

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/180

10:00 a.m., November 12, 1986

J. de Larosière, Chairman

Executive Directors

Alternate Executive Directors

A. Abdallah
Dai Q.

E. T. El Kogali

J. de Groote
A. Donoso

M. K. Bush
P. Péterfalvy, Temporary

A. Kafka
T. P. Lankester

T. Alhaimus
M. Sugita
B. Goos
J. Reddy

M. Massé
Mawakani Samba
Y. A. Nimatallah

H. Fugmann

H. Ploix
G. A. Posthumus
C. R. Rye

I. Al-Assaf
E. Ayales, Temporary

C.-Y. Lim
O. Kabbaj
A. S. Jayawardena
N. Kyriazidis

L. Van Houtven, Secretary
J. K. Bungay, Assistant

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Also Present

IBRD: C. Wallich, East Asia and Pacific Regional Office. Asian Department: P. R. Narvekar, Director; M. J. Fetherston, D. J. Goldsbrough, F. Le Gall, M. A. Pinho, K. Saito. European Department: P. C. Hole, H. O. Schmitt. Exchange and Trade Relations Department: E. H. Brau, M. R. Kelly, P. J. Quirk. External Relations Department: G. P. Newman. Legal Department: P. L. Francotte. Research Department: C.-Y. Lin, M. c. Williamson, T. A. Wolf. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, J. Hospedales, A. Ouanes, G. Pineau, I. Puro, M. Z. M. Qureshi, I. Sliper, Song G., D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, O. S.-M. Bethel, J. de la Herrán, F. Di Mauro, G. K. Hodges, Z. b. Ismail, S. King, K.-H. Kleine, T. Morita, R. Msadek, C. Noriega, C. A. Salinas, G. Seyler, B. Tamami, H. van der Burg, Wang X., Yang W.

1. PEOPLE'S REPUBLIC OF CHINA - 1986 ARTICLE IV CONSULTATION
AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with China and China's request for a 12-month stand-by arrangement in an amount equivalent to SDR 597.725 million (EBS/86/230, 10/10/86). They also had before them a background paper on recent economic developments in China (SM/86/260, 10/24/86).

The staff representative from the Asian Department made the following statement:

The staff has recently received information from the authorities concerning additional measures under their broad policy of continuing to open up the Chinese economy. These measures, which were announced on October 11, are designed to improve the climate for foreign direct investment, especially in the export and high-technology sectors. They include additional tax incentives, reductions in nonwage labor costs and land rents, streamlined export and import procedures, autonomy in operational and personnel matters, and permission for foreign investment enterprises to mutually adjust their foreign exchange positions.

The staff understands that the detailed regulations relating to the implementation of these provisions are still being drafted. The staff is awaiting additional information from the authorities concerning details of the proposed measures, including the scheme for mutual adjustment of foreign exchange positions.

Mr. Dai made the following statement:

The staff report on the 1986 Article IV consultation with China has been set out in full, along with details on the economic policies pursued by the Chinese authorities and the economic performance in the past year. I agree with the basic points contained in the report and highly appreciate the in-depth and comprehensive analysis made by the mission and its hard work in accomplishing the 1986 Article IV consultation. Here I would just like to concentrate my statement on a few points.

For a developing country like China, maintaining a reasonable rate of growth is essential and necessary to ensure the continuing improvement of the living standard of its people and the sustained development of the national economy. But what we really need is a coordinated and steady growth rather than too fast a growth. The "too fast" economic growth that emerged in the first half of last year brought about severe constraints in working capital, raw materials, energy, and foreign exchange, which in turn hampered the realization of long-term economic objectives. These consequences were not what we had expected.

By adopting a series of measures, my authorities responded quickly to the problems resulting from the overheated economy. The main measures included tightening fiscal and monetary policies, cutting down fixed capital investment, adjusting interest rates upward, depreciating renminbi exchange rates, and raising duties on imports of selective durable consumer goods. At the end of 1985, these measures proved to be quite successful in slowing economic activities to a more reasonable pace and in quelling inflationary pressures. Judging from the economic performance of the last three quarters, the economy has obviously returned to a normal rate of growth. Latest statistics indicate that the total value of agricultural production is very likely to increase by 4 percent and total grain production is expected to increase by 10 million tons to 390 million tons in 1986. Industrial production also picked up gradually on a quarter-to-quarter basis, with the total value of industrial production at the end of the third quarter of this year reaching Y 652.1 billion, which is about 72.7 percent of the annual Plan target and a 6.4 percent increase over the corresponding period last year. Preliminary projections indicate that a planned 7 percent rate of growth target for the total value of industrial production is viable for the whole year and probably an 8 percent growth rate could be reached if the momentum can be retained.

Measures taken to reduce the scale of fixed investment have now begun to show results. The growth rate of fixed investment spending in 1986 has so far been slower, with expenditure on fixed investment for the period January to September increasing to 18.7 percent over the corresponding period of last year. This is in sharp contrast to last year's 33.7 percent increase over the corresponding period of the year before.

