

EBS/86/230

CONFIDENTIAL

October 10, 1986

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of China - Staff Report for the 1986
Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with China and its request for a stand-by arrangement equivalent to SDR 597.725 million, which is proposed to be brought to the agenda for discussion on Friday, November 7, 1986. Draft decisions appear on page 26.

Mr. Saito (ext. 7365) or Mr. Fetherston (ext. 8761) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

CHINA

Staff Report for the 1986 Article IV Consultation and
Request for Stand-By Arrangement

Prepared by the Asian and Exchange and Trade
Relations Departments

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

Approved by P. R. Narvekar and Eduard Brau

October 9, 1986

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I. Introduction

The 1986 Article IV consultation discussions with China were held in Beijing from June 23-July 9 and September 10-15, 1986. The staff team ^{1/} also negotiated an economic program in support of which China has requested a first credit tranche stand-by arrangement with the Fund. The Chinese representatives included Mr. Liu Hongru, Deputy Governor of the People's Bank of China, Mr. Li Peng, Vice Minister of Finance, and Mr. Gan Ziyu, Vice Minister, State Planning Commission, as well as officials of the following organizations: the People's Bank of China; the Ministries of Finance, Foreign Affairs, Foreign Economic Relations and Trade, Commerce, and Labor and Personnel; the State Commission on Restructuring the Economic System, the State Planning Commission, the State Economic Commission, the State Statistical Bureau, the State Price Bureau, the Office of Special Economic Zones, the Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, and the People's Construction Bank. The staff representatives also met with Mme. Chen Muhua, Governor of the People's Bank of China and member of the State Council. Mr. Huang Fanzhang, Executive Director for China, participated as an observer. China continues to avail itself of the transitional provisions of Article XIV.

Since late 1985, the staff has visited China on several occasions to discuss with the authorities various aspects of macroeconomic policy formulation, including medium-term balance of payments analysis, external debt management, financial programming and monetary policy instruments, and indicators of export competitiveness. These discussions provided a technical base for the formal program negotiations.

In support of the economic adjustment program for 1986-87, which is described in the attached letter and annexed Memorandum on Economic Policies from the Governor of the People's Bank of China dated October 3, 1986, the Government of China has requested a first credit tranche stand-by arrangement for one year in an amount of SDR 597.725 million, equivalent to 25 percent of quota. The stand-by arrangement would be financed from ordinary resources. The full amount of the proposed arrangement would be made available upon Executive Board approval of the request.

China purchased SDR 450 million under a first credit tranche stand-by arrangement in March 1981; the full amount was repurchased by August 1983 (Annex I). A disbursement of SDR 309.5 million was made to China

^{1/} For the June-July discussions, Mr. Saito (ASD), Ms. Kelly (ETR), Mr. Fetherston (ASD), Ms. Tseng (ASD), Mr. Williamson (RES), Ms. Wallich (IBRD), and Miss Yeong (ADM). Mr. Narvekar (ASD) participated in the last few days of discussions. The September staff team comprised Mr. Saito, Ms. Kelly, Mr. Fetherston, and Mrs. Duffield-Sorkowitz (ETR).

from the Trust Fund, also in March 1981. Following the first repayment which fell due at end-September 1986, China's outstanding obligations to the Trust Fund amounted to SDR 278.57 million. The Chinese authorities have indicated their intention not to avail themselves of the structural adjustment facility.

II. Background

The Chinese economy has undergone dramatic change in recent years. Since 1979, a series of reforms have been implemented in agriculture and then in industry, considerably expanding the decision-making autonomy of individuals and enterprises and reducing the extent of direct state intervention in economic activity (Chart 1). The reforms were associated with a remarkable output performance (growth of GDP averaged 9 percent per annum during 1979-85) and a sustained improvement in living standards.

While the reforms gave the economy greater dynamism, they also posed new problems of economic management. Direct planning controls, formerly the mainstay of economic regulation, were reduced in scope, creating the need to establish a new framework of indirect economic management based on macroeconomic instruments and price mechanisms. Reflecting the novel and difficult nature of this task, the period since the beginning of reforms has been marked by sharp swings in China's external position. A large external deficit first emerged in 1979-80, largely on account of an ambitious program of budget-financed investment. The authorities responded in early 1981 by implementing a stabilization program which was supported by the first credit tranche stand-by arrangement referred to earlier. The program featured sharp cutbacks in budgetary investment and its implementation was followed by large balance of payments surpluses in 1982 and 1983.

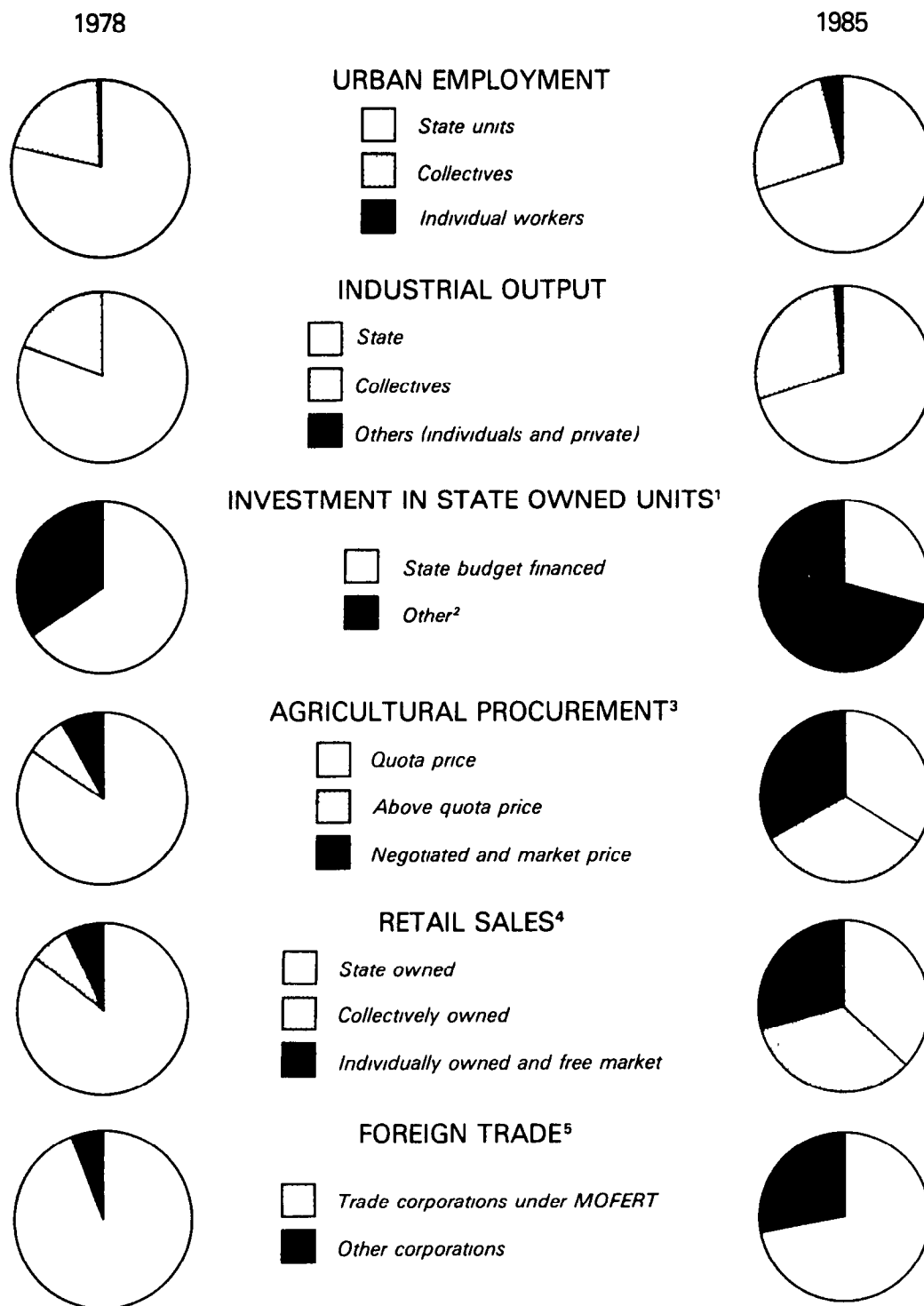
The external position began to deteriorate again in mid-1984. During that year, the focus of reforms shifted to the urban economy: enterprises were granted increased autonomy, exchange and trade restrictions were eased, and the People's Bank of China (PBC) was transformed into a separate central bank with responsibility for macroeconomic management. With the tools for this new system of economic management still in the process of development, the increased freedom granted to enterprises under the reforms contributed to buoyant economic activity and increasingly strong demand pressures, as the growth of money and credit accelerated dramatically to over 40 percent. Imports rose sharply, and the current account of the balance of payments shifted into deficit in the second half of 1984.

These trends persisted into 1985 (Chart 2). Domestic demand and output continued to rise sharply, with the growth of industrial production exceeding 20 percent in the first half of the year. Retail price increases also accelerated, partly on account of reform-related adjustments. In the external sector, the current account deficit

CHART 1

CHINA

ECONOMIC REFORMS: SELECTED INDICATORS



Source: State Statistical Bureau

¹ Investment in capital construction and equipment renewal and technical transformation

² Extrabudgetary funds of enterprises, local governments, and domestic bank credit

³ Data for 1984 shown instead of 1985

⁴ Includes sales on free market to both rural and urban residents

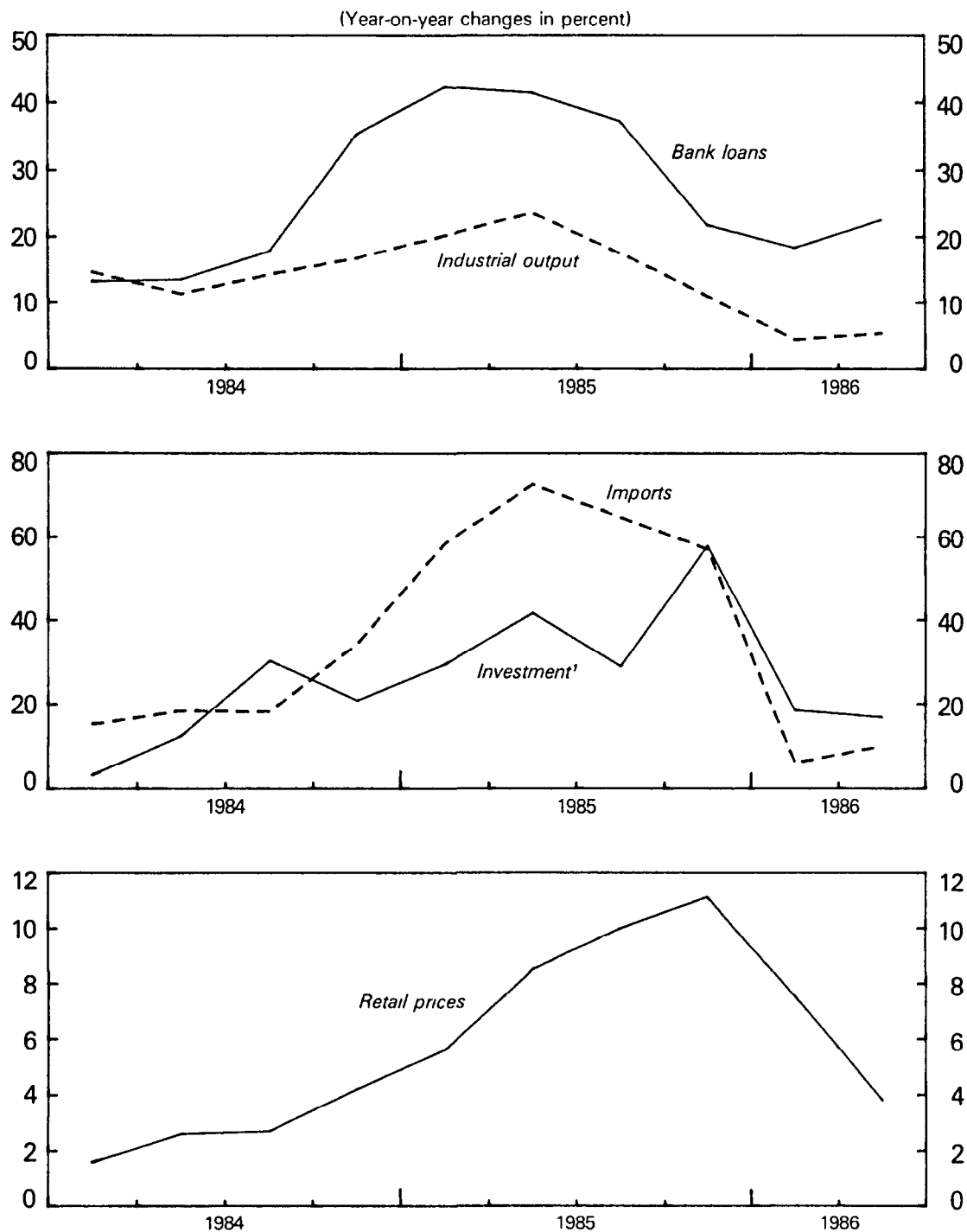
⁵ Exports and imports, data for 1980 shown instead of 1978

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CHART 2
CHINA
QUARTERLY INDICATORS OF DEMAND, OUTPUT,
AND PRICES, 1984-86



Sources: State Statistical Bureau, and People's Bank of China
¹Fixed investment by state-owned units



widened further, international reserves continued to decline, and external debt began to increase rapidly.

The authorities responded to the emerging macroeconomic imbalances during 1985 with steps to strengthen economic management and policies. In particular, techniques of monetary control were improved, and the stance of domestic financial policies was tightened. A number of pricing measures, including interest rate and exchange rate adjustments, were put in place. At the same time, some more traditional administrative controls over wages and investment were utilized, and foreign exchange allocations and import restrictions were selectively tightened, notably for luxury consumer goods. These measures and their prospective impact on the external position formed the background for the last consultation discussions in 1985.

III. Developments Since the Last Consultation

1. The last consultation

During the last consultation in November 1985, Executive Directors emphasized the following four points:

- the authorities had been well advised to introduce corrective measures aimed at reducing demand and output expansion and stemming the sharp decline in international reserves. In the present circumstances of transition in the mode of economic management, it was understandable that these measures involved a mix of direct and indirect controls, but over time greater emphasis should be given to macroeconomic instruments as price and market mechanisms are strengthened;
- active use of demand management and exchange rate and pricing policies would be called for to strengthen the balance of payments and in particular to improve export performance;
- external borrowing policies should be cautious, supported by efforts to ensure that the proceeds of such borrowing are used productively;
- the authorities' evident commitment to the continuation of economic reforms was welcome and encouraging, as was their recognition of the key role of price reforms. Measures in this area would need to be complemented by efforts to increase the role of market mechanisms, strengthen financial discipline for state enterprises, and liberalize the foreign trade and exchange control systems.

2. Recent economic developments

Since the last consultation, the authorities have made additional efforts to reduce macroeconomic imbalances while continuing to implement economic reforms. The stabilization measures succeeded in substantially reducing the growth of domestic demand and output, and dampened inflationary pressures. The external current deficit began to improve in the first half of 1986, as a substantial strengthening in non-oil trade performance more than offset the effect of the decline in prices of China's oil exports.

Growth of real GDP, which was 13 1/2 percent in 1984, slowed to 12 percent in 1985, and decelerated significantly during the year as the stabilization measures took effect (Table 1). Industrial output growth declined from 23 percent in the first half of 1985 to about 5 percent in the first half of 1986 and has since picked up to about 7 percent. Agricultural output (including the rapidly expanding output of village industries) increased by 14 percent in 1985, although crop yields were adversely affected by a series of natural disasters (Appendix Table I); preliminary information for 1986 indicates a more encouraging picture for crop production, while growth of output of village industries has slowed from its earlier hectic pace. Retail price increases, which accelerated from 3 percent in 1984 to 9 percent in 1985, partly on account of adjustments in urban food prices, slowed considerably to about 5 percent in the first half of 1986, as demand pressures eased and efforts were made to strengthen enforcement of price controls.

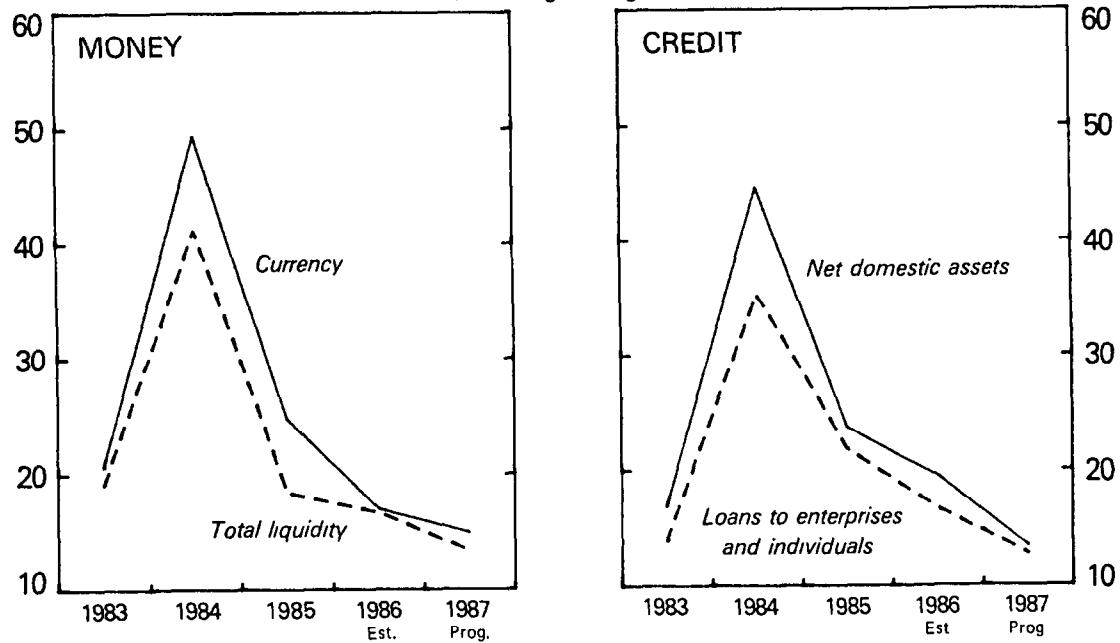
Consumption and investment demand, which had remained buoyant throughout most of 1985, began to moderate in the early part of 1986 as overall economic activity slowed. Growth of retail sales declined from 28 percent in 1985 to about 12 percent in the first half of 1986; over the same period, growth of investment by state-owned units moderated from 45 percent to 17 percent. The increase in wage payments remained about 20 percent on a year-on-year basis, largely reflecting the effects of adjustments made in mid-1985.

