, we concluded that we had no alternative but to make an arrangement for an account to administer resources provided by Japan in order to facilitate Japan's participation in the intensified collaborative approach.

We propose that the account be administered in accordance with the Articles of Agreement, the By-Laws, and the Fund's existing policies and practices. I have discussed this issue with management and staff, and understand that a modality could be found that would satisfy the needs of my authorities while strictly observing the Fund's existing policies and practices. This would be basically similar to administered accounts that have been established in other cases. Thus, provided that you find no major difficulties with the thrust of the proposal, I would ask the Managing Director to circulate a paper and a proposed instrument for Board approval very soon.

Before concluding, I should like to convey my authorities' hope that this account can be established by the middle of next month, so that the first installment of resources could be placed in the account within the fiscal year which ends in March.

The Chairman stated that the matter of Japan's contribution to the intensified collaborative approach to the resolution of the problem of arrears to the Fund was relevant to the discussion on that subject, which was to be held shortly (EBM/89/18 and EBM/89/19, 2/17/89).

It was his understanding, based on what Mr. Yamazaki had outlined, the Chairman went on, first, that Japan was prepared to extend grants to countries with overdue obligations to the Fund in the context of the intensified collaborative approach. Those funds would be disbursed to recipient countries to help finance the shadow programs endorsed and monitored by the Fund.

Second, the Chairman continued, the funds for that purpose were included in the Japanese budget proposal for the fiscal year ending in March. The internal institutional arrangements in Japan were such that those funds could not be channeled directly to sovereign governments. It was thus necessary for Japan to make those resources available in other ways, and the authorities believed that an administered account established with the Fund would serve that purpose. From the operational perspective, Japan would decide when and how much to place in the account, and to whom, how much, and when the funds would be disbursed from the account.

Japan would work with other countries in coordinating assistance to the country concerned, the Chairman observed. In essence, the arrangement would be similar to the bilateral assistance other countries would extend in the context of the intensified collaborative strategy. In that light, the account would have no implications for the Fund or for Fund policies, except, indeed, in relation to the important fact that the arrangement was a contribution to the resolution of the very difficult problem of arrears, and was thus especially welcome.

From the management side, the Chairman concluded, the administration of the account would be essentially the same as that of other administered accounts in terms of accounting, reporting, financial statements, audits, the separation of assets, and other matters.

Mr. Goos stated that the Japanese proposal was worth looking into, as it would serve a good purpose. He wondered if the Japanese authorities had in mind any specific amount of resources they intended to deposit to the account before the beginning of their new fiscal year.

Mr. Yamazaki replied that his authorities intended to place resources to the account from time to time, but no amount had been predetermined. At the time the Board discussed the proposal formally, the Japanese authorities would address the question of the amount of the initial contribution. It was necessary, for internal institutional reasons, for the Japanese authorities to make the first payment before the end of their current fiscal year, which ended on the last day of March. The amounts that would be placed to the account constituted part of the Japanese supplemental budget, which was currently under consideration.

Mr. Warner stated that he was impressed with the innovative initiative the Japanese authorities were proposing. He wished to reserve final judgment on the matter until he had had an opportunity to examine the details--which he trusted would be laid out fully in the explanatory formal paper the staff would be preparing. Nevertheless, he believed that all Directors could acknowledge the timely and constructive character of the proposal. There was the prospect that the funds that Japan would be making available would be some of the most effective monies to support groups of countries under the intensified collaborative approach, because they could be disbursed quickly. He looked forward to reviewing the staff's paper on the administered account.

Mr. McCormack stated that he wished to express his gratitude, as well as that of the countries in his constituency, to Mr. Yamazaki and the Japanese authorities for the proposed arrangement, which he was sure would be a valuable contribution to the intensified collaborative approach to the settlement of arrears to the Fund. The fact that the initiative was geared so explicitly to the support of adjustment programs within that framework was particularly welcome. As he understood it, the arrangement would be helpful in cases such as that of Guyana in helping to put the financing together in support of the adjustment effort, and particularly during the very difficult shadow program phase.

Mr. Jalan said that he wished to express his appreciation for the innovative proposal outlined by Mr. Yamazaki. He presumed that the grants that would be made available would have no bearing on the terms of Fund assistance, and that disbursements would be made available, and unrelated to any project financing.

Mr. Yamazaki confirmed that the resources that would be made available would be unrelated to projects. He wished to restate that the monies would be extended in the form of a grant--not a loan--to those countries with Fund arrears which were undertaking adjustment programs monitored by the Fund in the context of the intensified collaborative approach.