Total retail sales reached Y 354.9 billion at the end of the third quarter, which is about a 13.8 percent increase over the same period last year. This year, retail prices increased an average of 5 percent from January to September. Economic constraints and major imbalances resulting from last year's overheating have been eased and the economy is moving at a more coordinated and normal pace of growth. However, the normal rate of growth was interrupted early this year by the administrative measures used as the major means for macroeconomic management and lack of flexibility in the adjustment of money supply. In order to ensure an adequate and steady growth, money supply had to be increased in the second quarter of this year to meet the urgent needs for working capital of those enterprises with top priority or with the task of restructuring production. It is of crucial importance to avoid serious disturbance and disruption to the economy should there be too sharp a turn in the pace of economic development in a big country like ours. Despite the moderate increase in money growth, monetary policy will continue to be restrictive in general.

Regarding the external sector, excessive demand pressures continued to abate in the first half of this year and the external position began to show welcome signs of improvement despite a sharp weakening in oil export earnings. According to statistics, exports in the previous three quarters increased by 14.8 percent to \$21.4 billion, while imports increased by only 5.1 percent to \$30.36 billion. The external deficit, however, is still uncomfortably large and therefore a more comprehensive program of stabilization and external adjustment has been introduced. The program, in support of which China is requesting a first credit tranche stand-by arrangement, is aimed at the reduction of the current account deficit to a level that would be consistent with the debt-servicing capability, the maintenance of adequate international reserves, and the containment of domestic inflationary pressures, while keeping up adequate growth. With a sound financial base, further economic reform could also be ensured.

To achieve these short- and medium-term goals, the adjustment program stresses the continuation of a prudent and restrictive policy stance, coupled with an improvement in the price system. The tight stance of fiscal policies in recent years will be maintained into 1987, with tighter control of expenditures and further steps to improve the tax system. Following the August adjustment to the interest rates on People's Bank of China loans, additional steps are being taken to ensure that the growth rates of money and credit are compatible with the program's domestic and external objectives. The system of external debt management is undergoing a thorough overhaul to ensure that the process of adjustment will not be undermined by excessive recourse to foreign borrowing. My authorities recognize that improvement of the balance of payments position depends crucially on steps to increase China's non-oil exports. To this end, the renminbi has been devalued twice in the past 12 months. The magnitude of recent devaluations last July was quite drastic and unprecedented, yet its effects on the balance of payments have not been fully reflected. However, policies in this area will continue to be flexible.

China's adjustment program has been tailored to fit the special nature of the country's situation as it is in the process of transition from direct planning to indirect macroeconomic management. Therefore, reforms envisaged for 1987 by the Chinese authorities are based on the experiences of reforms in the past two years and will focus on the price adjustment of productive materials and the reform of the financial and banking system. Price reform is the precondition for other reforms, while adjustment of the price of productive materials will form the basis for the price reform in general. It is envisaged, first of all, that the price of steel will be decontrolled in order to create step by step a market for productive materials and to remove the

price distortion caused by the unreasonably low price levels for productive materials. In addition, reforms in the tax system and management of enterprises will be conducted side by side with price reform.

The reforms in the financial and banking system are designed mainly to strengthen the regulatory functions of the Central Bank in macroeconomic management. These reforms would include: improving the reserve requirement system and the system of financing by the Central Bank to the specialized banks and other financial institutions, establishing a short-term funds market, improving interest rate structure and adjusting lending rates charged by the Central Bank to the specialized banks and the lending rates by specialized banks to enterprises, establishing a banking system with diversified financial institutions playing different roles and functions and leaving them responsible for profits and losses, and strengthening the function of the Central Bank in monitoring and controlling external debt. During this transitional period, it is planned to continue with a prudent and pragmatic approach to economic policy, gradually reducing the role of the traditional direct controls on the economy.

The framework of China's economic management and policies in a midterm perspective has been set out in the Seventh Five-Year Plan from 1986-90, which was approved last April by the National People's Congress. The Plan aims at the further development of a socialist system with Chinese characteristics, through additional economic reforms, including measures to invigorate state enterprises, to develop markets with associated price reforms, and to use additional indirect methods of macroeconomic management. My authorities consider their program of short-term adjustment to be an integral element in the process of ensuring the achievement of the Seventh Five-Year Plan's objectives. Also central to these tasks is the continuation of reforms and the opening of the economy to foreign trade and investment. This process, in the further development of mutually beneficial international cooperation, is certain to continue.

Mr. Sugita made the following statement:

The economic reforms that have been pursued since 1979 have brought about impressive results in terms of rapid growth in production and improvement in living standards, although recently they have also given rise to some economic imbalances. During the five years from 1980 to 1985, industrial production expanded by 67 percent and agricultural production increased by 74 percent. These growth figures are particularly noteworthy against the background of the population growth of 6 percent during the same period. Undoubtedly the production responsibility system in the agricultural sector and the increased autonomy of enterprises in

the industrial sector contributed to the remarkable achievements through the provision of incentives to production units. At the same time they were implementing economic reforms, the authorities had to cope with the serious task of establishing a new policy framework for indirect economic management, based on macroeconomic instruments and the price mechanism, to replace the pervasive state planning system. The authorities have made considerable progress, as has been evidenced by the reduction in price controls, the liberalization of trade restrictions, and the flexible management of exchange rate policy and financial reform.