The expansion of money and credit was sharply reduced in 1985 following the dramatic expansion of late 1984 (Chart 3 and Appendix Tables II and III). Net domestic assets of the banking system increased by 24 percent, compared with 45 percent in 1984, and the growth of total liquidity declined from 41 percent to 18 percent. The slowdown in credit expansion largely reflected developments in loans to enterprises and households, on which ceilings were imposed for each of the specialized banks; also, the net position of the budget with the banking system strengthened during the year. The tighter stance of money and credit policies continued in the early months of 1986, but the economic slowdown which this stance had brought about led to pressures for credit expansion to finance enterprise losses and accumulation of unsalable inventories. As a result, growth of broad money on a year-on-year basis, after declining to 15 percent at end-March, picked up to 25 percent at end-June.

CHART 3 CHINA MONEY, CREDIT, AND STATE BUDGET

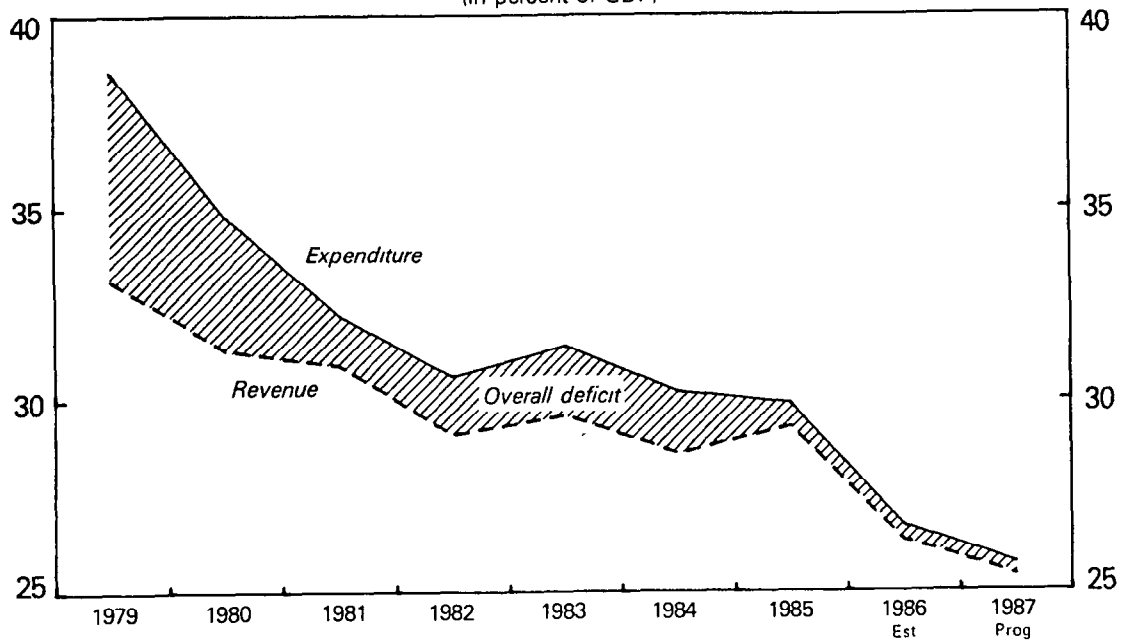
A. MONEY AND CREDIT, 1983-87

(Percentage changes)



B. STATE BUDGET, 1979-87¹

(In percent of GDP)



Sources: Appendix Tables II and IV, and Ministry of Finance.
¹On GFS basis

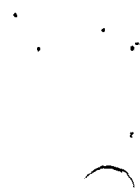


Table 1. China: Selected Economic Indicators, 1984-87

| | 1984 | 1985 | 1986 Est. | 1987 Program |
|--|--------|--------|---------------|-----------------|
| <u>(Changes, in percent)</u> | | | | |
| Real GDP | 13.5 | 12.3 | 6.5 | 6.0 |
| Agriculture <u>1/</u> | (17.1) | (14.2) | (6.0) | (...) |
| Industry <u>1/</u> | (14.0) | (18.0) | (7.1) | (...) |
| Retail prices | 2.8 | 8.8 | 5.5 | 7.0 |
| <u>(In percent of GDP)</u> | | | | |
| Investment | 33.5 | 38.5 | 37.5 | 35.9 |
| Savings | 34.2 | 33.9 | 33.4 | 33.5 |
| External current balance | 0.9 | -4.5 | -4.0 | -2.3 |
| Overall budgetary balance <u>2/</u> | -1.6 | -0.5 | -0.4 | -0.3 |
| <u>(Changes, in percent)</u> | | | | |
| Budgetary revenue <u>2/</u> | 15.1 | 24.4 | 0.8 | 9.5 |
| Budgetary expenditures <u>2/</u> | 14.8 | 19.8 | 0.6 | 9.2 |
| Net domestic assets | 44.6 | 23.6 | 19.4 | 13.5 |
| (loans) | (35.3) | (21.8) | (16.7) | (12.8) |
| Total liquidity | 41.2 | 18.4 | 16.7 | 13.4 |
| (currency) | (49.4) | (24.7) | (17.0) | (15.0) |
| Exports | 15.4 | 5.0 | 12.0 | 9.3 |
| Imports | 27.6 | 60.0 | 0.8 | -5.2 |
| <u>(In billions of U.S. dollars)</u> | | | | |
| Current account balance | 2.5 | -11.9 | -10.0 | -5.6 |
| Exports | 23.9 | 25.1 | 28.1 | 31.9 |
| Imports | -23.9 | -38.2 | -38.5 | -37.7 |
| Services and transfers (net) | 2.5 | 1.2 | 0.4 | 0.2 |
| Capital account balance | | | | |
| (Including errors and omissions) | -0.7 | 7.3 | 8.1 | 6.9 |
| Net external borrowing | 1.4 | 7.4 | 7.3 | 6.4 |
| Of which: Borrowing from commercial banks (net) | 0.2 | 5.9 | 3.0 | 2.8 |
| Other | -2.1 | -0.1 | 0.8 | 0.5 |
| Change in reserves | 1.8 | -4.6 | -1.9 | 1.3 |
| Gross reserves | 17.8 | 13.2 | 12.0 | 13.3 |
| (In months of imports) | (8.9) | (4.1) | (3.7) | (4.3) |
| State foreign exchange | 8.2 | 2.6 | ... | ... |
| External debt <u>3/</u> | 12.1 | 19.9 | 27.2 | 33.6 |
| Short-term debt (as percent of gross reserves) | 31.5 | 68.2 | 59.4 | 57.4 |
| Debt service ratio (as percent of exports of goods and services) | 3.9 | 7.2 | 7.6 | 6.9 |
| Exchange rate at end period (yuan per U.S. dollar) | 2.8 | 3.2 | 3.7 <u>4/</u> | ... |

Source: Appendix Tables I-VIII.

1/ Gross value of output.

2/ GFS definition.

3/ Fund staff estimates.

4/ As of September 30.

The overall deficit in the state budget was reduced from 1.6 percent of GDP in 1984 to 0.5 percent in 1985, reflecting a combination of a buoyant revenue performance and efforts to control expenditures (Chart 3 and Appendix Table IV). ^{1/} Financing through nonbank purchases of treasury bonds and from foreign sources was more than sufficient to cover the deficit, and the budget's position with the banking system improved. In the early months of 1986, revenue growth slowed as economic expansion moderated, while expenditure growth was sustained, particularly at local government level, by the carryover of funds arising from the buoyant revenues of the previous year.

Following a surplus of \$2.5 billion (0.9 percent of GDP) in 1984, the external current account recorded a deficit of almost \$12 billion (4.4 percent of GDP) in 1985 (Charts 4 and 5). Reflecting rapid expansion of domestic credit in late 1984 and liberalization of trade and exchange restrictions, as well as the absence of strict controls on external borrowing, imports rose by 60 percent. Export growth was only 5 percent, entirely on account of oil and other primary products; manufactured exports, hampered by earlier losses in competitiveness, registered a decline in both value and volume.

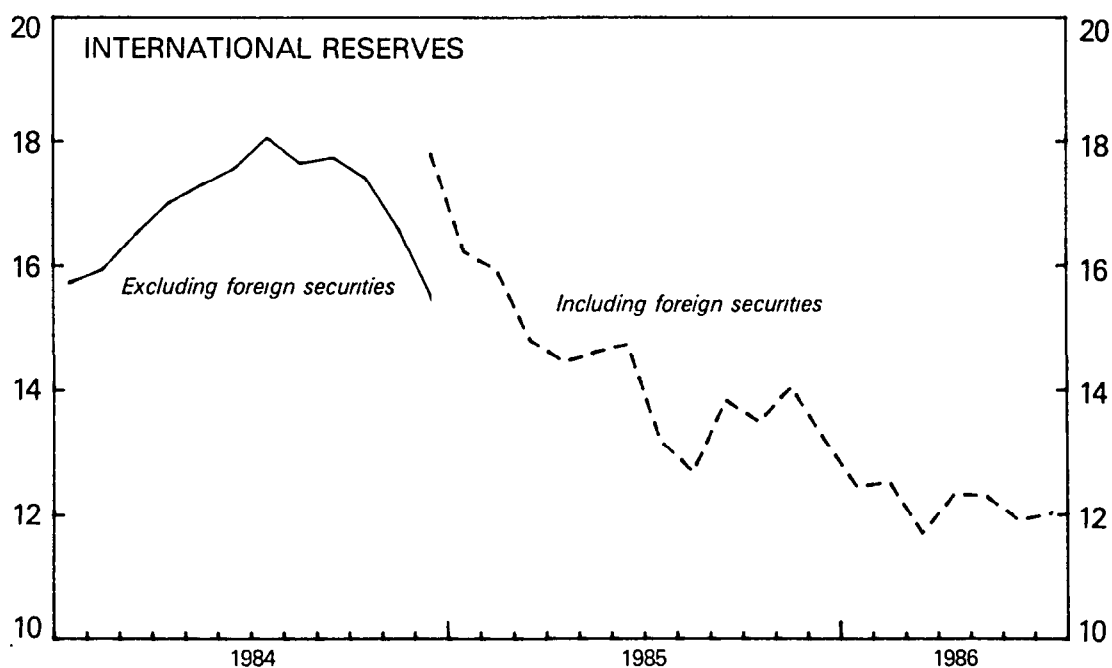
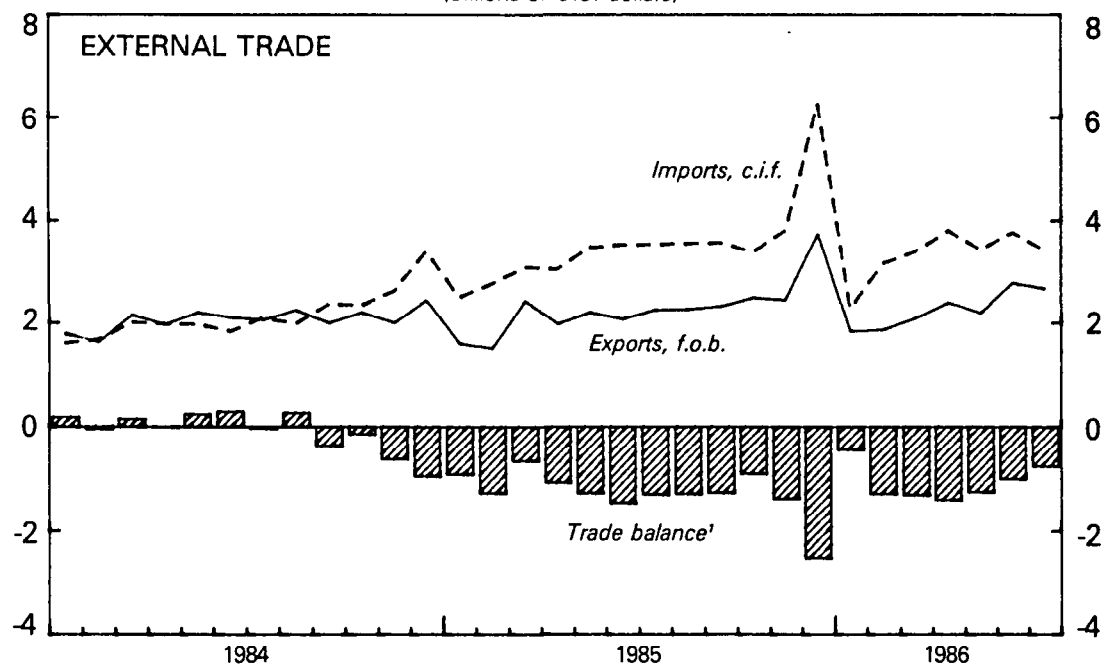
The current account position began to improve in the first half of 1986. Import expansion slowed sharply to about 9 percent, reflecting the earlier adjustment measures, stricter control on foreign short-term borrowing, and the slowdown in output growth, while growth of export earnings picked up to 14 percent, as a substantial improvement in non-oil export performance more than offset the effects of lower oil export prices. Consequently, the current account deficit narrowed to an estimated \$4 ½ billion in the first half of the year.

Financing for the large external deficit in 1985 was provided by a combination of reserve drawdown and borrowing. International reserves, which began to decline after July 1984, fell by \$4.6 billion to \$13.2 billion (4.1 months of imports) during 1985, and by a further \$1.2 billion to \$12.0 billion (3.7 months of imports) by end-July 1986. China's external debt is estimated by the staff to have increased from \$12.1 billion at end-1984 to \$19.9 billion (7.5 percent of GDP and

^{1/} The presentation of fiscal policies in this report is based on GFS concepts of revenue, expenditure, and the overall deficit as defined in the Fund's Manual on Government Finance Statistics. The statements in the annexed memorandum on economic policies are presented in terms of national definitions according to which certain subsidies are netted against revenue, rather than treated as expenditure items, and external and domestic nonbank borrowing are treated as revenue rather than financing, with repayment of such borrowing treated as expenditure; the national definition of the budgetary balance corresponds to net bank borrowing. A detailed reconciliation of national and GFS definitions is contained in the accompanying paper on Recent Economic Developments, to be issued shortly.

CHART 4
CHINA
EXTERNAL TRADE AND INTERNATIONAL RESERVES,
1984-86

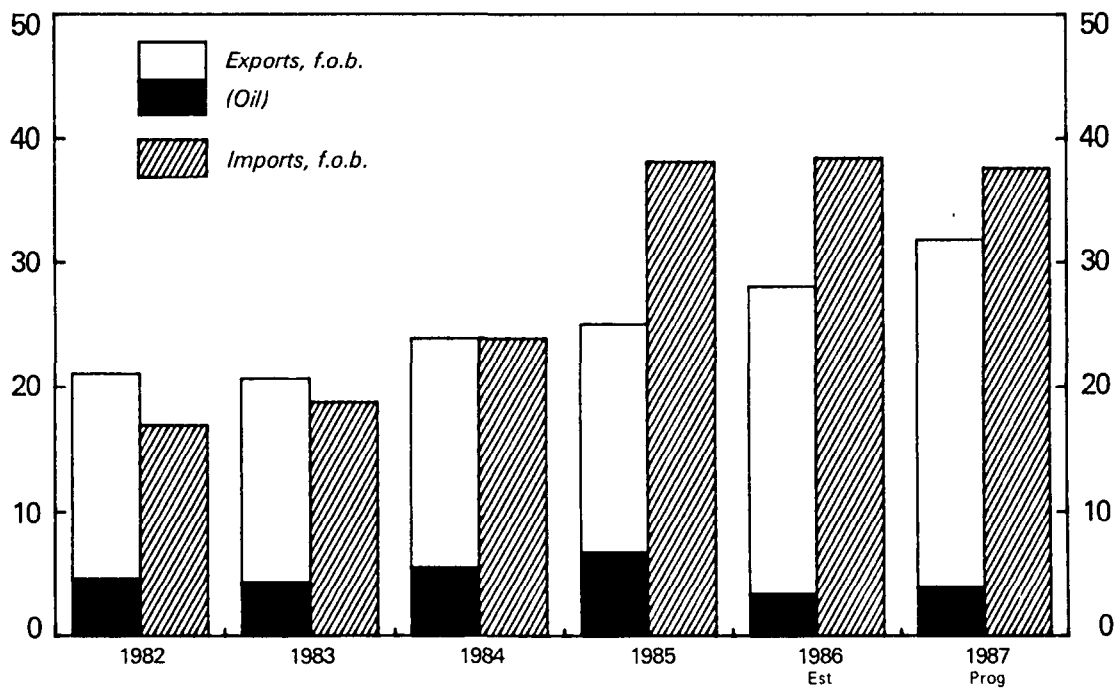
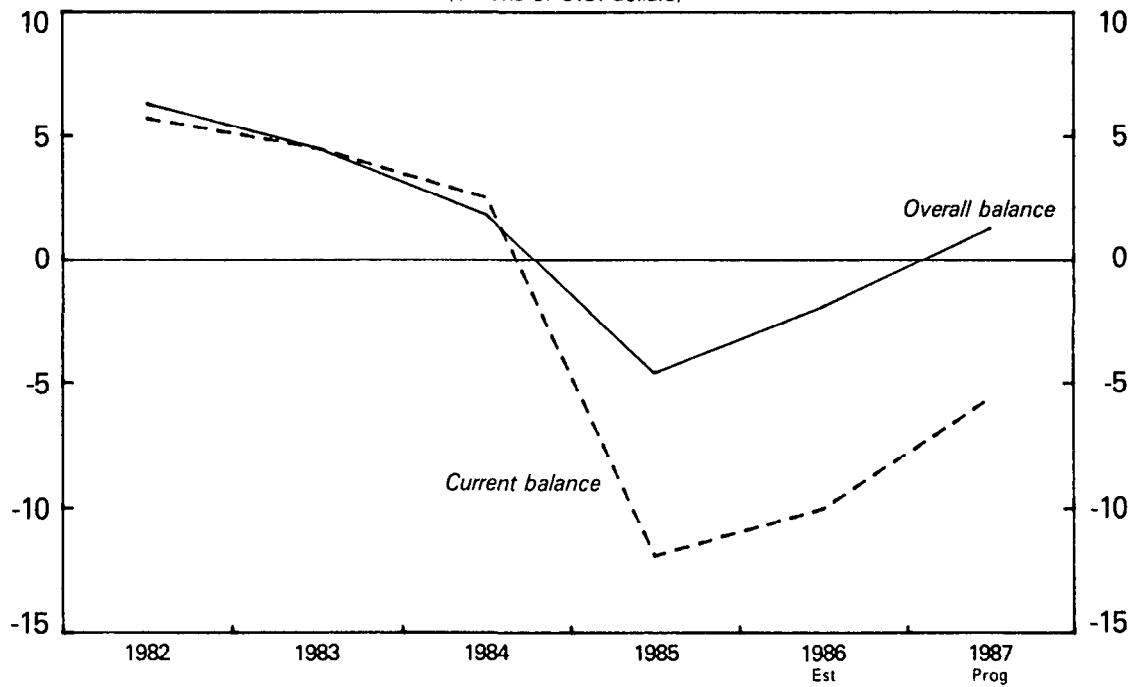
(Billions of U.S. dollars)



Sources: Customs Administration, and State Administration of Exchange Control

¹On the basis of imports measured c.i.f.