Mr. Fogelholm stated that he wished to join other speakers in welcoming the Japanese initiative. He wondered if the grants could be extended only in conjunction with a Fund-monitored shadow program, or under other circumstances as well. For example, the Board had just reviewed the case of Haiti's overdue financial obligations, which were not protracted, and the total amount of which was relatively small. Perhaps in a case like Haiti, the grants could be used to clear arrears at a very early stage.

Mr. Yamazaki confirmed that that might be worth considering. At present, the institutional and budgetary arrangements in Japan made it difficult for the authorities to extend bilateral assistance to countries with overdue financial obligations to the Fund. Consequently, the authorities wished to lend their assistance outside of existing channels, through the administered account in the Fund. Once the arrears were cleared, the existing channels of bilateral assistance could be employed once again.

Mr. El Kogali said that he welcomed the Japanese initiative. He wondered if other creditors in the Group of Seven intended to establish similar arrangements with the Fund.

Mr. Yamazaki said that his Japanese authorities did not intend to request other G-7 countries to establish similar arrangements--although, of course, such arrangements would be welcomed.

The supplemental budget to which he had referred earlier, which would contain the funds for the administered account, was currently being deliberated by the Diet, which was a difficult process, Mr. Yamazaki explained. Once that budget was approved, very quick action would be needed before the end of March to place the monies in the account, otherwise all rights to use the funds in that way would be lost. In that connection, he hoped that the Board's consideration of the matter might be expedited, so that once the funds were approved--which he believed might happen by the middle of March--the mechanics of the account within the Fund would have been established.

Other countries did not have the administrative obstacles facing the Japanese authorities, and so were free to make direct loans to countries in arrears, Mr. Yamazaki noted. There were also many other ways countries could contribute to the intensified collaborative approach to the resolution of arrears. Although he would naturally welcome all such contributions, his own focus had to be, as was that of his authorities, on the Japanese contribution that was being arranged, because of the time constraints that affected it.

Mr. Goos observed that the administered account represented an attempt by the Fund to overcome the administrative obstacles to contributing to the intensified collaborative approach that the Japanese authorities faced. The matter of other countries making the same kind of contribution was not an issue, in his view. A number of countries had already indicated that they were willing to participate in that approach--in the case of Guyana, for example--through bilateral contributions, which needed to be borne in mind.

Mr. Filosa stated that he joined other speakers in welcoming the Japanese proposal. The operational and legal details of the administered account would obviously need to be examined by the Board before it reached a final evaluation. He shared Mr. Fogelholm's question about the possibility of early disbursement of the grants from the account. In any case, the proposal appeared to be an entirely appropriate response to the administrative obstacles faced by the Japanese authorities, and he especially welcomed it in that light.

The Chairman noted that Directors, while reserving their judgment for the formal discussion of the upcoming staff paper, had no difficulties with the thrust of Mr. Yamazaki's proposal, and indeed welcomed it as a gesture of support for the Fund, and as a way in which Japan could help the Fund in eliminating arrears as rapidly as possible in the context of the collaborative approach that had been agreed by the Interim Committee.

He understood that there was some urgency, because of the Japanese parliamentary calendar, to establish the account and have funds placed to it before the end of March 1989, the Chairman went on. An expeditious consideration of the matter by the Fund would facilitate the deliberations in Japan. It might also facilitate Japan's contribution in the context of the support group that was being established for Guyana, and for other similar cases in the future.

He thanked Mr. Yamazaki for his proposal and for his personal efforts, the Chairman concluded. He wished to assure him that the staff would circulate a short paper on the proposed account to the Board as soon as possible to seek the Board's formal authorization, in order to meet the time constraints of the Japanese authorities (see EBM/89/27, 3/3/89).

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/15 (2/13/89) and EBM/89/16 (2/15/89).

4. WESTERN SAMOA - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1988 ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 1988 Article XIV consultation with Western Samoa, in the light of the staff report on the 1988 interim Article IV consultation discussions with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Western Samoa's exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions described in SM/89/27, which are maintained in accordance with Article XIV, Section 2. The Fund encourages Western Samoa to administer these restrictions in a liberal manner and to eliminate them as soon as possible.

Decision No. 9079-(89/16), adopted February 14, 1989

5. URUGUAY - TECHNICAL ASSISTANCE

In response to a request from the Uruguayan authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/89/37 (2/8/89).

Adopted February 13, 1989

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/41 (2/13/89) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/89/40 (2/13/89) is approved.

APPROVED: August 18, 1989

LEO VAN HOUTVEN
Secretary