Under the present socioeconomic conditions, however, this transition to a new system of economic controls has had to be a time-consuming, iterative process, and this has led to some difficulty in reining economic forces that have been unleashed by the provision of autonomy to production units. Toward the end of 1984, there had emerged worrying signs of rapid credit expansion, a reduction in the level of foreign reserves, increased foreign borrowing, and accelerated inflation. The authorities responded relatively quickly to this situation and took early corrective measures; on the basis of such stabilization measures, they are seeking Fund assistance in the form of a first credit tranche stand-by arrangement. It was unfortunate, though understandable, that the stabilization program involved some direct control measures. Nevertheless, I believe that the 1986-87 adjustment program represents the best efforts by the authorities, under the present circumstances. I warmly support the proposed decisions on the use of Fund resources.

The credit expansion in 1984 was followed by growth in industrial production, which, in the first half of 1985, exceeded the production of 1984 by 23 percent. After the introduction of ceilings on loans for specialized banks in April 1985, credit expansion decelerated, bringing down the rate of growth in industrial production to a more sustainable level. The rate of inflation declined, and a turnaround occurred in the external current account balance in the first half of 1986.

Looking back on the cause of the credit expansion in 1984, one might notice the unfortunate coincidence of financial reform and the provision of autonomy to state enterprises. Monetary control, then at an exploratory stage, could not cope effectively with a surge in credit demand from state- and collective-owned enterprises, which had been given broad financial autonomy under the economic reforms. Under the circumstances, it was inevitable that direct control measures, such as the ceilings on the credit expansion of each specialized bank, had to be introduced. Subsequent events have proved their effectiveness. Given these developments, it is quite appropriate that the authorities recognize that restrictive credit policy is a key element of

their overall stabilization efforts. Indeed, as state directives give way to a production system based on initiatives of each production unit, availability of credit will have to assume an increasingly important role in controlling economic activity. Recognizing this fact, the authorities have implemented far-reaching financial reforms.

I welcome the authorities' intention to improve further the instruments of monetary control, including the availability of central bank credit, redeposit requirements, and interest rate policy. At the same time, I recognize the authorities' difficulties in relying totally upon these indirect control instruments, as they are not yet fully developed, and I can see the need for supplementary direct controls for the time being.

While the instability of the velocity of money makes it difficult to pinpoint the most appropriate rate of monetary growth for 1986 and 1987, it is clear that the expansion in 1984-85 was excessive and should not be repeated. I believe that the targeted rates for 1986 and 1987 are broadly appropriate. However, reacceleration of credit expansion in the first half of 1986, which is attributed to excess inventory and liquidity difficulties, is a source of some concern. Although a surge in demand for credit at a later stage of economic downturn is not uncommon, it should not be accommodated by credit expansion. The difficulty experienced earlier this year in controlling monetary expansion is likely to be a reflection of insufficient financial discipline for enterprises and may underline the need for improvement, specifically in bankruptcy procedures.

I commend the authorities for their achievements in recent years in reducing the fiscal deficit, while curtailing the size of the budget. In 1986, the budget envisages an increase in the overall deficit. The actual deficit for the early months of 1986 appears to have exceeded the budget because of revenue shortfalls and expenditure overruns, although some improvement is expected for the remaining months, in response to corrective measures that have been taken. The authorities seem to feel that the scope for further tightening of the fiscal stance is rather limited because of the uncertainties about the effects of the reforms on fiscal prospects, and because of the reduced rate of economic growth. In this regard, I would like to stress the importance of maintaining a sound fiscal position, not only for short-term stabilization purposes, but also for enhancing growth potential over the longer run. Further improvement in the tax system is particularly important, as the system of transfers from enterprises is being progressively replaced by taxation as a major source of government revenue. Consideration is now being given to the rationalization of indirect taxation and the introduction of new taxes on the use of assets and on personal

incomes. Apart from the effects on revenues and incentives, the early implementation of these measures would provide the authorities with additional instruments for macroeconomic control that could be utilized for stabilization purposes in the future. The authorities need to maintain an overall restrictive stance on expenditure, while ensuring adequate funding for priority expenditures.

The major exchange rate adjustment made in July 1986, following a series of small adjustments, represents a major breakthrough, indicating the preparedness of the authorities to activate one of the most important policy instruments. Active use of a flexible exchange rate policy, coupled with the establishment of a link between international and domestic prices, would ensure a better allocation of resources and would improve the balance of payments prospects over the medium term. I also welcome the relaxation of export licensing restrictions that has been made with the aim of improving the balance of payments situation. Measures taken to improve the climate for foreign direct investment are also welcome. However, it is regrettable that a reduction in imports had to rely, at least partly, on direct import restrictions, which I hope will be phased out with the development of indirect policy tools.