CHART 5
CHINA
BALANCE OF PAYMENTS, 1982-87
(Billions of U.S. dollars)



Source: Appendix Table VI.

67 percent of exports of goods and services) at end-1985. The new borrowing was largely on commercial terms, and a sizable proportion was of short maturity, the latter accounting for almost half of the outstanding stock of debt at the end of the year. The debt service ratio is estimated by the staff to have risen from 4 percent of exports of goods and services in 1984 to about 7 percent in 1985. During the first half of 1986 the structure of debt improved, with relatively greater recourse to concessional borrowing from bilateral and multi-lateral sources and a significant reduction in the Bank of China's short-term liabilities.

IV. Report on Discussions and the 1986-87 Economic Program

The policy discussions focused on the additional measures needed to strengthen China's external position while maintaining the thrust of economic reforms and promoting sustainable output growth. The authorities appreciate the urgency of this task and have recently implemented important policy actions relating to the exchange rate, interest rates, and external debt management. These actions form part of a comprehensive economic and financial program which was discussed with the staff team as a basis for Fund support with a first credit tranche stand-by arrangement.

The reforms of recent years have radically changed the nature of China's system of economic management. The reduced scope of planning controls and the greater autonomy provided to households and enterprises have lessened the effectiveness of the traditional system of economic regulation through direct methods. In its place, the authorities are developing a new framework of economic management in which the emphasis of economic policy would shift to regulating the supply of financing available to the economy and on establishing appropriate price and market mechanisms to guide household and enterprise behavior. The authorities are keenly aware of the importance of this task, and have assigned it high priority within the Seventh Five-Year Plan (1986-90). For the period immediately ahead, the authorities place strong emphasis on strengthening macroeconomic management as the basis for further structural reforms that would promote continued growth.

1. Macroeconomic objectives and prospects for 1986 and 1987

a. Domestic economy

The Chinese representatives considered that the double-digit growth rates of 1984-85 could not be expected to continue. These high growth rates had exacerbated shortages and bottlenecks in the domestic economy, strengthened inflationary pressures, and contributed to an unsustainable deterioration in the balance of payments. Consequently, since early

1985, policies had been geared to slowing the pace of economic activity to a more reasonable rate and, as noted earlier, had already achieved considerable success.

The Seventh Five-Year Plan, which was approved by the National People's Congress in the spring of 1986, targets an average rate of GDP growth of 7.5 percent during 1986-90. The authorities stressed that, against the background of the macroeconomic imbalances which had emerged since late-1984, it was essential to be cautious on growth, and that for the time being priority needed to be given to stabilization. Output growth in the immediate future might therefore need to be lower than the targeted average of 7.5 percent as a sound financial foundation is laid for faster growth in the later years of the Plan period. Accordingly, the program sets the growth target for 1986 at 6 ½ percent, assuming some pickup in industrial output in the second half of the year and, in line with early indications, that the agricultural harvest would meet original expectations. For 1987, the target is set cautiously at about 6 percent. However, the authorities believed that actual growth could turn out to be higher--near the Plan target of 7.5 percent--and still be compatible with their external objectives; foreign trade is still not large in relation to China's economy, and the relationships between imports, investment, and output are changing rapidly under reforms.

The recent macroeconomic imbalances have been in large part a reflection of a boom in investment, especially outlays financed from sources outside the budget--i.e., from funds retained earlier by enterprises and local governments, and from domestic and external borrowing by enterprises. As a ratio to GDP, total investment rose by 7 ½ percentage points to 38 ½ percent between 1983 and 1985, while the aggregate savings ratio increased over the same period by 1 ½ percentage points to about 34 percent (Appendix Table V). The authorities consider the recent level of investment as unsustainable and indicative of the absence of adequate macroeconomic controls. Accordingly, their adjustment policies under the program aim to achieve a progressive reduction in the investment/GDP ratio (by about 2 ½ percentage points between 1985 and 1987) while maintaining the rate of saving close to its recent high level.

The objective of price stability remains a central one for the authorities. They emphasized the importance of stabilizing inflationary expectations after the experience of 1985, when retail prices rose by nearly 9 percent after many years of much lower rates. On their estimate, about 5 percentage points of that increase was attributable to price reform measures implemented in the spring of 1985. For 1986, their objective was to limit the average year-on-year rate of price increase--which would reflect the lagged impact of the 1985 reforms, together with the effect of the recent exchange rate adjustment--to the range of 5-6 percent. Prospects for 1987 depend in large part on the impact of further major price reforms which are expected to be

introduced early in the year, as well as the impact of exchange rate adjustment; the program for 1987 assumes a modest upturn in the average year-on-year rate of price increases to 7 percent.

b. Balance of payments and reserves

The principal immediate objective of the authorities' economic program is to secure a reduction in the external current account deficit to a level consistent with a viable external position over the medium term. Progress toward this objective is already underway, despite the adverse effects of the decline in oil export prices, as non-oil export performance has improved significantly in recent months while imports have levelled off. For 1986 as a whole, the current account deficit is projected to decline from \$11.9 billion in 1985 to \$10 billion (4.0 percent of GDP) in 1986 (Appendix Table VI). For 1987, the program targets a further reduction to \$5.6 billion (2.3 percent of GDP). The authorities regard a level of gross international reserves equivalent to four months of imports as the minimum which would be prudent and comfortable; accordingly, reserves are targeted to recover from \$12.0 billion (3.7 months of imports) projected for end-1986 to \$13.3 billion (4.3 months of imports) at end-1987.

2. Medium-term prospects

a. Seventh Five-Year Plan

The Seventh Five-Year Plan for the period 1986-90 sets out three general objectives: (i) to further improve living standards; (ii) to maintain economic growth; and (iii) to achieve a balance between social demand and supply and to lay the groundwork for a socialist economic structure with Chinese characteristics. Emphasis is also placed on maintaining balance in credit and finance, investment, and foreign exchange. Achievement of these objectives is to be based on further economic system reforms in three main areas: (i) greater financial responsibility for state enterprises; (ii) development of markets for goods, services, and capital, with associated price reforms; and (iii) the use of indirect methods of macroeconomic management in place of direct planning controls.

The principal quantitative objectives of the Seventh Plan include growth of gross domestic product at 7.5 percent. This rate, which is well below that of almost 10 percent recorded during the Sixth Plan period (1981-85), is considered by the authorities to be compatible with the likely availability of energy and raw material resources. In the external sector, export growth is planned to take place in non-oil commodities such as coal, non-ferrous metals, grain, and cotton, as well as manufactured goods such as machinery and electronic equipment; import

growth is planned to focus on raw materials, technology, and equipment. ^{1/} The Plan does not elaborate on details of the balance of payments or borrowing requirements over the 1986-90 period.

b. Medium-term balance of payments scenarios

Starting from the general framework provided by the Seventh Plan, the staff team prepared several scenarios as background for discussions on policies to ensure balance of payments viability over the medium term. Such scenarios are especially tentative in the case of China, because the relationships between output growth, investment, and import demand and between output and export supply are even more difficult to estimate than for most other countries.

A first scenario assumes that the policy stance adopted in the program for 1986-87 is maintained over the medium term. ^{2/} The key element in policy strategy under the scenario would be a strengthening of export performance, especially for non-oil products, so that China can establish a sound external position while at the same time securing the imports needed to sustain future economic growth. Policies to this end would include financial restraint--both domestic and external--together with further improvements in pricing and maintenance of external competitiveness. These policies would raise growth of non-oil export volume to about 7 percent per annum--compared with about 3-5 percent during 1983-85, and above the growth of demand in foreign markets; import volume growth, following a decline of 8 percent in 1986 and 7 percent in 1987, would be contained at 3 ½ percent per annum, compared with over 30 percent per annum during 1983-85. As a result, the current account deficit would be progressively reduced to 1 percent of GDP by 1990, net borrowing from commercial banks would not be required after 1987 and the proportion of short-term to total debt would decline from 45 percent in 1985 to about 20 percent in 1990. Total external debt would not exceed 17 percent of GDP and the debt service ratio could be limited to about 9 percent during the period to 1990 (Appendix Table VII).

An alternative scenario describes the case where no major policy adjustment is implemented initially; the relationships between output growth and imports, and between growth of foreign markets and China's exports would be about one-for-one over the medium term. Under this scenario, domestic economic activity and hence import volumes would grow

^{1/} Plan targets for exports (about 8 percent per annum) and imports (about 6 percent) are based on definitions employed by the Ministry of Foreign Economic Relations and Trade, which have significantly narrower coverage than Customs data, on which official balance of payments data and the staff's medium-term scenarios are based.

^{2/} For details of assumptions regarding the external environment, see Appendix Table VII.

at about twice the likely rate of growth of foreign markets and export volumes. As a result, the current deficit would widen substantially to 9 percent of GDP by 1990, a level that would clearly not be compatible with external payments viability; borrowing to finance such large deficits would lead to a rapid expansion of external debt to almost 40 percent of GDP and the debt service ratio would rise from the present 7 percent to as much as 25 percent. A third scenario explores the consequences of limiting external borrowing to manageable levels through sharply curtailing imports; on this scenario the external position would be viable, but only at the cost of sharp curtailment of growth to no more than about 1-2 percent per annum.

As it is exceptionally difficult to associate a given set of measures with precise quantitative results, the scenarios described in the preceding paragraphs can only provide broad implications for policies. In essence, the policy message is that the stance which the authorities have adopted for their 1986-87 economic program will need to be continued and implemented flexibly over the medium term. Flexibility in policy implementation will also be needed should the underlying assumptions regarding the external environment turn out to be overly optimistic. ^{1/}

3. Policies

The achievement of the short- and medium-term objectives described above requires substantial policy efforts, among which the key measures have already been put in place. In particular, the policy program features domestic financial restraint; control over external financing; and improvements in pricing policies, including the exchange rate and interest rate policies as well as other price reform measures.

a. Economic reforms and structural measures

During the last few years far-reaching reforms have been introduced, involving first agriculture and more recently the urban economy and financial system. The authorities are firmly committed to the continuation of reforms as the main avenue by which they will reach

^{1/} These scenarios are sensitive to changes in external assumptions. If nominal prices of oil remained unchanged during 1987-90, instead of increasing by 3 percent per annum, the current account deficit in 1990 would be higher by 0.5 percent of GDP (assuming unchanged imports) and the debt/GDP ratio would be higher by 1 percentage point. If, in addition, growth of world markets was 1 percentage point less than assumed, the deficit/GDP ratio in 1990 would be raised by 1.4 percentage points and the debt/GDP ratio by 3.2 percentage points. Finally, if LIBOR were 1 percent higher, the debt service ratio in 1990 would be raised by 0.5 percentage points and the debt/GDP ratio by 0.3 percentage points.

their long-term economic objectives, and indicated that significant new measures will be implemented in 1987, notably in the area of pricing policies.

(i) Price reform

The authorities recognize that in a more decentralized economic system, proper pricing policies are of prime importance in guiding economic behavior. Substantial progress has already been made in decontrolling food prices and permitting an increasing volume of enterprise transactions to be conducted outside the Plan at flexible prices. Improvements in the tax system since 1983, and more recent policy actions in the areas of the exchange rate and interest rates, are also expected to make a significant contribution to improving the allocation of resources. At the same time, the authorities are aware that much remains to be done to establish a price system that will meet the needs of a reformed economy. Areas which cause them particular concern are the low prices of energy and raw materials relative to manufactured goods, the large price subsidies on basic consumer goods, and the lack of adequate differentials for quality. The staff team shared these concerns, and also pointed to the benefits for resource allocation and exchange rate policy of increasing links between world and domestic prices of traded goods.

In light of the priority attached to price reform, the authorities are preparing a major package of new measures for implementation in early 1987. Details of this package are still being worked out, but it is likely to involve prices for selected key energy and raw materials and some consumer goods. Over the next few years, the authorities envisage the development of a system under which state price control remains only for a few principal activities, such as railways, aviation, posts, and electricity. For major raw materials and daily household necessities, prices would be free to float within a fixed margin around a basic price set each year by the State; for most manufactured goods, including less essential consumer items, prices will be set by market forces or by negotiation between buyer and seller.

(ii) Wages and employment

The authorities indicated that wage reform has an important role to play in securing improvements in productivity. To this end, wages in government institutions had since 1985 been more closely linked with job responsibilities and performance. Also, a sizable proportion of enterprises had introduced a new wage system which linked the total payroll with the enterprise's profitability. This new system would not, however, achieve optimum results until the arbitrary element in financial performance resulting from the present price structure had been removed through further price reforms.

During the last few years the authorities have experimented with fixed-term labor contracts in place of the traditional system of lifetime employment. The contract system has proved beneficial in fostering labor mobility and improved productivity, and is now being extended to cover most newly hired workers.

(iii) Enterprises

The decentralization of decision-making power under reforms has increased the responsibilities of enterprises and the extent of competition among them. These developments in turn raised the need to establish mechanisms to promote rational and disciplined enterprise behavior. In addition to proper price signals and functioning markets, these mechanisms would include effective disincentives for poor financial performance. In this connection; the possibility of bankruptcy as a sanction has been introduced in three cities on a trial basis, and draft legislation to establish bankruptcy procedures is under consideration by the National People's Congress. The authorities pointed out, however, that the concept of bankruptcy is an unfamiliar one in a socialist system and raises many complex and difficult issues which may take time to resolve. The staff team, while acknowledging these complexities, stressed that the new instruments of macroeconomic management which are being developed will only reach full effectiveness when enterprises are subject to greater financial discipline than has hitherto been the case.

As part of reforms, a significant portion of investment responsibilities has been decentralized from the budget to enterprises in recent years. The Chinese representatives pointed out, however, that so far improvements in enterprise financial discipline and in the price system had not yet reached a point where decentralized investment decisions were always soundly based. As a result, investment demand had tended to be excessive, and its composition did not always reflect social priorities or the most efficient use of funds. In the present transitional period of economic management, the authorities have therefore been following a pragmatic approach to the regulation of investment which entails a mix of traditional and new policy instruments. Most recently, new regulations announced in July include both prohibition of certain investments and a 30 percent penalty interest rate on loans financing investment projects which are not included in the Plan.

b. Domestic financial policies

(i) State budget

The state budget has undergone two major changes in recent years. First, the dominant role of the budget in resource allocation has been significantly reduced--expenditure declined from almost 40 percent of GDP in the late 1970s to below 30 percent in 1985--and the basis of revenue has been switched from remittance of all enterprise

profits to a system of corporate income taxation, both as part of reforms which provided greater financial autonomy to enterprises. Second, while implementing these reforms, the authorities reduced the overall fiscal deficit substantially from over 5 percent of GDP in 1979 to 0.5 percent by 1985.

The Chinese representatives indicated that the cautious approach of recent years would continue so that fiscal policies make an adequate contribution to the overall stabilization effort. At the same time, they felt that the scope for tightening of the fiscal stance was limited, as many of the reform measures which the authorities intend to introduce, while yielding long-term benefits, create uncertainties for fiscal prospects in the short term, and their cautious approach on output growth was adversely affecting revenues derived from enterprise profits. While acknowledging the impressive progress in budgetary performance during the 1980s, the staff representatives stressed the need to support external adjustment through further tightening the fiscal stance.

The budget for 1986 envisaged an overall deficit of Y 7 billion, or 0.8 percent of GDP. The authorities explained that in the first eight months revenue growth, compared to the corresponding period of 1985, was below the rate budgeted for the year as a whole, largely due to the slowdown in output growth and a corresponding weakening of the financial performance of enterprises. Growth of expenditure was somewhat above the rate budgeted for the year, partly reflecting the full-year impact of policy changes (income transfers to compensate for price increases, and wage adjustments for government employees) which were implemented in mid-1985; also, the buoyancy of revenues in 1985 had led to pressures to increase local government spending in the early part of 1986. Fiscal performance was expected to improve in the remaining months, reflecting the introduction of a number of measures introduced since July. These measures include limits on central administrative outlays and on expenditures of local governments, a freeze on local spending from revenues in excess of budgeted amounts, and cancellation or postponement of lower priority investment projects. On the revenue side, efforts are being made to improve tax collection and strengthen the financial performance of enterprises. With these measures, the authorities expect to achieve at least the budgeted overall position and hope, as in 1985, to reduce the deficit below the budgeted level, to about Y 3.5 billion (0.4 percent of GDP). Given anticipated foreign and domestic nonbank financing, the budget's net position with the banking system would improve by Y 4 billion.

The budget for 1987 is still in the preliminary stages of preparation. To provide further support for the stabilization effort, the authorities intend to budget for a further reduction in the fiscal deficit and an improvement in the budget's net position with the banking system. They explained that details of revenue and expenditure for 1987 and of the policy measures required to achieve their fiscal objectives depend to an important extent on the nature of the further substantial

economic reforms which are being worked out for introduction in 1987. In terms of broad strategy, the authorities intend to maintain strict control of expenditure, while providing adequate funding for priority expenditures on energy, transport, education, and culture. Improvements in the tax system, including rationalization of the structure of indirect taxation, an increase in the rate of tax on extrabudgetary construction, and the introduction of new taxes on use of assets and on personal incomes, are being considered, with the objectives of raising additional revenue, improving the structure of incentives and greater equity. Concerning budgetary presentation, subsidies for daily living necessities and agricultural inputs were listed for the first time in the 1986 budget as items of expenditure, rather than deductions from revenue; the authorities have found this change conducive to better decisions on the allocation of fiscal resources and are considering its application to other subsidy items.

(ii) Money and credit

The authorities shared the staff team's view that the tightening of credit policies since early 1985 had played a crucial role in bringing under control the overheated domestic economy. They recognized the heightened importance of restrained financial policies under the evolving system of economic management, and underscored their intention to maintain a restrictive stance. In this connection, they explained that the easing of credit conditions in the second quarter of 1986 was partly a consequence of the slowdown in economic expansion, as in the absence of regulations that permit enterprises to go bankrupt, there had been strong pressures to provide credit to finance enterprises with excessive inventories and related liquidity difficulties. Steps to tighten policies again, including adjustments to interest rates charged on lending by the People's Bank to specialized banks, had already been taken with a view to restraining monetary expansion to about 17 percent for 1986 as a whole.

The Chinese representatives pointed out that under China's present circumstances monetary targeting is an exceptionally challenging exercise, in particular because of the effects of reforms on the behavior of velocity. The reforms have brought about reductions in the use of barter and in the size of accounting units, thereby increasing the transactions demand for money and leading to a trend reduction of some 5-6 percent per annum up to 1984 in the velocity of broad money (defined as the value of output during the year divided by the stock of money at end-year). In 1985, however, velocity measured on this basis instead increased somewhat. The Chinese representatives argued that this development was temporary and did not represent a change in underlying trends. In particular, the sharp credit expansion at the end of 1984 had brought about a rapid temporary buildup in excess liquidity that had been drawn down when credit policies were tightened in 1985. The staff team observed that while certain aspects of the reforms had undeniably contributed to a declining trend in velocity, other factors--such as efforts to improve the efficiency of financial intermediation through

the banking system, and the introduction of new nonbank financial instruments--could operate in the opposite direction, as would any rekindling of inflationary expectations that might be associated with price reforms. In view of these considerations, together with the priority attached by the authorities to external adjustment, the staff representatives suggested a cautious approach to projecting velocity and monetary targeting. Consistent with this approach, the financial program for 1987 assumes no change in velocity and targets broad money growth at about 13 percent.

The effort to restrain money and credit expansion has focused increased attention on the authorities' arsenal of monetary policy instruments. The People's Bank is in the process of developing a system of monetary management in which the principal role is assigned to indirect instruments such as control of PBC credit, redeposit requirements, and interest rate policies. During the present period of transition, however, the authorities are adopting a pragmatic approach to credit control. The Chinese representatives stressed that tight control of PBC credit to the specialized banks would continue, and indicated that ceilings on the lending of each of the specialized banks--applied on a temporary basis during 1985--would be reintroduced if necessary to achieve their money and credit objectives. Regarding reserves of the specialized banks at the PBC, the authorities indicated that the apparent high level of these reserves held in excess of required redeposits mostly represents working balances necessitated by the present cumbersome procedures for intermediating funds within the banking system. They explained that the level of reserves would be monitored closely, and should it begin to pose problems for monetary control, corrective measures--such as issuance of a compulsory PBC bond to the banks or an increase in redeposit requirements--would be introduced. The financial program includes indicative limits on the net domestic assets of the PBC, including its deposit liabilities to the specialized banks; within these limits, reductions in bank reserves would need to be compensated by offsetting adjustments in the provision of PBC credit (Appendix Table IV).

Interest rates are coming to play a more important role as the system of intermediation increasingly features price signals rather than mandatory allocation. The Chinese representatives indicated that the active interest rate policies pursued since 1985 would continue. They are currently undertaking an overall review of the interest rate structure, which will seek to maintain positive real rates for depositors and continue improvements in the structure of lending rates to enterprises; it will also address the possible need for adjustments on account of the increased cost of PBC credit (see below). Ultimately, they intend to substantially increase the autonomy and responsibilities of the specialized banks, including greater flexibility in setting interest rates.

A significant proportion of specialized bank resources is provided by borrowing from the PBC at interest rates which, until recently, had been well below most deposit rates. This encouraged banks to rely

unduly on PBC credit as a source of funds, and posed difficulties for credit control. To correct this situation, on August 1, 1986 the PBC implemented adjustments for all types of its credit, ranging up to almost 6 percentage points for temporary loans outstanding more than three months. Also, rollovers of temporary loans would no longer be permitted, and the supply of planned loans, which have no maturity, would continue to be strictly limited. On the deposit side, the rate on specialized bank reserves held in excess of required redeposits was increased by 1.4 percentage points. The staff representatives welcomed these changes, and observed that an active and flexible interest rate policy would continue to play an increasingly important role in supporting credit restraint, promoting financial saving, and improving the allocation of resources. Also, the effectiveness of interest rate policies would be further improved by the greater responsibilities envisaged for specialized banks.

c. External policies

(i) Trade policies and exchange system

The Chinese representatives stressed that the large deterioration in the trade balance which had taken place in 1985 could not be allowed to continue. Already a number of corrective measures had been taken, including stronger financial policies, tighter restrictions and higher tariffs on luxury consumer imports, relaxation of export licensing restrictions, efforts to improve export quality and, above all, exchange rate adjustment and improved control over external financing. The Chinese representatives indicated that the authorities are prepared to take additional steps to promote non-oil exports and contain import demand. To the maximum possible extent, these steps would involve indirect policy instruments, as the authorities plan to continue reducing the extent of administrative control over foreign trade activities.

The reforms of recent years have increased the share of foreign trade for which pricing considerations play a direct role in trading decisions, thereby enhancing the potential effectiveness of exchange rate policy. In the four-year period from 1981, during which an internal settlement rate of Y 2.8 per U.S. dollar was maintained for foreign trade transactions, competitiveness had deteriorated, contributing to the weakness of manufactured exports and the rapid rise in imports, especially in late 1984 and in 1985. In response, the authorities gradually depreciated the renminbi from Y 2.8 to Y 3.2 per U.S. dollar during 1985 and, subsequently on July 5, 1986, made a major exchange rate adjustment from Y 3.2 to Y 3.7 per U.S. dollar (Chart 6). Reflecting these adjustments, the real effective exchange rate has depreciated by about 40 percent since May 1985, using weights based on the Fund's Information Notice System; against a basket of China's main Asian competitors, whose currencies have generally moved closely with the U.S. dollar, the real effective depreciation over the same period is estimated to be about half as large.

The authorities intend to continue a flexible approach to exchange rate policy in order to increase export volumes and strengthen the balance of payments. To this end, they are monitoring closely developments in exports, net foreign assets of the banking system, and competitive positions vis-a-vis major trading partners and competitors. In this context, they also stressed the need to take account of the implications of price reforms to be introduced in early 1987. The staff representatives welcomed the authorities' flexible approach, and observed that the effectiveness of exchange rate policy would be further enhanced by additional price and foreign trade reforms, notably by increasing links between world and domestic prices of traded goods.

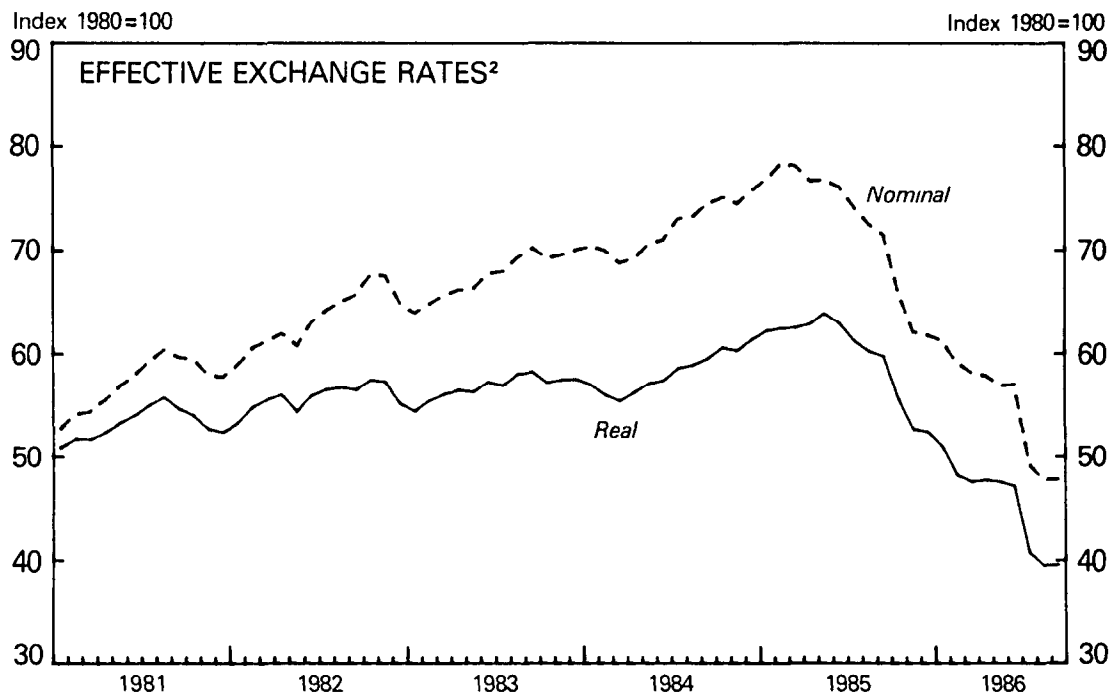
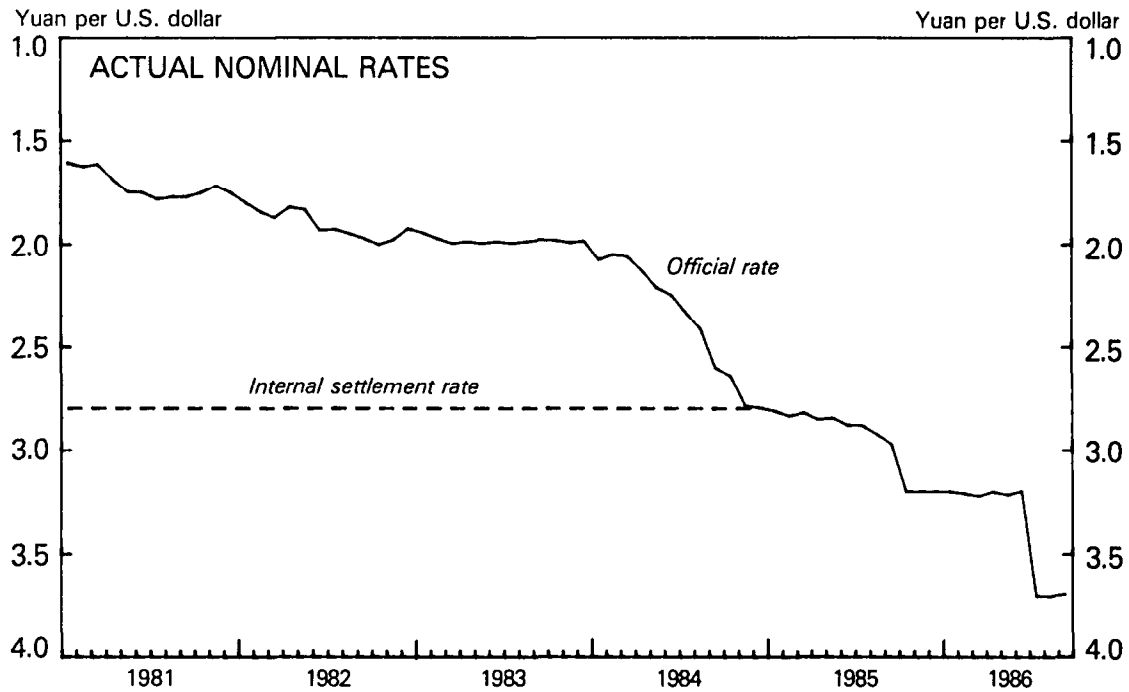
China maintains restrictions on current transactions that fall under Article IV. It also maintains a 10 percent tax on profit remittances by joint ventures, which gives rise to a multiple currency practice subject to approval under Article VIII. The applicability of this tax is small at present since, as part of efforts to promote foreign direct investment, the tax is not applied to investment in the special economic zones, in certain designated areas in 14 open coastal cities, and to certain projects in three river delta areas designated for promotion of foreign investment. No new bilateral payments arrangements with Fund members have been introduced since the last consultation, and it remains the authorities' intention to eliminate the remaining arrangements.

(ii) External financing

Recourse to external financing began only in the late 1970s and until recently remained modest. Since 1984, however, external debt has grown rapidly, both in absolute terms and in relation to gross reserves; short-term debt increased from 25 percent of gross reserves at end-1983 to almost 70 percent at end-1985 (Appendix Table VIII). The lack of a centralized debt management system, in conjunction with the decentralization of financial responsibility under the reforms, created difficulties in controlling and monitoring external borrowing, which in turn threatened to undermine overall macroeconomic management.

The authorities recognize that the achievement of their medium-term balance of payments objectives and the maintenance of China's record of creditworthiness depends, inter alia, on their ability to control external borrowing and to improve the composition of external debt. To this end a number of measures have been taken in recent months to strengthen debt management. In April 1986, the State Administration of Exchange Control (SAEC), a unit within the People's Bank, was designated by the State Council as the sole agency responsible for monitoring external debt. The SAEC has since established reporting channels for all borrowing units and compiled more comprehensive data on debt

CHART 6
CHINA
EXCHANGE RATES, 1981-86¹



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

¹Downward movement indicates depreciation of the yuan

²Data for 1981 through 1984 are based on the internal settlement rate

outstanding and on scheduled debt service payments. ^{1/} Approval procedures have also been revised to ensure that total external borrowing (including borrowing within the annual plan and borrowing outside the plan) and short-term debt do not exceed the amounts that are consistent with a viable medium-term balance of payments position. Within these limits, all commercial borrowing, including placement of bonds abroad, has been made subject to prior approval by SAEC. While there is a need to further improve approval and control procedures, the measures taken so far should enable the authorities to keep external borrowing within targeted limits.

The authorities aim to limit the external current account deficit to a level that beyond 1987 can be financed by direct foreign investment and concessional borrowing. This strategy would keep the ratios of debt to GDP and debt service to exports of goods and services within prudent limits during the program period and over the medium term (Appendix Table VII). At the same time, short-term debt would be reduced substantially both as a proportion of total debt and in relation to gross reserves. Commercial borrowing is to be limited to \$3 billion for 1986 and \$2.8 billion for 1987; while such borrowing remains relatively high in these years it is partly for the purpose of restoring gross reserves to a level above four months of imports by end-1987. Other capital inflows are projected at \$5 billion in 1986 and \$4.2 billion in 1987. Of these amounts foreign direct investment is projected to provide \$1.4 billion each year, borrowing from governments and international organizations (mainly the World Bank) \$2.5 billion in 1986 and \$2.7 billion in 1987, and proceeds of bond issues \$1.4 billion in 1986 and \$0.5 billion in 1987.

External borrowing benchmarks consistent with the above targets have been established under the program for: contracting or guaranteeing of medium- and long-term nonconcessional borrowing; short-term debt of the Bank of China; and net foreign liabilities of financial institutions (the Bank of China and international trust and investment corporations). The authorities stated that every effort will be made to ensure that concessional capital inflows and direct investment are in line with the amounts projected above, and that nonconcessional borrowing remains within the benchmarks.

^{1/} These data show total debt outstanding at end-1985 of \$16 billion, compared with the staff's estimate of about \$20 billion derived from creditor and official sources (Appendix Table VIII); the difference appears mainly to reflect the omission from official data of some trade credits and also some borrowing from foreign banks by Chinese enterprises. The SAEC is currently focusing its data collection efforts in these areas.

4. Program benchmarks

The financial program contains the following indicative benchmarks (Table 2): (i) quarterly limits for net domestic assets of the banking system; and (ii) quarterly limits for net domestic assets of the People's Bank, both for the period September 1986 through December 1987; (iii) cumulative limits from October 1, 1986 through end-1986, and through end-1987, on the contracting or guaranteeing of nonconcessional external debt with a maturity of over 1 year and up to 15 years, with a sublimit for debt with less than 5 years' maturity; (iv) quarterly limits on outstanding short-term debt of the Bank of China; and (v) quarterly limits for the net foreign liabilities of the financial institutions, also both for the period September 1986 through December 1987. These benchmarks are designed to guide policy implementation during the period of the stand-by arrangement.

5. Obligations to the Fund

Apart from a Trust Fund drawing, China has made use of Fund resources on one previous occasion, and promptly made early repurchase when the external position improved more rapidly than anticipated. Assuming approval of the proposed stand-by arrangement, China's debt to the Fund (including Trust Fund obligations) would amount to no more than 4 percent of total external debt and 0.5 percent of GDP over the medium term; debt service to the Fund would peak during the expected period of repurchases at less than 1 percent of exports of goods and services.

V. Activities of the World Bank in China

The World Bank group has been increasingly active in China during the last few years, both in terms of its lending activity and its economic work (Annex II). Loan commitments exceeded \$1.1 billion in the fiscal year 1985/86, with disbursements amounting to \$0.6 billion; the Bank envisages a further expansion in the period ahead, with commitments possibly amounting to \$10 billion over the next five years. To date, the Bank's lending has been devoted entirely to projects, but the authorities have expressed an interest in policy-based lending which will be discussed in the coming months.