While the level of external debt clearly remains manageable, its rapid increase in the past two years is a source of some concern. It is therefore appropriate that limits have been set for external borrowing as a benchmark for the program. The establishment of a sole agent responsible for monitoring external debt will contribute to better debt management. It must be difficult to make any reliable balance of payments projections for such a country as China, which is undergoing a dynamic, structural change in its socioeconomic framework. This situation underscores the need for a flexible response by the authorities to the changing macroeconomic and external conditions; it may also argue for a flexible approach to the implementation of the Five-Year Plan, and may raise a question about the desirability of having a rolling, instead of a fixed, Five-Year Plan.

I heartily welcome the authorities' strong commitment to economic reforms, in spite of the emergence of temporary macroeconomic imbalances. Indeed, according to Mr. Dai's statement, his authorities consider their program of short-term adjustment to be an integral element in ensuring the achievement of the objectives of the Seventh Five-Year Plan. In particular, the major reform of pricing policies envisaged for 1987 is both timely and appropriate, as prices have come to play an increasingly important role in economic decisions of enterprises under the decentralized system.

Low prices for energy and materials, which have often posed serious restraints on output growth, need to be reviewed. The dismantling of subsidies for basic consumer goods would improve both overall resource allocation and the fiscal position. It is also important to ensure that the differential for quality be reflected in prices. This point cannot be overemphasized, since the balance of payments constraint can be overcome in the longer run only by the exportation of products of higher quality with higher value added. Similarly, consideration needs to be given to the differentiation of wages. Some progress has been made in making wage allocation reflect productivity differentials among enterprises. It may be worth considering the introduction of a productivity-based system of wage differentiation among individuals within an enterprise as well. While fully acknowledging the difficult, far-reaching nature of the issue of labor mobility in China, I appreciate the recent experimental introduction of fixed-term labor contracts in place of the existing lifetime employment system, and I look forward to further progress in this direction. Finally, the financial discipline of enterprises must be strengthened, and bankruptcy procedures need to be applied more widely than has been the case.

The authorities have addressed, at a relatively early stage, the macroeconomic imbalances that had emerged as a consequence of economic reforms, and have sought financial assistance from the Fund on the basis of a comprehensive stabilization program. While resorting partially and temporarily to direct control measures for stabilization purposes, the authorities are firmly committed to pursuing economic reforms and are facing up to the challenging task of promoting decentralization while maintaining the broad framework of a planned economy. I support the basic policy direction and I warmly endorse the proposed decisions.

Mr. Posthumus made the following statement:

I am impressed by the way in which the authorities are transforming the economy into a more decentralized market economy, and by their pragmatic approach to solving their unique problems. The staff's observation--that the use of new macroeconomic instruments to tackle large macroeconomic imbalances is in itself an integral part of the reform process, but that some recourse to direct controls may be inevitable--witnesses the same pragmatic approach.

The apparent intention to limit the budget deficit to a low level in 1987 and to strengthen external debt management with a view to improving the structure of debt, indicates that the authorities have taken into account the sustainability of policies

in the longer term, and I want to underline explicitly the importance of this. We support the policy aimed at maintaining positive real interest rates. In EBS/86/230 reference is made to active and flexible interest rate policies. Although I understand the aims of these policies, the content of the policies is not clear and more information about them would be helpful.

Price reform is of prime importance in the current process of restructuring the economic system. It is perhaps unavoidable that price reform would lead to some increase in prices, although this increase should be of a once-and-for-all nature. Despite the risk that such price increases might lead to inflationary expectations, the authorities should continue with the price reform program in the interest of longer-term development.

The external sector remains vulnerable, the more so in the light of the uncertainties about the relationship between growth and imports. In a period of profound structural changes, of course, a review of past relationships is not very indicative. The task of keeping external indebtedness under control will not be made easier by these uncertainties.

Monetary policy can be effective only when, among other things, state enterprises are subject to financial discipline. Apparently, most problems of monetary control have been associated with excessive credit to these enterprises in the past. It is interesting that the possibility of bankruptcy--and the acceptance of bankruptcy in specific situations--is necessary to prevent excessive bank or state financing of enterprises. Quite a few countries, including my own, have some experience in this matter.

I support the proposed decisions.

Mr. Lankester said that China had, in many ways, made further substantial progress in the past year. The estimated growth of 6 1/2 percent, though slower than the remarkable rates recorded in the two previous years, still seemed to represent a clear vindication of the economic reforms implemented over the past few years. Nonetheless, signs of strain in the economy were evident, resulting partly from the heavy growth rates of the previous years, and partly from the rapid, albeit welcome, move to decentralization of the economy. The authorities had rightly utilized the whole range of policy instruments open to them--both direct and indirect--to deal with the situation. However, they seemed to recognize that in the longer term greater weight would need to be given to indirect controls if the advantages of the more flexible economic system currently being put in place were to be fully realized.