The Bank's recent economic work includes a major report on long-term issues and options for the Chinese economy, and a study of long-term trends and issues in finance and investment. The former report, published in late 1985, concluded that the authorities' long-term growth targets (to quadruple gross industrial and agricultural output and to raise per capita national income from about \$300 to \$800 between 1980 and 2000) were achievable with prevailing levels of investment efficiency, if the investment/national income ratio of the early 1980s were maintained and reasonable improvements in energy and raw material use were achieved. The study on finance and investment, based on a mission in March 1986 in which a Fund staff member participated, explores

Table 2. China: Quantitative Benchmarks for
Stand-by Arrangement, 1986-87

| | <u>Actual</u> | <u>Indicative Limits</u> | | | | | |
|--|---------------|--------------------------|---------------|-------------|-------|-------|---------------|
| | <u>1986</u> | <u>1986</u> | | <u>1987</u> | | | |
| | June | Sept. | Dec. | March | June | Sept. | Dec. |
| <u>(In billions of yuan, end of period)</u> | | | | | | | |
| Net domestic assets of the banking system | 518.7 | 527.9 | 573.3 | 574.4 | 567.8 | 588.3 | 651.0 |
| Net domestic assets of the People's Bank | 118.0 | 131.2 | 143.8 | 140.6 | 135.0 | 143.9 | 162.2 |
| <u>(In billions of U.S. dollars, end of period)</u> | | | | | | | |
| Contracting or guaranteeing of new nonconces- sional external debt | | | | | | | |
| Over 1 year and less than 15 years | ... | ... | 0.5 <u>1/</u> | ... | ... | ... | 3.0 <u>1/</u> |
| Of which: | | | | | | | |
| Over 1 year and less than 5 years | ... | ... | 0.1 <u>1/</u> | ... | ... | ... | 0.6 <u>1/</u> |
| Short-term debt of the Bank of China | 3.8 | 3.8 | 4.1 | 4.2 | 4.3 | 4.4 | 4.6 |
| Net foreign liabi- lities of finan- cial institutions | 2.2 | 4.0 | 5.8 | 6.5 | 7.2 | 7.4 | 7.8 |

Source: Data provided by the Chinese authorities.

1/ Cumulative from October 1, 1986.

possible avenues for long-term development of the financial system in ways that would support the authorities' overall reform and growth objectives. For its future economic work, the Bank is planning a study of issues in China's external trade and capital, based on findings of a mission in October 1986, in which a Fund staff member is participating. Among other issues this study will examine the scope for a greater use of tariffs and reduced reliance on quantitative restrictions in controlling imports. The Bank also expects to carry out analyses of selected issues in the energy and transport sectors in connection with its substantial lending programs in those areas.

There are no serious policy disagreements between the Fund and Bank staffs on major policy issues in China. The Bank staff shares the view that measures are needed to ensure that adequate growth and macro-economic stability can be sustained, and fully endorses the need for continued economic system reforms, especially in the area of pricing.

VI. Staff Appraisal

The Chinese economy continues to be the scene of impressive change. Reforms have wrought a transformation of the economic system that is virtually without precedent and contributed to a substantial improvement of living standards. Understandably, however, the introduction of change on such a scale has not been free of difficulty, and the very nature of the reforms of recent years has created significant new challenges for economic policy.

The reforms feature a reduction in the scope of direct planning controls and hence in the effectiveness of traditional methods of economic regulation, creating the need for a new policy framework based mainly on macroeconomic management. The authorities have been making progress in establishing this new framework, but this is a complex and time-consuming process, and in the meantime the economy has become more vulnerable to macroeconomic imbalances. In the most recent instance, the easing of planning controls associated with urban reforms in 1984, coming at a time when macroeconomic instruments were in an early stage of development, was followed by a surge in domestic demand, inflationary pressures, a sharp deterioration in the balance of payments, and a rapid accumulation and weakening of the structure of external debt.

The authorities reacted to these developments with important steps to strengthen demand management and pricing policies, and by mid-1986 the economic situation was being brought under control. Growth of domestic demand and output had been reduced from earlier unsustainable rates, and the external position showed signs of improvement, both with regard to the current account deficit and the structure of debt. This improvement was particularly noteworthy against the background of sharply lower prices for China's oil exports.

The staff fully agrees with the authorities' position that, in China's present circumstances, priority has to be given to the elimination of macroeconomic imbalances as a precondition for the continuation and eventual success of the reforms and for sustainable economic growth. The staff would also emphasize that the use of new macroeconomic instruments, prices and markets to tackle the imbalances is in itself an integral part of the reform process. At the same time, the economic system is still in transition and some limited use of more traditional instruments of economic regulation may be inevitable in areas where macroeconomic instruments have not reached full effectiveness.

Domestic financial policies have already made an important contribution to economic stabilization, with growth of money and credit reduced sharply in 1985 and early 1986 from the rapid rates of late 1984. Some easing of financial conditions occurred in the second quarter of 1986, partly reflecting pressures to extend credit to cover liquidity problems related to the slowdown in growth of domestic demand and output. In view of the need to strengthen the external position, the authorities' determination to tighten money and credit further in the second half of 1986 and in 1987 is welcome, and the staff hopes that it will be persevered with. The staff welcomes the authorities' intention to implement further improvements in monetary instruments and control techniques, and in this connection would stress the importance of monitoring closely the positions of the specialized banks with the People's Bank. The emphasis on indirect monetary instruments is appropriate; at the same time, in view of the still limited experience in China with such instruments, the staff supports the authorities' pragmatic approach to credit control, including if necessary the reintroduction of credit ceilings on the specialized banks.

The recent adjustments in interest rates charged by the People's Bank on lending to the specialized banks should reduce the dependence of specialized banks on credit from the People's Bank, and thereby make an important contribution to improved monetary control. Regarding the general structure of interest rates, the staff considers the authorities' policy of maintaining positive real rates to be appropriate in view of the need to sustain China's high rate of saving.

Since the large imbalances of 1979-80, fiscal restraint has played a valuable role in promoting economic stability. The staff welcomes the authorities' determination to maintain this cautious stance despite the uncertainties for fiscal planning that arise from economic reforms. To support the external adjustment, the staff would encourage every effort to secure further improvements in the overall budgetary balance through tight control of expenditure and improvements in the tax system. The proposed further tax reforms can also play a valuable role in rationalizing incentives and improving resource allocation.

In addition to domestic financial restraint, measures to control external financing form a major element of policies to ensure external viability. In this respect, the recent steps to strengthen external debt management are both timely and welcome. The new debt management framework should ensure that total external borrowing, and in particular its nonconcessional elements, can be kept within appropriate limits and that the structure of debt can be further improved. The staff would encourage further efforts to perfect the debt management system in the period ahead.

The July devaluation of the renminbi by 13.5 percent constituted an important demonstration of the authorities' preparedness to take decisive adjustment measures. The staff believes that this action will contribute significantly to promoting exports and containing import demand, although given the evolving nature of China's foreign trade system the impact of the exchange rate adjustment cannot be estimated precisely. In view of this imprecision, the uncertainties in the outlook for the payments position, and the need for continued external adjustment, the staff considers the flexible exchange rate policy envisaged by the authorities to be absolutely essential, and would stress the need for prompt adjustment should circumstances so warrant. The staff would also emphasize the need to strengthen further the effectiveness of exchange rate policy through additional price and foreign trade reforms that would enhance the role of pricing considerations in trading and production decisions.

The adjustment measures implemented by the authorities should reduce the current account deficit in the near term to a level that would permit a substantial reduction in commercial borrowing, while permitting some recovery in gross reserves. While implementing these measures to establish a sound financial base, the authorities have reaffirmed their commitment to future reforms as the key to achieving their long-term objectives for further economic development and improvement in living standards. The staff fully supports this commitment, and believes that the emphasis of forthcoming reforms--greater responsibilities for enterprises, establishment of markets with associated price reforms, and development of indirect instruments of economic management--is appropriate.

The authorities are preparing a major new package of price reforms for implementation in the near future. The staff would place a high priority on measures to adjust prices of energy and raw materials, to establish closer links between international and domestic prices, and to reduce the scope of price subsidies, all of which would promote improved resource allocation and strengthen the effectiveness of the new system of economic management. Also, the implications of price reforms would need to be taken into account in determining future exchange rate policy.

The tax on remitted profits of certain joint ventures gives rise to a multiple currency practice subject to approval under Article VIII. This practice does not appear to be temporary, and, therefore, the staff does not recommend its approval by the Executive Board. The staff welcomes the authorities' intention to eliminate the remaining bilateral payments arrangements with Fund members.

The staff noted last year that China faces a complex and challenging task to reconcile the objectives of system reform, output growth, and economic stability. Developments of the last 12 months have, if anything, rendered this task more challenging yet, but at the same time have provided further encouraging evidence of the authorities' determination to pursue their goals. The adjustment measures which they have put in place should promote greater stability and establish a firm foundation for further growth and reforms. To build on this foundation over the period ahead, the authorities will need to continue the pragmatic and flexible approach to economic policymaking which they have shown on numerous occasions in recent years.

China has requested a first credit tranche stand-by arrangement from the Fund to support its program of economic stabilization. The staff believes that this program will bring about an appropriate improvement in the balance of payments, and that the external position will be manageable over the medium term. China's track record in using Fund resources is good, with one previous purchase under a first credit tranche arrangement that was repurchased as soon as the balance of payments position improved. Assuming approval of the proposed arrangement, China's future obligations to the Fund will still be relatively small on the basis of all relevant indicators; in view of this and the authorities' commitment to maintaining creditworthiness through appropriate policies, the staff does not consider it likely that the servicing of these obligations would cause difficulty.

It is recommended that the next Article IV consultation with China be held on the standard 12-month cycle. In the meantime, a staff visit is envisaged for early 1987 to discuss economic developments and policies with the authorities, and to prepare a report for the information of the Executive Board.

VII. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

1986 Consultation

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Section 3, in concluding the 1986 Article XIV consultation with China, in the light of the 1986 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, as described in SM/86/

The maintenance of an exchange tax on remitted profits of joint ventures, excluding most ventures in designated areas, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The Fund welcomes China's efforts to continue to simplify its exchange system and notes with satisfaction the intention of the authorities to eliminate the remaining bilateral payments arrangements with Fund members.

Stand-By Arrangement

1. The Government of China has requested a stand-by arrangement for the 12-month period beginning November , 1986 for an amount equivalent to SDR 597.725 million.

2. The Fund approves the stand-by arrangement attached to EBS/86/230.

Table I. China: National Income and Output, 1982-86

| | 1982 | 1983 | 1984 | 1985 | 1986 Est. |
|---|-------|--------|--------|--------|--------------|
| (In percent change at constant 1980 prices) | | | | | |
| National income | 8.3 | 9.8 | 13.5 | 12.3 | 6.5 |
| Gross agricultural output | 11.1 | 9.6 | 17.6 | 14.2 | 6.0 |
| Of which: | | | | | |
| Rural industry | (9.4) | (23.7) | (53.7) | (67.5) | (15.0) |
| Gross industrial output | 7.7 | 10.5 | 14.0 | 18.0 | 7.1 |
| Light industry | 5.7 | 8.7 | 13.9 | 18.1 | 7.2 |
| Heavy industry | 9.9 | 12.4 | 14.2 | 17.9 | 7.0 |
| State enterprises | 7.1 | 9.4 | 8.9 | 12.9 | ... |
| Collective and individual enterprises | 10.0 | 14.6 | 31.2 | 32.1 | ... |
| (In millions of tons, unless otherwise specified) | | | | | |
| Grain | 353.4 | 387.3 | 407.3 | 379.1 | 400.5 |
| Cotton | 3.6 | 4.6 | 6.2 | 4.1 | 4.5 |
| Oil bearing crops | 11.8 | 10.6 | 11.9 | 15.8 | ... |
| Coal | 666.0 | 715.0 | 789.0 | 872.0 | ... |
| Crude oil | 102.1 | 106.1 | 114.6 | 124.9 | ... |
| Steel | 37.2 | 40.0 | 43.5 | 46.8 | ... |
| Cotton cloth (bn. meters) | 15.4 | 14.9 | 13.7 | 14.7 | ... |
| Television sets | 5.9 | 6.8 | 10.0 | 16.7 | ... |
| Household refrigerators (mn.) | 0.1 | 0.2 | 0.5 | 1.4 | ... |

Sources: State Statistical Bureau; and staff estimates.

Table II. China: Monetary Survey, 1982-87 1/

| | 1982 Dec. | 1983 Dec. | 1984 Dec. | 1985 Dec. | 1986 | | 1987 Dec. Program | 1987 Dec. Program |
|--|--------------|--------------|--------------|--------------|--------|--------|-------------------------|-------------------------|
| | | | | | March | June | | |
| (In billions of yuan; end of period) | | | | | | | | |
| Net foreign assets | 31.8 | 43.1 | 51.9 | 41.2 | 35.8 | 35.4 | 35.1 | 39.2 |
| Net domestic assets | 229.7 | 268.7 | 388.5 | 480.1 | 484.0 | 518.7 | 573.3 | 651.0 |
| Loans to enterprises and individuals | 335.2 | 382.0 | 517.0 | 629.5 | 632.8 | 669.5 | 734.8 | 824.4 |
| Budget (net) 2/ | -0.6 | 0.6 | 8.8 | -9.3 | -14.9 | -9.6 | -13.3 | -17.3 |
| Other assets (net) | -104.9 | -113.9 | -137.3 | -140.2 | -133.9 | -141.2 | -148.1 | -156.1 |
| Money and quasi-money | 261.5 | 311.8 | 440.4 | 521.3 | 519.8 | 554.1 | 608.4 | 690.2 |
| Money | 201.6 | 236.3 | 337.6 | 376.3 | 361.0 | 380.0 | 424.9 | 481.9 |
| Currency in circulation | 43.9 | 53.0 | 79.2 | 98.8 | 89.9 | 88.9 | 115.6 | 132.9 |
| Household demand deposits | 16.5 | 21.8 | 31.4 | 39.7 | 41.2 | 42.7 | 51.4) | 132.9 |
| Enterprise deposits | 108.1 | 123.7 | 194.6 | 205.2 | 197.2 | 212.2 | 220.9) | 349.0 |
| Official institutions and organizations | 33.1 | 37.8 | 32.4 | 32.6 | 32.7 | 36.3 | 37.0) | |
| Quasi-money | 59.9 | 75.6 | 102.7 | 145.0 | 158.8 | 174.1 | 183.5 | 208.3 |
| Household term deposits | 53.7 | 69.8 | 90.1 | 122.5 | 137.8 | 150.2 | 158.6 | ... |
| Capital construction deposits | 6.2 | 5.8 | 12.6 | 22.5 | 21.0 | 24.0 | 25.0 | ... |
| (Percent change from a year earlier) | | | | | | | | |
| Net domestic assets | ... | 17.0 | 44.6 | 23.6 | 18.9 | 29.3 | 19.4 | 13.6 |
| Of which: Loans to enterprises and individuals | (...) | (14.0) | (35.3) | (21.8) | (18.3) | (22.5) | (16.7) | (12.2) |
| Money and quasi-money | ... | 19.2 | 41.2 | 18.4 | 15.3 | 24.7 | 16.7 | 13.4 |

Sources: People's Bank of China; and staff estimates.

1/ Foreign exchange assets and liabilities of the Bank of China, other than gross foreign reserves, are not included.

2/ Includes all local governments deposits, both budgetary and extrabudgetary.

Table III. China: Operations of the People's Bank, 1985-87

| | 1985 | | | 1986 | | | 1987 |
|---|-------|-------|-------|-------|-------|-----------------|-----------------|
| | June | Sept. | Dec. | March | June | Dec. Program | Dec. Program |
| (In billions of yuan; end of period) | | | | | | | |
| Net foreign assets | 19.9 | 14.1 | 11.6 | 10.7 | 9.0 | 10.7 | 14.8 |
| Claims on specialized banks | 170.3 | 180.6 | 224.9 | 214.9 | 222.2 | 268.2 | 298.7 |
| Other domestic assets (net) | 2.9 | -3.7 | -7.9 | -9.1 | 0.1 | -11.9 | -15.9 |
| Loans | 0.6 | 0.6 | 1.8 | 1.8 | 2.1 | 2.1 | ... |
| Budget (net) <u>1/</u> | -2.9 | -11.3 | -9.3 | -14.9 | -9.6 | -13.3 | -17.3 |
| Other items (net) | 5.2 | 7.0 | -0.4 | 4.0 | 7.6 | -0.7 | ... |
| Liabilities to banks | 86.4 | 76.9 | 96.4 | 92.9 | 104.3 | 112.5 | 120.6 |
| Required deposits | 25.4 | 25.9 | 42.0 | 44.2 | 47.4 | 53.9 | ... |
| Other deposits | 55.8 | 45.9 | 47.0 | 42.5 | 50.2 | 50.2 | ... |
| Cash in vault | 5.1 | 5.1 | 7.3 | 6.2 | 6.7 | 8.4 | ... |
| Liabilities to nonbanks | 106.7 | 114.2 | 132.2 | 123.6 | 127.1 | 154.5 | 177.0 |
| Currency in circulation | 75.8 | 82.7 | 98.8 | 89.9 | 88.9 | 115.6 | 132.9 |
| Household demand deposits | 0.1 | 0.1 | — | 0.1 | 0.1 | 0.1 | ... |
| Enterprise deposits | 0.3 | 0.3 | 0.7 | 0.8 | 1.6 | 1.7 | ... |
| Official institutions and organizations' deposits | 30.5 | 30.9 | 32.6 | 32.7 | 36.3 | 37.0 | ... |
| Household term deposits | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | ... |
| Memorandum item: | | | | | | | |
| Net domestic assets <u>2/</u> | 86.8 | 100.1 | 120.6 | 112.9 | 118.0 | 143.8 | 162.2 |

Sources: People's Bank of China; and staff estimates.