The signs of strain had been most apparent in the external sector, where the substantial deterioration in the current account had led to a depletion of reserves, Mr. Lankester considered. In the face of that

situation, the authorities had already taken measures to slow the growth of the economy and to strengthen the external sector. Those measures were showing positive results, although the external position clearly remained under pressure. In addition, the authorities had sought the Fund's assistance. The authorities' recognition of the importance of tackling a potential balance of payments problem at an early stage, well before it led to an excessive rise in the debt burden, was indeed welcome.

In some ways, the situation facing the Chinese authorities was unusual, Mr. Lankester went on. The pressures on the external position resulting from a rapid growth rate were not unique; what was unusual was that those pressures were not associated with a particularly weak fiscal performance. On the contrary, the state budget was in near balance and had actually strengthened over the past few years, with the deficit of 1985 being the smallest since 1981. The state budget deficit--including the Central Government, provinces, and municipalities--was estimated at 0.5 percent of GDP for 1986, which was low by international standards. Although China had been a net loser owing to the oil price decline, a major reason for the balance of payments deterioration had been the strong investment demand.

The appropriate policy response to such a situation seemed to depend on the efficiency of the investment being undertaken, Mr. Lankester observed. If investment at the margin were thought to be highly productive, then the appropriate policy response would appear to be to tighten the fiscal position sufficiently to ensure that the rapid investment growth could be accommodated without leading to excessive pressure on the balance of payments. However, the authorities seemed to have decided that the overall macroeconomic balance should be corrected partly by a curb on investment through credit tightening. They apparently believed that the investment forgone would not have been particularly productive and that economic growth would not be adversely affected to any significant extent. That opinion seemed to be supported by the figures on page 31 of SM/86/260, which suggested that despite all the efforts being made, there had not been any great improvement in capital efficiency in recent years.

The question of investment efficiency raised a central problem that faced the authorities in their reform efforts, namely, how to ensure that the appropriate incentives were given so that resources were efficiently allocated and utilized, Mr. Lankester added. In a theoretical model in a fully centrally planned economy, that problem was dealt with by the authorities' direct intervention. In the competitive model, investment was allocated by market forces. Although most economies actually lay somewhere between those two paradigms, the authorities faced a particularly difficult problem resulting from both the rapid changes of recent years and the mixed nature of planning and decontrol currently marking the economy.

In seeking to increase the efficiency with which capital was utilized, the authorities were implementing one reform that was of particular potential importance, namely, the experiments in introducing the threat of bankruptcy, Mr. Lankester commented. Those experiments seemed to be an important way of helping to give enterprises the incentive to operate as efficiently as possible. The tax reform that had been introduced over the past couple of years should also prove helpful to the extent that it replaced the automatic remittance of profits with more conventional profit taxation.

It was also important that the authorities were able to attract capital inflows, particularly where they did not add to the existing debt burden, Mr. Lankester continued. In that light, the recent measures to liberalize the controls on direct investment appeared to be welcome, although that subject merited a more detailed treatment than it had received in the staff papers. For example, it would have been interesting to have the staff's views on the new regulatory regime that continued to allow only joint ventures aimed primarily at exporting and continued to impose controls on profit repatriation.

The authorities had made substantial efforts in recent years to curb the state budget deficit, Mr. Lankester recalled. It was important that those welcome efforts be maintained. It was appropriate, therefore, that the authorities had taken measures to tighten controls on expenditure in the second half of 1986, after the apparent relaxation in the fiscal position in the first eight months of the year. More generally, the move for the first time to score basic subsidies as expenditure rather than as revenue losses was a useful step in increasing the transparency of the fiscal accounts.

Tighter credit policies had played an important role in helping to control the economy, Mr. Lankester noted. Given the authorities' decision not to pursue a significantly more restrictive fiscal policy, it was appropriate--after the relaxation of the monetary stance in the second quarter of 1986--that the authorities had taken measures to tighten credit through 1987.

Despite the welcome measures that had already been taken, the authorities would need to continue to monitor the external position carefully, Mr. Lankester stated. The objective of curbing the current account deficit to a level that could be financed by direct investment and concessional borrowing might be achievable; however, it was predicated on the assumption that export growth would substantially exceed the growth of China's export markets. If that objective was to be attained, it would be important for the authorities to stand ready to take additional measures--including possible further action on the exchange rate--should the external position prove weaker than expected. Finally, he supported the proposed decisions.

Mrs. Ploix made the following statement:

Our discussion on both the Article IV consultation for 1986 and the request for a stand-by arrangement exemplifies the close relationship between China and the Fund since 1980. At the 1985 discussion of the Article IV consultation with China (EBM/85/162, 11/8/85), we voiced some concern about the growing economic and financial strains that were already apparent. Unfortunately, those fears about a possible overheating of the economy proved warranted. The problems facing China are of a temporary nature, since they reflect the delicate course of action that the authorities have been steering deliberately and steadfastly since the late 1970s. The traditional trade-off between growth and stability is all the more difficult in the context of sweeping economic reforms and commendable far-reaching structural changes.