1/ Includes all deposits of local governments, both budgetary and extrabudgetary.

2/ Liabilities to nonbanks minus net foreign assets.

Table IV. China: Overall Budgetary Operations, 1982-87 ^{1/}

| | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | |
|--|--------|--------|--------|--------|--------|--------|---------|
| | | | | | Budget | Est. | Program |
| (In billions of yuan) | | | | | | | |
| Total revenue | 141.2 | 159.4 | 183.5 | 228.3 | 230.2 | 230.2 | 252.1 |
| Tax revenue ^{2/} | 70.0 | 86.9 | 106.8 | 218.8 | 220.7 | 220.7 | 241.6 |
| Nontax revenue | 71.2 | 72.5 | 76.7 | 9.5 | 9.5 | 9.5 | 10.5 |
| Total expenditure and net lending | 148.3 | 169.0 | 193.9 | 232.4 | 237.2 | 233.7 | 255.2 |
| Current | 113.1 | 126.4 | 138.1 | 168.1 | 178.5 | 177.7 | 192.3 |
| Of which: | | | | | | | |
| Subsidies ^{3/} | (37.2) | (42.5) | (41.0) | (50.7) | (55.3) | (...) | (...) |
| Capital | 35.2 | 42.6 | 55.8 | 64.3 | 58.7 | 56.0 | 62.9 |
| Overall surplus (+) or deficit (-) | -7.1 | -9.6 | -10.5 | -4.1 | -7.0 | -3.5 | -3.1 |
| Financing | 7.1 | 9.6 | 10.5 | 4.1 | 7.0 | 3.5 | 3.1 |
| Domestic | 7.3 | 8.5 | 8.7 | 4.0 | 5.0 | 1.0 | 0.1 |
| People's Bank of China | 2.9 | 4.3 | 4.5 | -2.1 | -- | -4.0 | -4.0 |
| Nonbank ^{4/} | 4.4 | 4.2 | 4.2 | 6.1 | 5.0 | 5.0 | 4.1 |
| Foreign ^{5/} | -0.2 | 1.1 | 1.8 | 0.1 | 2.0 | 2.5 | 3.0 |
| Gross foreign borrowing | 4.0 | 3.8 | 3.5 | 2.9 | 5.5 | 6.0 | 7.0 |
| Amortization (-) | -4.2 | -2.7 | -1.7 | -2.8 | -3.5 | -3.5 | -4.0 |
| (As percent of GDP) | | | | | | | |
| Revenue | 29.1 | 29.6 | 28.6 | 29.3 | 26.3 | 26.3 | 25.4 |
| Expenditure | 30.6 | 31.4 | 30.2 | 29.9 | 27.1 | 26.7 | 25.7 |
| Subsidies | (7.7) | (7.9) | (6.4) | (6.5) | (6.3) | (...) | (...) |
| Capital expenditures | (7.3) | (7.9) | (8.7) | (8.3) | (6.7) | (6.4) | (6.3) |
| Surplus (+) or deficit (-) | -1.5 | -1.8 | -1.6 | -0.5 | -0.8 | -0.4 | -0.3 |
| Domestic bank financing | (0.6) | (0.8) | (0.7) | (-0.3) | (--) | (-0.5) | (-0.4) |
| Memorandum item: | | | | | | | |
| Overall surplus/deficit on national definition (Y bn.) | -2.9 | -4.3 | -4.5 | 2.1 | -- | 4.0 | 4.0 |
| (percent of GDP) | (-0.6) | (-0.8) | (-0.7) | (0.3) | (--) | (0.5) | (0.4) |

Sources: Ministry of Finance; and staff estimates.

^{1/} These budgetary statistics represent a consolidation of the budget of the Central Government, provinces, counties, and municipal governments. Intergovernmental transfers are netted out. Extrabudgetary financial operations of the various levels of government are omitted.

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

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

^{4/} Treasury bonds.

^{5/} Foreign borrowing by the Ministry of Finance through the Bank of China.

Table V. China: Investment and Savings, 1982-87

| | 1982 | 1983 | 1984 | 1985 | 1986 Est. | 1987 Program |
|---|--------------|--------------|--------------|--------------|--------------|-----------------|
| (In billions of yuan) | | | | | | |
| Total investment | <u>146.7</u> | <u>166.5</u> | <u>214.6</u> | <u>299.9</u> | <u>327.8</u> | <u>356.1</u> |
| Fixed investment | <u>120.0</u> | <u>136.9</u> | <u>183.3</u> | <u>254.3</u> | <u>279.8</u> | <u>316.1</u> |
| Public fixed investment <u>1/</u> | <u>84.5</u> | <u>95.2</u> | <u>118.5</u> | <u>168.0</u> | <u>183.2</u> | <u>207.1</u> |
| Budget financed | <u>31.0</u> | <u>38.7</u> | <u>46.2</u> | <u>44.0</u> | <u>38.0</u> | <u>43.0</u> |
| Extrabudgetary | <u>53.5</u> | <u>56.5</u> | <u>72.3</u> | <u>124.0</u> | <u>145.2</u> | <u>164.1</u> |
| Other fixed investment <u>2/</u> | <u>35.5</u> | <u>41.7</u> | <u>68.3</u> | <u>86.2</u> | <u>96.6</u> | <u>109.0</u> |
| Stockbuilding and work-in-progress | <u>26.7</u> | <u>29.6</u> | <u>31.3</u> | <u>45.5</u> | <u>48.0</u> | <u>40.0</u> |
| Total savings | <u>156.5</u> | <u>174.3</u> | <u>219.4</u> | <u>265.6</u> | <u>290.2</u> | <u>332.3</u> |
| Balance on external trade in goods and services | <u>9.8</u> | <u>7.8</u> | <u>4.8</u> | <u>-35.6</u> | <u>-41.0</u> | <u>-23.8</u> |
| (In percent of GDP) | | | | | | |
| Total investment | 30.3 | 30.9 | 33.4 | 38.5 | 37.5 | 35.9 |
| Total savings <u>3/</u> | <u>32.3</u> | <u>32.4</u> | <u>34.1</u> | <u>33.9</u> | <u>33.4</u> | <u>33.5</u> |
| Of which: | | | | | | |
| Household financial savings <u>4/</u> | (4.3) | (5.8) | (9.1) | (7.9) | (7.7) | (7.8) |
| Current account surplus of the budget | (5.9) | (6.2) | (6.7) | (7.2) | (6.0) | (6.0) |

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

1/ This item corresponds to the sum of "capital construction" and "renewal of equipment and technical transformation" in national data.

2/ Investment in collectively-owned units and by households.

3/ Because the production and expenditure sides of China's national accounts are estimated separately, there is a statistical discrepancy between the two that complicates estimation of the savings rate. For 1982 and 1983, alternate estimates of savings could be 1-2 percentage points lower.

4/ Change in savings deposits and currency holdings plus subscription to treasury bonds.

Table VI. China: Balance of Payments, 1982-87

(In billions of U.S. dollars) 1/

| | 1982 | 1983 | 1984 | Staff Est. 1985 | Staff Est. 1986 | Program 1987 |
|--|---------------|----------------|---------------|-----------------------|-----------------------|-----------------|
| Current account | 5.7 | 4.5 | 2.5 | -11.9 | -10.0 | -5.6 |
| Exports | 21.1 | 20.7 | 23.9 | 25.1 | 28.1 | 31.9 |
| Oil | 4.6 | 4.3 | 5.5 | 6.7 | 3.3 | 3.9 |
| Non-oil | 16.5 | 16.4 | 18.4 | 18.4 | 24.7 | 28.0 |
| Imports | -16.9 | -18.7 | -23.9 | -38.2 | -38.5 | -37.7 |
| Services (net) | 0.9 | 2.0 | 2.0 | 1.0 | 0.1 | -0.1 |
| Credit | (3.6) | (4.3) | (4.8) | (4.5) | (4.3) | (4.5) |
| Debit | (-2.7) | (-2.3) | (-2.8) | (-3.5) | (-4.2) | (-4.4) |
| Net unrequited transfers | 0.5 | 0.5 | 0.4 | 0.2 | 0.3 | 0.3 |
| Capital account (net) | 0.3 | 0.6 | 0.2 | 8.5 | 8.1 | 6.9 |
| Direct investment | 0.4 | 0.5 | 1.1 | 1.6 | 1.4 | 1.4 |
| Borrowing from governments and international organizations | 0.3 | 0.7 | 0.8 | 0.8 | 2.5 | 2.7 |
| Borrowing through bond issues | -- | -- | 0.1 | 0.8 | 1.4 | 0.5 |
| Borrowing from banks | -1.1 | 0.3 | 0.2 | 5.9 | 3.0 | 2.8 |
| Other capital | 0.7 | -0.9 | -2.0 | -0.6 | -0.2 | -0.5 |
| Errors and omissions 2/ | 0.3 | -0.3 | -0.9 | -1.2 | -- | -- |
| Overall account | 6.3 | 4.8 | 1.8 | -4.6 | -1.9 | 1.3 |
| Reserve changes (- increase) | -6.3 | -4.3 | -1.8 | 4.6 | 1.2 | -1.3 |
| IMF drawings | -- | -0.5 | -- | -- | 0.7 | -- |
| Reserves at end-year (months of imports) 3/ | 11.2 (8.0) | 16.0 (10.3) | 17.8 (8.9) | 13.2 (4.1) | 12.0 (3.7) | 13.3 (4.3) |
| Memorandum item: Current account/GDP (in percent) | 2.2 | 1.6 | 0.9 | -4.5 | -4.0 | -2.3 |

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

1/ Totals may not add up due to rounding.

2/ Residual.

3/ Of the current year.

Table VII. China: Medium-Term Balance of Payments Scenario I, 1/
1985-90

(In billions of U.S. dollars)

| | 1985 | 1986 Est. | 1987 | 1988 | 1989 | 1990 |
|----------------------------|----------|--------------|--------|--------|--------|--------|
| | Scenario | | | | | |
| Current account | -11.9 | -10.0 | -5.6 | -4.1 | -2.9 | -3.2 |
| Exports, f.o.b. | 25.1 | 28.1 | 31.9 | 35.0 | 38.4 | 42.2 |
| Imports, f.o.b. | -38.2 | -38.5 | -37.7 | -39.2 | -41.3 | -45.4 |
| Net services and transfers | 1.2 | 0.4 | 0.2 | 0.1 | -- | -- |
| Capital account (net) | 7.3 | 8.1 | 6.9 | 4.1 | 3.9 | 4.5 |
| Net external borrowing | 7.4 | 7.2 | 6.2 | 3.0 | 3.1 | 3.5 |
| Of which: borrowing | | | | | | |
| from commercial banks | (5.6) | (3.0) | (2.8) | (--) | (--) | (--) |
| Other 2/ | -0.1 3/ | 0.9 | 0.7 | 1.1 | 0.8 | 1.0 |
| Overall balance | -4.6 | -1.9 | 1.3 | -- | 1.0 | 1.3 |
| Reserve changes | | | | | | |
| (- = increase) | 4.6 | 1.2 | -1.3 | -- | -1.0 | -1.0 |
| IMF drawings | -- | 0.7 | -- | -- | -- | -0.3 |
| Memorandum items: | | | | | | |
| Current balance | | | | | | |
| (percent of GDP) | -4.4 | -4.3 | -2.3 | -1.8 | -1.0 | -1.0 |
| Gross reserves | 13.2 | 12.0 | 13.3 | 13.3 | 14.0 | 15.5 |
| (in months of imports) 4/ | (4.1) | (3.7) | (4.3) | (4.1) | (4.1) | (4.1) |
| External debt | 19.8 | 27.2 | 33.6 | 36.6 | 39.7 | 43.2 |
| (in percent of GDP) | (7.5) | (10.7) | (13.7) | (15.2) | (15.0) | (16.5) |
| Debt service ratio | 7.2 | 7.6 | 6.9 | 6.8 | 7.3 | 8.7 |

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

1/ External assumptions for the period 1987-90 are as follows: growth of China's non-oil export markets, 3.7 percent per annum (compared with 3.1 percent in 1986); oil prices increasing by about 3 percent per annum (48 percent decline); non-oil terms of trade broadly unchanged (improvement of about 5 percent); and LIBOR at 6.5 percent (6.8 percent).

2/ Direct investment and asset transactions.

3/ Including errors and omissions.

4/ Current year imports.

Table VIII. China: Outstanding External Debt, 1983-87 ^{1/}
(In millions of U.S. dollars)

| | 1983 | 1984 | 1985 | | Projections ^{2/} | |
|---|-----------------------|-----------------------|-------------------|-------------------------|---------------------------|---------------|
| | Staff Estimate | | Official Estimate | Staff Estimate | 1986 | 1987 |
| Foreign governments ^{3/} | 2,216 | 2,727 | 3,634 | 3,634 | 5,734 | 7,834 |
| International institutions | 568 | 593 | 1,185 | 1,185 | 2,085 | 2,985 |
| Foreign banks | 4,489 | 4,520 | 8,130 | 9,589 | 12,589 | 15,389 |
| Buyers' credits | (666) | (540) | (549) | (549) | ... | ... |
| Bank of China foreign branches | (1,290) | (1,382) | (2,680) | (2,680) | ... | ... |
| Loans | (...) | (286) | (4,879) | (4,879) | ... | ... |
| Foreign banks in China | — | (2) | (22) | (22) | ... | ... |
| Other | (2,533) | (2,310) ^{4/} | (...) | (1,459) ^{4/5/} | ... | ... |
| Bond issues | 60 | 62 | 1,000 | 1,000 | 2,300 | 2,800 |
| Suppliers' credits and advanced export receipts ^{6/} | 1,592 | 1,600 | 1,736 | 1,736 | 1,756 | 1,776 |
| Other trade credits | 683 ^{7/} | 2,039 ^{7/} | ... | 2,100 ^{7/5/} | 2,100 | 2,100 |
| Leasing companies and parent companies of foreign enterprises | ... | 38 | 140 | 140 | 150 | 200 |
| Other | — | 508 ^{8/} | ... | 500 ^{8/5/} | 500 | 500 |
| Total | 9,608 | 12,085 | 15,825 | 19,884 | 27,214 | 33,584 |
| Memorandum items: | | | | | | |
| Medium- and long-term debt | 5,624 ^{9/} | 6,485 ^{9/} | 9,406 | 10,834 | 20,092 | 25,952 |
| Short-term debt | 3,984 ^{9/} | 5,600 ^{9/} | 6,419 | 9,007 ^{10/} | 7,122 | 7,632 |
| Of which: foreign banks | (2,057) ^{9/} | (2,600) ^{9/} | (3,737) | (6,407) ^{10/} | (4,522) | (5,032) |
| Total debt as percent of GDP | 3.5 | 4.5 | 6.0 | 7.5 | 10.3 | 12.8 |
| Short-term debt | | | | | | |
| as percent of total | 41.5 | 46.3 | ... | 45.4 | 26.2 | 22.7 |
| as percent of reserves | 24.9 | 31.5 | ... | 68.2 | 59.4 | 57.4 |

Sources: State Administration of Exchange Control (SAEC); OECD Statistics on External Indebtedness; Paris 1985; BIS International Banking Statistics, First Quarter 1986, Basle, July 1986; and staff estimates.

^{1/} Includes known medium- and long-term debt and short-term debt. Short-term nonbank trade credits that are not guaranteed by Export Credit Agencies are not included.

^{2/} Consistent with balance of payments projections in Appendix Table VI.

^{3/} Includes some trade credits provided by Export Credit Agencies.

^{4/} Equal to the difference between China's debt to foreign banks as identified in creditor data and its debt to foreign banks as identified in official (SAEC) statistics.

^{5/} Estimated.

^{6/} Suppliers' credits are referred to as deferred payments in official statistics.

^{7/} Derived as the difference between official development assistance plus nonbank trade credit guaranteed by Export Credit Agencies in creditor statistics; and loans from foreign governments plus deferred payments in official statistics.

^{8/} Equal to the difference between external debt based on creditor statistics and external debt based on official statistics.

^{9/} Based on creditor statistics.

^{10/} Based on creditor statistics for trade credits and official (SAEC) statistics for foreign bank debt.

China--Fund Relations
(As of September 30, 1986)

I. Membership status

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

A. Financial Relations

II. General Department

- a. Quota: SDR 2,390.90 million
- b. Total Fund holdings of currency: SDR 2,088.3 million or 87.34 percent of quota
- c. Reserve tranche: SDR 302.6 million
- d. Current operational budget (September-November 1986): not included
- e. Lending to the Fund: None

III. Stand-By or Extended Arrangements and Special Facilities

- a. Current stand-by: None
- b. Stand-by and extended arrangements in last ten years: Stand-by (first tranche), March 1981; SDR 450 million (25 percent of quota); China repurchased the full amount by end-August 1983
- c. Special facilities in last two years: None

IV. SDR Department

- a. Net cumulative allocation: SDR 236.8 million
- b. Holdings: SDR 458.2 million (193.5 percent of cumulative allocation)
- c. Current designation plan (September-November 1986): not included

V. Administered Accounts

- a. Trust Fund
 - (i) Disbursed: SDR 309.5 million
 - (ii) Outstanding: SDR 278.57 million
- b. SFF Subsidy Account: None

VI. Overdue obligations to the Fund: None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

China maintains a managed floating exchange arrangement. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi vis-a-vis the U.S. dollar. As of September 30, 1986, the representative rate for the renminbi was Y 3.7147 per U.S. dollar.

VIII. Last Article IV Consultation

The Executive Directors reviewed SM/85/226 on November 8, 1985 and adopted the following decision (excluding the first paragraph):

"China continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. The Fund welcomes the termination of the bilateral payments arrangement with a Fund member, and notes with satisfaction the intention of the authorities to eliminate the remaining bilateral payments arrangements with Fund members. The Fund also welcomes the elimination of the internal settlement rate for trade transactions. The maintenance by China of an exchange tax on remitted profits of joint ventures, excluding most ventures in designated areas, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The exchange restrictions, multiple currency practice and bilateral payments arrangements that relate to this decision are described in SM/85/266 (9/27/85) and in SM/85/272 (10/24/85)."

IX. Technical Assistance

Since 1980, the IMF Institute has received more than 30 Chinese officials in its courses and seminars. In late 1983, the Institute organized a three-week course in Xian on "Banking and Monetary Policy." The Bureau of Statistics has sent four missions to discuss data presented in IFS, including a mission on balance of payments statistics in November 1985, and has presented seminars in China on balance of payments methodology in 1983 and on government finance statistics (May 1986).

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

The External Relations Department held a colloquium in China in November 1982. The proceedings of the colloquium were published in 1983 under the title "The Fund and China in the International Monetary System." A second colloquium is scheduled for November 1986 on "Macroeconomic Management, Growth, and the Role of the IMF."

X. Resident Representative/Advisor: None

China--Relations with the World Bank Group

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

Capital subscription: China holds 25,142 shares or 3.1966 percent of the total authorized capital of the Bank. China voted in favor of the Special Capital Increase under which it would be eligible to subscribe to 1,660 additional shares. No formal action has yet been taken to subscribe for these shares.

Lending activities:

| | <u>Commitments</u> | | <u>Disbursements</u> | |
|--|--------------------|------|----------------------|------|
| | IDA | IBRD | IDA | IBRD |

(In millions of U.S. dollars)

| | | | | |
|---------|--------------|--------------|--------------|--------------|
| FY 1981 | 100.0 | 100.0 | -- | -- |
| 1982 | 60.0 | -- | 0.1 | -- |
| 1983 | 150.4 | 463.1 | 32.6 | 0.6 |
| 1984 | 423.5 | 616.0 | 100.9 | 19.6 |
| 1985 | 442.3 | 661.2 | 146.2 | 235.7 |
| 1986 | <u>450.0</u> | <u>687.0</u> | <u>251.9</u> | <u>352.2</u> |
| Total | 1,626.2 | 2,527.3 | 531.7 | 608.1 |

Approved projects: FY 1981, University Development; FY 1982, North China Plain Agriculture; FY 1983, Three Ports, Agricultural Education and Research, China Investment Bank I, Petroleum I and II, and State Farms I; FY 1984, Polytechnic/TV University, Technical Cooperation, Rubber Development, Lubuge Hydroelectric, Railway I, Rural Credit I, Rural Health/Medical Education, Petroleum III, China Investment Bank II, and Agricultural Education II; FY 1985, Agricultural Research II, Power II, University Development II, Changcun (Luan) Coal Mining, Seeds, Rural Water Supply, Highway I, Railway II, Fertilizer Rehabilitation and Energy Saving, Forestry Development, PiShi Hang-Chaohu Area Development, and Weiyuan Gas Field Technical

Assistance; FY 1986, Rural Credit II, China Investment Bank III, Technical Cooperation II, Provincial University, Railway III, Tianjin Port, and Freshwater Fisheries, Beilungang Thermal Power, Yantan Hydroelectric, Liaodong Bay Petroleum Appraisal, and Rural Health and Preventive Medicine.

**Economic Development
Institute:**

Since May 1981, the Economic Development Institute has held several courses a year for China, making it EDI's largest country program. Nine courses were given by EDI in FY 1984, ten in FY 1985, and 13 are planned for FY 1986, using UNDP funds. Chinese participants have also been attending EDI regional courses and programs in Washington. In June 1985 a three-week seminar on development policy and management was held in Washington and New York for senior Chinese officials.

Economic missions:

The 1980 economic mission resulted in the publication of China: Socialist Economic Development (nine volumes). An updating country economic memorandum, China: Recent Economic Trends and Policy Developments (No. 4072-CHA), was distributed to the Bank's Executive Directors in March 1983. In early 1984 an economic mission visited China to focus on long-term economic issues and options. A Fund staff member participated in this mission. A report by this mission (No. 5206-CHA) entitled China: Long-Term Issues and Options was discussed with the Chinese authorities in March 1985 and approved by the Bank's Executive Directors in June 1985. In October the report was published in book form by the Johns Hopkins University Press. A Chinese translation was published concurrently in China. In February/March 1986 a mission which included a Fund staff member examined finance and investment issues. The report is expected to be discussed with the authorities in October/November 1986. A mission which includes a Fund staff member is planned for October 1986 to examine issues in China's foreign trade.

Resident mission:

A resident IBRD office in Beijing was formally opened in October 1985.

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CHINA

Basic Data

| | | | | |
|--|---|---------------|-------------|-----------------|
| <u>Area</u> | 3,748,800 sq. miles (9,597,000 sq. km.) | | | |
| <u>Population (mid-1985)</u> | 1,040 million | | | |
| | <u>1982</u> | <u>1983</u> | <u>1984</u> | <u>1985</u> |
| <u>GDP (in billions of yuan, at current prices)</u> | 484.7 | 538.1 | 641.9 | 778.0 |
| <u>Population growth (in percent, mid-year)</u> | 1.4 | 1.2 | 1.0 | 1.0 |
| <u>GDP per capita (US\$)</u> | 254 | 267 | 269 | 254 |
| <u>Annual percentage changes</u> | | | | |
| Real GDP | 8.3 | 9.8 | 13.5 | 12.3 |
| Real gross industrial output | 7.7 | 10.5 | 14.0 | 18.0 |
| Real gross agricultural output | 11.1 | 9.6 | 17.6 | 14.2 |
| Gross domestic investment | 9.6 | 13.5 | 28.9 | 39.7 |
| Budgetary revenue | 1.9 | 12.9 | 15.1 | 24.4 |
| Budgetary expenditure | 2.7 | 14.0 | 14.8 | 19.8 |
| Currency in circulation | 10.8 | 20.7 | 49.4 | 24.7 |
| Total liquidity | 14.9 | 19.2 | 41.2 | 18.4 |
| Net domestic assets | ... | 17.0 | 44.6 | 23.6 |
| Cost of living index | 2.0 | 2.0 | 2.7 | 11.9 |
| Agricultural procurement prices | 2.2 | 4.4 | 4.0 | 8.6 |
| Value of imports (balance of payments basis in U.S. dollars) | -18.7 <u>1/</u> | 10.9 | 27.6 | 60.0 |
| Value of exports (balance of payments basis in U.S. dollars) | 2.0 <u>1/</u> | -2.0 | 15.4 | 5.0 |
| <u>Ratios to GDP (in percent)</u> | | | | |
| Agricultural production | 38.5 | 39.0 | 38.7 | 36.3 |
| Industrial production | 37.2 | 36.4 | 35.6 | 36.4 |
| Gross domestic investment | 30.3 | 30.9 | 33.4 | 38.5 |
| Budgetary expenditure | 30.6 | 31.4 | 30.2 | 29.9 |
| Budgetary revenue | 29.1 | 29.6 | 28.6 | 29.3 |
| Overall budget balance | -1.5 | -1.8 | -1.6 | -0.5 |
| Currency in circulation | 9.1 | 9.8 | 12.3 | 12.7 |
| Total liquidity | 54.0 | 57.9 | 68.6 | 67.0 |
| Net domestic assets | 47.4 | 49.9 | 60.3 | 61.7 |
| Imports of goods and services (balance of payments basis) | 7.6 | 7.7 | 9.6 | 15.8 |
| Exports of goods and services (balance of payments basis) | 9.7 | 9.2 | 10.4 | 11.2 |
| <u>Balance of payments (US\$ mn.)</u> | | | | |
| Exports, f.o.b. | 21,125 | 20,707 | 23,905 | 25,108 |
| Imports, f.o.b. | -16,876 | -18,717 | -23,891 | 38,231 |
| Trade balance | 4,249 | 1,990 | 14 | -13,123 |
| Current account balance | 5,823 | 4,487 | 2,509 | -11,917 |
| Capital account (net) <u>3/</u> | 209 | 650 | 239 | 8,453 <u>2/</u> |
| Overall balance | 6,331 | 4,771 | 1,816 | -4,609 |
| <u>International reserves (US\$ mn.)</u> | | | | |
| (In months of imports) | 8.0 | 10.3 | 8.9 | 4.1 |
| <u>Debt and debt service</u> | | | | |
| External debt (percent of GDP) <u>4/</u> | 3.4 | 4.0 | 4.5 | 7.5 |
| Debt service payments (percent of exports of goods services) | 11.3 <u>5/</u> | 6.1 <u>5/</u> | 3.9 | 7.2 |
| | 6.9 <u>6/</u> | 4.2 <u>6/</u> | 3.9 | 7.2 |
| <u>Official exchange rate</u> | | | | |
| (Yuan per U.S. dollar, average during the year) | 1.892 | 1.976 | 2.320 | 2.950 |

1/ Not comparable with data for subsequent years, which exclude re-exports.2/ Includes an additional \$768 million of borrowing included in data provided by creditor sources but not in official statistics.3/ Excluding errors and omissions.4/ Based on creditor statistics.5/ Includes early repayments/repurchases.6/ Excludes early repayments/repurchases.

China--Statistical Issues1. Outstanding statistical issuesa. Real sector

Considerable improvements have been made in recent years in the scope and quality of general economic statistics. Monthly data on the consumer price index and industrial production are now expected to be provided on a regular basis.

b. Government finance

There is no presentation for China in the Government Finance Statistics Yearbook. Data published in IFS have methodological shortcomings and are not comparable with other countries. Following a government finance statistics (GFS) seminar, held in China in May 1986, the authorities have set up a group to examine the application of GFS principles and make recommendations within two years. To facilitate application of GFS in China, arrangements are being made to translate A Manual on Government Finance Statistics into Chinese.

c. Monetary accounts

The People's Bank of China recently completed the task of separating its accounts from those of the other specialized banks, and the Bureau will shortly be in contact with the People's Bank with a view to establishing separate reporting systems for the monetary authorities, commercial banks, and other financial institutions. This will enable the compilation of a revised monetary survey. The consultation mission was provided with data on foreign currency assets and liabilities of the Bank of China (BOC) for the last few years, which may provide the basis for an eventual extension of the coverage of monetary survey data to encompass the foreign currency operations of the BOC.

d. External sector

No data have been reported to the Bureau of Statistics in respect of external trade price indices. The authorities are currently in the process of computing unit value indices of exports and imports.

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

The table below shows the currentness and coverage of data published in the country page for The People's Republic of China in the October 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the People's Bank of China, which during the past year have been provided on a timely basis, although the monetary accounts are reported with a three-month lag.

| <u>Status of IFS Data</u> | | <u>Latest Data in October 1986 IFS</u> |
|---------------------------|------------------------------|--|
| Real Sector | - National Accounts | 1985 |
| | - Prices: agricultural goods | 1985 |
| | consumer | 1984 |
| | - Production: Industrial | 1985 |
| | Agricultural | 1985 |
| | - Employment | n.a. |
| Government Finance | - Earnings | n.a. |
| | - Deficit/Surplus | 1985 |
| | - Financing | n.a. |
| Monetary Accounts | - Debt | n.a. |
| | - Monetary Survey | Q2 1986 |
| Interest Rates | - Discount Rate | n.a. |
| | - Bank Lending/Deposit Rate | n.a. |
| | - Bond yield | n.a. |
| External Sector | - Merchandise Trade: Value | April 1986 |
| | Prices | n.a. |
| | - Balance of Payments | 1985 |
| | - International Reserves | June 1986 |
| | - Exchange Rates | August 1986 |

China--Summary of the Economic Program, 1986-87I. Targets

1. Real GDP is expected to increase by 6.5 percent in 1986 and about 6 percent in 1987. The inflation rate, as measured by the change in the index of retail prices (annual average basis) is projected at 5.5 percent in 1986 and 7 percent in 1987.

2. The current account deficit is targeted to decline from \$11.9 billion (4.5 percent of GDP) in 1985 to \$10.0 billion (4.0 percent of GDP) in 1986 and \$5.6 billion (2.3 percent of GDP) in 1987. Gross international reserves are to decline from \$13.2 billion (4.1 months of imports) at end-1985 to \$12.0 billion (3.7 months of imports) at end-1986 and to recover to \$13.3 billion (4.3 months of imports) at end-1987.

II. Assumptions

1. Export unit values for non-oil trade are projected to rise in terms of the U.S. dollar by 15 percent in 1986 and 6 percent in 1987. External demand, measured by the growth of China's non-oil export markets, is projected to increase by 3.1 percent in 1986 and 3.8 percent in 1987. Non-oil export volume is projected to increase by 16 percent in 1986 and 7 percent in 1987.

2. The world price of oil in terms of U.S. dollars is assumed to decline by 48 percent in 1986, and to increase by 3 percent in 1987. Oil export volume is projected to decline slightly in 1986 and remain broadly unchanged in 1987.

3. Import unit values are expected to rise in terms of U.S. dollars by 10 percent in 1986 and 5 percent in 1987. Import volume, after increasing by over 60 percent in 1985, is projected to decline by 8 percent in 1986 and 7 percent in 1987, reflecting continued financial restraint and recent exchange rate adjustment.

4. LIBOR is assumed to average 6.8 percent in 1986 and 6.5 percent in 1987.

5. The income velocity of money, defined as the ratio of nominal GDP to broad money, is projected to remain unchanged in 1987.

III. Principal Elements of the Program 1/

1. Domestic financial policies

a. Quarterly benchmarks have been established for net domestic assets of the banking system and of the People's Bank of China for the period through December 1987. Consistent with the program's external objectives and the targeted increase in broad money of 16.7 percent in 1986 and 13.4 percent in 1987, these benchmarks indicate (i) growth in net domestic assets of the banking system of 19.4 percent in 1986 and 13.5 percent in 1987; (ii) growth in net domestic assets of the People's Bank of 19.2 percent in 1986 and 12.8 percent in 1987. The authorities will closely monitor the operations of the specialized banks to ensure that credit expansion is consistent with the program's objectives.

b. Interest rates charged on lending by the People's Bank to specialized banks were raised by up to almost 6 percentage points in August 1986. The structure of specialized bank lending and deposit rates is being reviewed with a view to maintaining positive real rates.

c. The state budget deficit is to be reduced in 1986 and 1987 from the level of 0.5 percent recorded in 1985, implying a further improvement in the budget's net position with the banking system. These objectives will be achieved through a combination of expenditure restraint, including limits on local government outlays and cancellation or postponement of low priority projects, and further steps to improve the tax system.

2. External financial policies

a. Continuing the work undertaken since the State Administration of Exchange Control was designated as the responsible agency in April 1986, further progress will be made to improve the coverage of external debt statistics (particularly with reference to trade credit and borrowing by enterprises from foreign banks) and to strengthen approval and control procedures for all external borrowing.

b. Quantitative benchmarks, consistent with the external objectives of the program, have been established for (i) contracting or guaranteeing of nonconcessional external debt of from 1 to 15 years' maturity, with a sublimit covering 1 to 5 year's maturity; (ii) short-term debt of the Bank of China; and (iii) net foreign liabilities of financial institutions (i.e., net foreign liabilities of the Bank of China and gross liabilities of other financial institutions). According to these benchmarks, contracting or guaranteeing of nonconcessional debt (1 to 15 years) would amount to \$0.5 billion between October 1 and December 31, 1986 and \$3.0 billion between October 1, 1986 and

1/ Quantitative benchmarks through end-December 1987 are shown in Table 2 of the main text.

December 31, 1987, of which amounts up to 20 percent would be of from 1 to 5 years' maturity; short-term debt of the Bank of China would increase by \$0.3 billion between end-June and end-December 1986, and by \$0.5 billion during 1987; and net foreign liabilities of financial institutions would rise by \$3.6 billion between end-June and end-December 1986, and by \$2.0 billion during 1987.

3. Exchange rate policy

The renminbi was devalued by 13.5 percent to Y 3.7 per U.S. dollar on July 5, 1986. A flexible exchange rate policy will be maintained in order to increase export volumes and strengthen the balance of payments. Further exchange rate adjustments will be implemented as warranted by the implications of price reforms to be introduced in early 1987, as well as export performance, developments in the net foreign assets of the banking system, and movements in the exchange rates and prices of major trading partners and competitors.

4. Pricing policies and other reforms

a. Price reforms slated for introduction in early 1987 will focus on adjustments to major energy and raw material prices; steps to increase links between domestic and international prices will continue.

b. The financial responsibilities of enterprises and extent of competition between them will be further increased, and the experimental use of bankruptcy will continue. The use of labor contracts will be further expanded.

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Stand-By Arrangement--People's Republic of China

Attached hereto is a letter, with annexed memorandum, dated October 3, 1986 from the Governor of the People's Bank of China requesting a stand-by arrangement and setting forth the objectives and policies which the authorities of the People's Republic of China intend to pursue for the period of this stand-by arrangement. To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of one year from November ..., 1986 China will have the right to make purchases from the Fund in an amount equivalent to SDR 597.725 million, subject to paragraphs 2 and 3 below, without further review by the Fund. Purchases under this arrangement shall be made from ordinary resources only.

2. China will not make purchases under this stand-by arrangement during any period of the arrangement in which China has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

3. China's right to engage in the transactions covered by this arrangement can be suspended only with respect to a request received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of China. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 3, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and China and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of China, the Fund agrees to provide them at the time of the purchase.

5. China shall pay a charge for this arrangement in accordance with the decisions of the Fund.

6. (a) China shall repurchase the outstanding amount of its currency that results from a purchase under this arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as China's balance of payments and reserve position improves.

(b) Any reductions in China's currency held by the Fund shall

reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

7. During the period of the arrangement, China shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to China or of representatives of China to the Fund. China shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of China in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

8. In accordance with paragraph 2 of the attached letter, China will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable.

Washington, D.C.
October 3, 1986

Dear Mr. de Larosiere:

The attached Memorandum on Economic Policies of the Government of the People's Republic of China outlines the policies and measures that we will implement to achieve balance of payments adjustment in the context of sustainable growth, price stability, and continued structural reforms. In connection with the adoption of these measures, China requests a one year stand-by arrangement in the first credit tranche in an amount equivalent to SDR 597.725 million.