At the present juncture, where internal and external imbalances seem unsustainable in the medium term, the emphasis must be put on macroeconomic regulation. By gaining tighter control over some major policy instruments that are still at an early stage of development, the authorities will ensure that the necessary institutional and structural steps are introduced in a less disruptive manner that will not jeopardize a steady growth rate.

Fiscal policy deserves mention. Since the excessive growth upswing originated from an investment boom, I wonder whether the investment program should not be scrutinized more closely. The current ratio of capital spending to GDP--35.9 percent--may be excessive if compared with the corresponding savings ratio--33.5 percent--and if compared with a 1985 study on China by the World Bank, in which an optimal ratio allowing long-term growth was put at 30 percent. To address this issue without questioning the broader autonomy devolved to the local entities, the authorities should be able to improve the monitoring of investment programs undertaken at this decentralized level. One avenue to be explored might be the strengthening of financial constraints and sanctions for these entities. In addition, the World Bank has a part to play in clarifying the areas of special interest for the development of production potential. In this regard, I wonder whether the staff could comment on the report relating to finance and investment issues that is currently being discussed with the authorities. In the meantime, even if there is little scope for action on the government budget side, perhaps an even more conservative fiscal approach could be considered by the authorities--namely, the switch from a slight deficit, 0.4 percent of GDP, to a surplus position.

Some major uncertainties prevail in the monetary area. Indeed, China could be considered a case study for the theoretical aspects of the design of Fund-supported adjustment programs. The dramatic

changes in the institutional setting and in the financial structure have made it difficult to predict future developments in the demand for money. Moreover, despite all the progress made in the promotion of market mechanisms, price distortions are still too large to allow an allocation of financial resources based mainly on interest rates and indirect monetary regulation. Given these conditions, the monetary stance has to remain cautious in order to prevent any slippages. Furthermore, the introduction of new instruments should remain pragmatic, so as to follow the structural developments in the real economy and not to anticipate them. During this transitional stage, the authorities should not deprive themselves of any direct or quantitative device that could prove essential in keeping the monetary situation under control.

Dramatic changes have already occurred in China, but the drive for modernization and liberalization has to be carried on. With the benefit of hindsight, we could add that more attention could be paid to the timing and coordination of this broad-based scheme.

External conditions must have a significant bearing on all other components of structural policy. Furthermore, given the lack of responsiveness of domestic supply to a high, prolonged level of activity, I welcome the authorities' determination to develop a more outward-looking approach to their long-term growth objectives, as was emphasized by Mr. Dai. In the short run, the external deficit--which cannot be reasonably sustained--must be tackled through demand-restraint measures. The move toward a more export-led growth is the appropriate approach for the longer run. To this end, the authorities will have to continue focusing on the exchange rate policy, which is to remain a key element in the opening up of the economy, and on the financing of the current account deficit, which is expected to be a permanent feature on the external side through the 1980s. In this regard, a more centralized information and monitoring system could help improve the debt management policy.

The authorities have chosen to rely to a fairly large extent on direct foreign investment to cover the residual financing gap, which is further evidence of their cautious and eclectic approach. They must be encouraged in this direction, not only because recent economic history highlights the risks attached to debt accumulation, but also because of the benefit that could be derived from foreign investment in speeding up modernization and diversification. To these ends, the authorities must deal with the multiple currency exchange practice that remains on some profit remittances. Obviously such practices have to be eliminated if the share of direct foreign investment in external financing flows is to become more significant in the future.

Streamlining the relative price structure lies at the core of the far-reaching structural measures that have already been initiated. By bringing the internal prices more in line with international ones, the authorities would improve competitiveness and create an anchor around which an entire range of related prices could be consistently set, with a view to alleviating the distortions that still hinder the resource allocation process. I would welcome staff comments on the steps envisaged toward introducing a new price system.

I am convinced that the authorities will once again display wisdom and skill in overcoming their present difficulties, in order to return rapidly to a path of strong and sustainable growth. In this connection, the supplemental measures included in the program before us will certainly be helpful. We hope that the recovery will be as rapid as that of the previous arrangement, in 1981-83. I commend the authorities for having turned to the Fund for assistance and monitoring at such an early stage in their adjustment process, and I endorse the proposed decisions.

Mr. Ayales made the following statement:

The vigor and dynamism with which the Chinese economy has grown in the past years is propitious for the introduction of profound reforms in the planning process. Decisions at lower levels of government and by enterprises are now more decentralized and prone to respond to market mechanisms. The transition process, difficult in itself, has been affected by unfavorable market conditions for oil exports and has resulted in economic disequilibria--some internal and some external. One might think that if the authorities adopted direct measures--such as trade restrictions and wage and price adjustments--aimed at correcting these disequilibria, they could help the economy achieve higher rates of growth in the short run. However, the current situation poses a difficult dilemma for the authorities--whether to confront the situation with more direct measures, endangering the decentralization of decisions, or to pursue the decentralization, impairing the prospects of sustained growth. The authorities' pragmatic approach, which characterizes the 1986-87 program, appears to be the most appropriate course of action under the current circumstances. The disequilibrium that appears to worry the authorities the most for the short term is the balance of payments financing gap. The surplus registered in the current account in 1982-84 became a deficit in 1985, and that deficit is now expected to be eliminated before 1990. The deficit derives mostly from the dramatic growth of imports, which more than doubled in value terms between 1983 and 1985. Heavy industrial and chemical goods, as well as consumer goods, which represented

more than 50 percent of total imports in 1985, explained most of the increase in imports, which partially reflects the authorities' pursuit of import liberalization and their domestic credit expansion policies. However, it is important to consider whether the present level of imports is necessary for sustaining the current pace of investment and/or the increased production of exportable goods.