The Chinese authorities will remain in close contact with the Fund staff on developments and progress in implementing these policies. The Government of the People's Republic of China believes that the policies set forth in the attached memorandum are adequate to achieve the objectives of the adjustment program, but will take any further measures that may become appropriate for this purpose. China will consult with the Fund on the adoption of any measures that may be appropriate in accordance with the policies of the Fund on such consultations.

Sincerely yours,

Liu Hongru
First Deputy Governor
People's Bank of China

On behalf of
Chen Muhua
Governor
People's Bank of China

Attachment

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
Washington, D. C. 20431
U.S.A.

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Memorandum on the Economic Policies of China

1. Over the past several years, China has made tremendous progress in socialist modernization and reforms, and achieved profound changes in the nation's economic structure. The overall objectives of the reforms are to promote economic development through the establishment of a socialist commodity economy in which, within the general framework of predominant state ownership, market mechanisms play an increasing role. Already, increased autonomy has been granted to agricultural producers and then to industrial enterprises. The reforms contributed to a remarkable output performance with growth of GDP averaging 10 percent annually during 1981-85. Both agricultural and industrial production grew rapidly and substantial increases in personal incomes were registered. Key plan targets in transport, communications, capital construction, coal and power output were fulfilled or overfilled. Major reforms were begun in the areas of taxation, finance, and planning, and as China continues to open to the outside world, there was significant expansion of international trade, foreign borrowing, and foreign direct investment.

2. These achievements notwithstanding, we are aware that difficulties and problems remain while our economic system is changing from an old structure to a new one. Over the past few years, we have worked hard to ensure coordinated development of the economy. Sometimes, however, insufficient attention was given to effectively controlling the excessive growth of money supply and aggregate demand, and by late 1984/early 1985 macroeconomic strains were evident. The expansion of demand and output became excessive; inflation accelerated, partly on account of reform-related adjustments; and the balance of payments began to deteriorate. The current account shifted to a \$12 billion deficit (4.5 percent of GDP) in 1985 from a \$2.5 billion surplus (0.9 percent of GDP) in 1984. This shift occurred largely on account of imports, which rose by 60 percent. Exports rose by only about 5 percent, the increase being entirely on account of a sharp increase in the volume of oil exports; manufactured exports declined as China lost market shares. Gross international reserves declined by \$4.6 billion to \$13.2 billion at end-1985, equivalent to about 4.1 months of imports. External borrowing increased sharply and is estimated to have amounted to close to \$7-8 billion. On the basis of national data our external debt is estimated to be about \$16 billion (6 percent of GDP) at end-1985. The debt service ratio rose from an estimated 4 percent in 1984 to an estimated 6 percent in 1985.

3. We responded to the situation with a series of corrective measures since early 1985. Fiscal and monetary policies were tightened; the state budget improved from a deficit of 0.7 percent of GDP in 1984 to a surplus of 0.3 percent in 1985 (on the basis of national definition), and the rate of monetary expansion was reduced by more than half to about 18 percent. During 1985 interest rates were raised on two occasions and duty rates increased on selected imports; selected food prices were allowed to rise as part of price reforms; and the renminbi was depreciated by 13 percent vis-a-vis the U.S. dollar and by about 15 percent in real effective terms. At the same time, administrative controls over wages and investments were strengthened and import restrictions and foreign exchange allocations were tightened selectively.

4. These measures have reduced macroeconomic imbalances. The growth in industrial production decelerated sharply from 23 percent in mid-1985 to about 5 percent in the first half of 1986; and investment demand became less buoyant. Inflation has decelerated; retail price increases slowed from nearly 9 percent in 1985 to 5.5 percent in the first half of 1986. Slower growth of domestic demand contributed to a sharp reduction in import growth from 60 percent in 1985 to 9 percent in the first half of 1986. As the effects of slower import growth and a pickup in non-oil exports offset declining oil prices and rising net interest payments, the external payments situation began to improve. The current account deficit is estimated to have been about \$4.4 billion in the first half of the year. Gross international reserves declined further by \$1.2 billion in the first seven months to \$12.0 billion.

The adjustment program for 1986-87

5. We recognize that the successful continuation of reforms requires that the balance of payments situation be promptly brought under control and inflationary pressures be contained. Therefore, the objectives of our economic policies for the program period are to attain a basic balance between total supply and demand so as to reduce the current account deficit to a level that will prevent debt servicing problems, maintain an adequate level of international reserves, contain domestic inflationary pressures, and maintain reasonable and sustainable economic growth.

6. Our target is to reduce the external current account deficit to \$10 billion in 1986 and \$5.6 billion in 1987, equivalent to 4.0 percent and 2.3 percent of GDP, respectively. The achievement of the external current account targets will limit the debt service ratio to 10 percent or less in 1986 and 1987. The import coverage of gross international reserves would fall to around 4 months in 1986 and would be restored to about 4 1/2 months (\$13.3 billion) by the end of 1987. We have targeted the growth of real GNP at an average annual rate of 7.5 percent during the period of the Seventh Five-Year Plan (1986-90), compared with the average annual rate of 11 percent during the past five years. However, growth may be somewhat slower in the initial two years

so that the pressures on the balance of payments imposed by excessive economic growth can be alleviated and a sound financial basis created for sustainable growth and continuing reform of the economic system. Inflation is projected to decelerate to 5.5 percent in 1986 and increase to 7 percent in 1987; the latter reflects mainly the effects of exchange rate adjustments and further price reform measures.

Fiscal policies

7. The 1986 State Budget aimed at attaining overall budgetary balance (on the basis of national definition). Revenue was budgeted to increase by 15 percent, while total expenditure and net lending was budgeted to increase by 16 percent; within the latter, budgeted capital construction investment was to decline by 3 percent. In the first eight months of 1986, a surplus of Y 2.6 billion was recorded, partly reflecting the seasonal pattern of revenues and expenditures. However, over this period, revenue grew only by 8 percent compared with the corresponding period a year earlier, while expenditures rose by 21 percent. The large growth in expenditures in 1986 reflected mainly the lagged effects of wage reform and the increases in income transfers associated with the decontrol of nonstaple food prices in mid-1985, as well as the expenditures of local governments from revenues carried over from 1985. In light of these developments, we have instructed all ministries and work units to strictly control their expenditures within the originally budgeted level. We also intend to allow virtually no increase in the level of state sector investment in 1986 over the levels reached in 1985; a group of investment projects which are not in urgent need will be cancelled; no new projects have been initiated so far in the second half of 1986 and none will be initiated for the remainder of the year. Local governments will receive no central assistance to cover any revenue shortfalls, and their excess revenues may not be used to finance additional expenditures. To improve revenue collection, we shall continue with a nationwide examination of taxation and financial operations of enterprises, which produced very good results in 1985. We believe that these measures will help achieve at least the targeted budgetary balance for 1986, and we hope, although under the circumstances it will be very difficult, to realize a small surplus.

8. We have begun our preparatory work for the 1987 State Budget. The Budget will be formulated to achieve the twin objectives of macroeconomic adjustments and continuing the reforms of the fiscal system. It is our intention to maintain a tight fiscal stance in 1987 with the overall balance targeted to be in surplus. Toward this end, we will continuously exert strict control over fixed investment and other expenditure, in particular price subsidies, while providing necessary funds for the construction of key projects, development of education and culture, and economic reform. To keep major price subsidies under more effective control, subsidies for people's daily necessities (except imports) and agricultural inputs were listed explicitly as an item of expenditures in the State Budget beginning 1986 and no longer deducted from revenues as in previous years. For the 1987 budget we will

consider extending this treatment to other major subsidies, possibly including those for the operating losses of state enterprises. This will allow us to better examine revenue and expenditure policies for resource allocation. On the revenue side, we plan to review the tax system with the objective of increasing revenues, improving incentives, and promoting technological transformation. This review will focus on improving industrial and commercial taxation, in particular by expanding the scope of the VAT, by standardizing its rates, and by readjusting rates of product tax. We are also considering raising the rate of tax on extrabudgetary construction and the introduction of new taxes, such as taxes on use of land and real assets, and personal income adjustment tax.

Monetary policies

9. We intend to maintain our restrictive credit policy as a key element in the overall stabilization effort. Our original objective for 1986 was to limit the growth in broad money to about 17 percent. However, the economic slowdown in early 1986 created pressures to extend credit, partly to support enterprises suffering from accumulation of excessive inventories and related liquidity problems, and monetary expansion reached almost 25 percent in the year ended June 1986. Subsequently we have tightened credit policies, including the implementation of higher interest rates on credit from the People's Bank (PBC) to specialized banks as described below, and we intend to contain monetary expansion for 1986 as a whole to the original objective of about 17 percent. Regarding 1987, we have begun to formulate our money and credit policies, taking account of domestic and external prospects and other policy measures, including economic reforms. There are many uncertainties in the outlook, and we believe that a cautious policy stance is warranted. Accordingly, we will aim for a further reduction in monetary growth, to a rate of the order of about 13 percent. To achieve these monetary targets, the growth of net domestic assets of the banking system will be further reduced from 24 percent in 1985 to about 19 percent in 1986 and about 14 percent in 1987. To facilitate the control of total liquidity and credit, we intend to limit the expansion of the net domestic assets of the PBC (including its deposit liabilities to the specialized banks) to about 19 percent in 1986 and about 13 percent in 1987. Quarterly targets consistent with this plan for net domestic assets of the banking system and the PBC are contained in Table 1. We will monitor closely the operations of the specialized banks and, if necessary, impose ceilings on the credit extended by individual specialized banks to ensure achievement of the monetary targets specified above.

10. To strengthen the role of interest rates as a policy instrument, we have introduced more flexibility in interest rate policy; deposit and lending rates were adjusted on two occasions in 1985. Effective August 1, 1986 the interest rate on both new and outstanding PBC credit to specialized banks has been increased from 4.68 percent to 6.48 percent for planned loans. For temporary loans, the previous rate

of 5.04 percent was raised to 6.48 percent (up to 20 days), 6.84 percent (up to 3 months), and 10.80 percent for loans outstanding for more than three months; no rollovers of temporary credit will be permitted. These changes should encourage specialized banks to reduce their recourse to PBC credit, increase efforts to mobilize deposits, and should encourage interbank borrowing which will serve to develop further the system for financial intermediation. Specialized banks' interest rates will be reviewed carefully to ensure that they remain positive in real terms, and that lending rates are appropriately differentiated according to maturity.

Enterprise reform

11. We intend to intensify efforts to improve the performance of enterprises. As part of the reform process, decision-making power of enterprises has gradually been increased. As the reform goes deeper, enterprises will have greater responsibility for their own profits and losses. The factory manager responsibility system has been introduced on a selective basis, and many enterprises may now choose for themselves their sources of supplies, their level and structure of production and the direction of their sales. Moreover, measures have been introduced to rationalize the job grading system and to link wages and bonuses to the performance of an enterprise (about 14 percent of workers in state-owned enterprises are now covered by this "floating wage" system); and to improve efficiency, about three quarters of state-owned enterprises in the distribution and retail sectors have been transferred to collective or individual management. In order to encourage enterprises to be fully responsible for the financial consequences of their actions, we have introduced measures to encourage enterprises to use funds prudently, including the replacement of budgetary appropriations with loans to finance working capital and fixed investment; and we are experimenting with a draft regulation on bankruptcy in three industrial cities. The experiment will continue in 1987. We intend to pursue our policy of devolving responsibilities to enterprises, and there will be a further broadening and deepening of the discretionary powers of enterprise management in 1987. Fiscal and credit policies will be adjusted to give priority to enterprises which produce items of marketable quality; credit to loss-making enterprises will be restricted and state subsidies to loss-making enterprises will be held at about the 1986 level.

Extrabudgetary funds

12. We also intend to exert strong controls over extrabudgetary funds which have increased rapidly in recent years and were equivalent to about three quarters of total budgetary revenues in 1985. The growth of extrabudgetary funds is consistent with the progress of economic reform that has given greater flexibility and autonomy to enterprises and local governments. While control on extrabudgetary funds are needed

to achieve macroeconomic stabilization, it will be exercised mainly through indirect instruments so as not to contradict the goals of reform.

Price and wage reforms

13. The reform of the system of pricing and price control is the key to our objective of developing and improving the socialist commodity economy. We have aimed to expand the scope of transactions at flexible prices and to adjust the levels of controlled prices. Following the major steps taken in 1985, price reform this year has mainly involved increasing the number of goods traded at flexible prices and decentralizing price control authority. More flexibility has been permitted to allow for quality, regional, and seasonal variations in controlled prices. In 1987, as stated in paragraph 16 below, domestic and international prices will be better linked by allowing greater flexibility in price determination by enterprises engaged in foreign trade. We also plan to adjust the controlled prices of energy, raw and semi-finished materials, and other means of production.

14. Wage reform is an important aspect of our policies to promote efficiency while maintaining macroeconomic control. We intend to improve the "floating wage" system by selecting the most appropriate indicator on which to base the movement in wages and bonuses. We have tightened financial controls over the level of enterprise payments of wages and bonuses; we shall continue to monitor the level of wage payments and to ensure that credit is not diverted from its intended purpose into enterprises' consumption funds.

External policies

15. In the years to come, China will need to achieve export growth at a substantially faster rate than the growth in imports to reduce the external payments deficit. Since the reforms, the greater financial accountability of foreign trade corporations and the larger share of trade carried out through other channels have made the exchange rate an important macroeconomic instrument affecting export performance. To enhance our capacity to earn foreign exchange through export, effective July 5, 1986, the value of the renminbi was changed to Y 3.7 per U.S. dollar, representing a devaluation of 13.5 percent in U.S. dollar terms. With this adjustment, the depreciation of the renminbi against all our major trading partners during the last 18 months amounts to about 40 percent in real effective terms; against our competitors in Asia, the depreciation is estimated to have been about half that amount. We intend to maintain a flexible exchange rate policy in order to increase export volumes and strengthen the balance of payments. We will make further exchange rate adjustments as warranted by the implications of price reforms to be introduced in early 1987, as well as export performance, developments in the net foreign assets of the banking system and movements in the exchange rates and prices of our major trading partners and competitors.

16. We recognize that the effectiveness of exchange rate policy needs to be complemented by further price and trade reforms. In 1986, enterprises engaged in foreign trade have been given greater flexibility in setting prices they offer in domestic and international markets through the removal of a number of items from state price control. Additional items will be removed from state control in 1987. In addition, we will continue to increase the linkage between domestic and international prices by expanding the scope of the agency system and by increasing the number of items which enterprises can import and export directly.

17. External debt has grown rapidly in recent years. Although external debt and debt service could still be considered modest by international standards, we are concerned about the rapid growth of debt and the increased proportion of short-term debt from commercial banks. Therefore, we consider it of utmost importance to bring all external borrowing under control, to improve the structure of our external debt, and to ensure that the loans are put to effective use. To do this, we are in the process of establishing an external debt management system that will ensure that external borrowing can be monitored and borrowing limits and regulations can be fully enforced. As a first step in this direction, effective April 11, 1986, the State Administration of Exchange Control (SAEC) was designated as the central unit to manage and monitor all external debt. By the end of August 1986, we had collected data on external debt on a loan by loan basis including debt not previously covered by our debt reporting system. On the basis of these data, outstanding external debt as of end-1985 amounted to \$16 billion; short-term debt amounted to \$6.4 billion, 39 percent of total debt. In addition, it is estimated that there is a substantial amount of short-term trade credit outstanding; we intend to collect data on such credit by early 1987. On the basis of available data we have projected debt service payments through 1990.

18. For the remainder of 1986 and 1987, consistent with the targeted reduction in the current account deficit of the balance of payments, we intend to strictly control the use of nonconcessional sources of foreign financing, including short-term debt. Accordingly, we plan to limit the contracting of nonconcessional external borrowing, the net foreign liabilities of the financial institutions and use of short-term debt within the benchmarks set forth in Table 1. To ensure that we meet our objectives, we have also established approval procedures and reporting requirements on all external borrowing. All borrowing units have been instructed to limit their use of foreign borrowing to the planned amounts, to obtain prior approval from the SAEC for all foreign borrowing, and to report use of all foreign borrowing to SAEC. We intend to further improve our debt reporting system and to streamline our approval procedures.

19. Over the past several years, we have implemented policies to open our economy to the outside world, resulting in a significant expansion of international trade and greater use of foreign capital and technology. We will continue with these policies. During the program period, the Government of the People's Republic of China does not intend to introduce new or modify existing multiple currency practices, or to introduce new or intensify existing restrictions on payments and transfers for current international transactions, or to introduce new or intensifying existing restrictions of imports for balance of payments purposes, or to conclude new bilateral payments agreements with Fund member countries. It remains our intention to eliminate the remaining bilateral payments arrangements with Fund members.

Table 1. China: Quantitative Benchmarks for
Stand-by Arrangement, 1986-87

| | <u>Actual</u> | <u>Indicative Limits</u> | | | | | |
|--|---------------|--------------------------|---------------|-------------|-------|-------|-------|
| | <u>1986</u> | <u>1986</u> | | <u>1987</u> | | | |
| | June | Sept. | Dec. | March | June | Sept. | Dec. |
| <u>(In billions of yuan, end of period)</u> | | | | | | | |
| Net domestic assets of the banking system | 518.7 | 527.9 | 573.3 | 574.4 | 567.8 | 588.3 | 651.0 |
| Net domestic assets of the People's Bank | 118.0 | 131.2 | 143.8 | 140.6 | 135.0 | 143.9 | 162.2 |
| <u>(In billions of U.S. dollars, end of period)</u> | | | | | | | |
| Contracting or guaranteeing of new nonconces- sional external debt | | | | | | | |
| Over 1 year and less than 15 years | ... | ... | 0.5 <u>1/</u> | ... | ... | ... | 3.0 |
| Of which: | | | | | | | |
| Over 1 year and less than 5 years | ... | ... | 0.1 <u>1/</u> | ... | ... | ... | 0.6 |
| Short-term debt of the Bank of China | 3.8 | 3.8 | 4.1 | 4.2 | 4.3 | 4.4 | 4.6 |
| Net foreign liabi- lities of finan- cial institutions | 2.2 | 4.0 | 5.8 | 6.5 | 7.2 | 7.4 | 7.8 |

1/ Cumulative from October 1, 1986.