The 1987 program contemplates a rate of economic growth below the current rate and proposes a more restrictive monetary policy, the maintenance of exchange rate incentives, and tighter restrictions on luxury consumer imports. The recent level of investment, moreover, is considered unsustainable.

Given the previous considerations, the current account projections could be interpreted as being somewhat conservative, because even a lower level of imports, particularly of investment goods, could be sufficient to attain the objectives stated in the program. An alternative, more disturbing interpretation is that the measures contemplated in the proposed adjustment program do not impinge sufficiently on trade flows; this conclusion can be derived from the balance of payments projections through 1990.

Although China's total foreign debt is not large in relation to the size of the economy, the estimates for 1986 and the projections reflect a steep increase--from 7.5 percent of GDP in 1985 to 16.5 percent in 1990. The service on the foreign debt does not seem to pose a restriction on the growth rate of the Chinese economy through 1990, as the debt service ratio is projected to increase from 7.2 percent in 1985 to only 8.7 percent in 1990, but we wonder whether the comfortable situation envisioned for the period 1987-90 can be sustained in the future.

In referring to the balance of payments adjustment, the staff states that it is exceptionally difficult to associate a given set of measures with precise quantitative results. It is important to reconsider the role assigned to the exchange rate, if price stability remains the authorities' central objective, as well as linking world and domestic prices of traded goods and adjusting the balance of payments financing gap. Although it is difficult to pronounce an exchange rate undervalued, the real effective exchange rate had fallen about 25 percent by September 1986, relative to its average value between 1981 and 1984, and about 35 percent with respect to the first quarter of 1985. This behavior has important bearings on the management of exchange rate policies to stimulate the international competitiveness of Chinese exports and to stabilize domestic prices.

Although public finances are almost balanced, they are expected to register a deficit of about 0.4 percent of GDP in 1986, a year in which the economy has been growing at a rate below

its longer-run trend. Fiscal restraint should not be expected to make an important contribution to the balance of payments adjustment. In 1985, while the ratio of the fiscal deficit to GDP decreased by 1.1 percentage point, the balance of payments current account went from a surplus of 0.9 percent of GDP to a deficit of 4.5 percent. It may be inferred from this experience that a tight fiscal policy, while necessary, is not sufficient to correct external imbalances.

We consider this adjustment program appropriate to deal with the unique circumstances of the Chinese economy. Therefore, we support the proposed decisions.

Mr. Goos made the following statement:

Like others, we continue to be deeply impressed by the courageous reform policies pursued by the Chinese authorities. A striking feature of recent economic developments is the extraordinary vitality with which economic activity has responded to the liberalization measures--and this is all the more remarkable in view of China's long history of virtually total direct government control. The vitality, or responsiveness, of the Chinese economy should serve as a strong encouragement to other governments to push ahead wherever possible with structural reforms to unleash private sector potential.

One must acknowledge that the fundamental, far-reaching shifts in policy orientation in China are bound to cause initial frictions, such as the recent recurrence of financial difficulties, especially as long as the policy instruments for effective macroeconomic controls are not yet fully in place. Accordingly, the recent swings in the external position hardly come as a surprise. The authorities have reacted most judiciously to the challenges arising from their reform policies. Moreover, the pragmatism and flexibility that they have exhibited in the process are highly commendable.

This recent experience is quite reassuring with respect to China's economic prospects for the years ahead, and we fully share the staff's assessment that the stabilization program underlying the request for Fund support will help to ensure macroeconomic stability and adequate growth over the medium term.

I have little to add to the staff appraisal, particularly with respect to financial policies, which clearly are of fundamental importance to the maintenance of a stable macroeconomic environment. That environment in turn is a prerequisite for the successful continuation of the reform policy.

In terms of structural reforms, the crucial issue confronting the authorities is the determination of the scope and pace of the liberalization process. While this may involve difficult social and political issues, experience in other countries does suggest that partial liberalization and too gradual an approach often have serious drawbacks in that they cause distortions in the allocation of resources and are detrimental to financial stability, efficiency, and growth. In general, therefore, I would encourage the authorities to pursue an approach to structural reform that is as balanced and comprehensive as possible. Of course, this is easier said than done. However, I believe that such an approach should encompass--as integral parts of an effective reform strategy--further resolute progress in the liberalization of prices and wages and of the financial system, as well as in enterprise reform.

Against this background, it is most encouraging to note from Mr. Dai's statement that these items are already on his authorities' agenda for reform. Important progress has indeed already been achieved in those areas. Nonetheless, I wonder whether price liberalization in particular should not aim at fuller coverage, notably of energy and commodity products, which appear to be priced low. Further price adjustments would not only be conducive to a more efficient use of resources, but also help reduce the substantial budgetary burden resulting from the existing large-scale price subsidization. Having reduced that budgetary burden, the authorities could then achieve a more productive mix of government spending, for example, by stepping up urgently needed infrastructural investment. In the same vein, I would also recommend that the authorities progressively extend the new floating wage system and the recent employment reforms to the labor force at large. These steps would greatly strengthen workers' motivation and performance, labor mobility, and hence, overall productivity. Other particularly commendable areas of structural reform include the authorities' efforts to strengthen the financial responsibility of enterprises, most notably by their experiments with the threat of bankruptcy, and by the ongoing reforms in the financial banking system, which have led to the establishment of regional stock and bond markets. The potential beneficial effects of those measures on the functioning of indirect macroeconomic management, on domestic savings, and on overall economic performance can hardly be overstressed.

The authorities' continued commitment to a realistic exchange rate policy is highly commendable. However, in the circumstances of China, which has just begun opening up to the outside world, one should not overestimate the immediate impact of exchange rate policy--and in particular that of the recent depreciation--on export performance. There is considerable evidence that exports are being hampered by weaknesses in product quality and marketing arrangements,

as well as by the requirement that exporters must surrender the bulk of their foreign exchange earnings to the Government. The authorities should give high priority to redressing these weaknesses.

The projected decline in foreign direct investment in the years ahead is a matter for concern, in view of the important role that such investment could play in accelerating structural change and in contributing to the financing of the external current account. We therefore welcome the continued efforts of the authorities to improve the climate for foreign investors, as evidenced by the recent adoption of the program that the staff mentioned today. I hope that this program will also aim at a more flexible allocation of foreign exchange to joint ventures in order to overcome what appears to be one of the most important impediments to such investment. I support the proposed decisions.

Mr. Massé made the following statement:

The authorities have made remarkable progress in recent years in decentralizing their economic decision making and in relying increasingly upon the market mechanism to allocate resources and provide economic incentives. As the reform has progressed, however, it has become clear that the authorities need to develop stronger policy instruments to regulate the pace of growth. Some progress has already been made, but further steps will be required. In this context, I welcome and support the proposed stand-by arrangement. This first credit tranche purchase will not provide large-scale financing from the Fund but should assist the authorities in developing the necessary tools of macroeconomic management and in improving discipline within the system.

Two central purposes of the stand-by arrangement must be to continue the adjustment toward market-oriented price determination, and to strengthen the more indirect policy instruments, particularly with respect to monetary and credit policy.

I share the views of the staff and the authorities on the need for further action to reduce monetary and credit expansion and to promote fiscal consolidation. This should help ease pressure on aggregate demand, on the balance of payments position, and on inflationary expectations. Nonetheless, I recognize that in the short term, some limited use of traditional instruments of economic regulation might be unavoidable. For example, the authorities' intention to adopt a pragmatic approach to credit control, including use of credit ceilings on specialized banks if necessary, is appropriate in the circumstances. The financial position of the enterprises will require particular attention if

the authorities are to avoid unnecessary buildup of stocks while freeing resources for productive investment. The reforms in the productive structure will be able to proceed smoothly if the monetary, credit, and fiscal performance criteria in the stand-by arrangement are deserved. However, the recent easing of some financial conditions during the second quarter of 1986, in the face of liquidity problems of some enterprises, is a cause for concern. This highlights the need for credit restraints if market forces are indeed to be allowed to play a greater role in determining the viability of enterprises.

On a related issue, given the need for efficient investment, plus China's recent experience with excessively rapid expansion of domestic demand and the demand for imports, it is worth emphasizing the importance of maintaining positive real interest rates to help sustain a high domestic savings rate and encourage efficient investment. The authorities plan to reduce investment as a share of GDP to about 36 percent, compared with an average of 38.5 percent during the previous three years. While this investment target is more in line with available domestic savings, it is still likely to be beyond sustainable levels through the medium term, in part because it puts a strain on available savings. This makes the need for positive real interest rates all the more pressing.

I have already noted the link between control of domestic aggregate demand and strengthening of the external position. Promoting China's international competitiveness is also a vital element in balance of payments viability. In that regard, the 40 percent devaluation of China's real effective exchange rate since May 1985 has been one important means of enhancing competitiveness. I am pleased that the authorities intend to continue to promote a flexible approach in the pricing of foreign exchange, which should clearly help to improve the external situation. Moreover, the effectiveness of exchange rate policy would be enhanced by additional price and foreign trade reform, most notably by increased links between the world and domestic prices of traded goods.

Nonetheless, I am somewhat concerned about the viability of the balance of payments over the medium term. Nearly all the projected improvement in the current account balance is to come through a strengthening of export performance. It is fair to ask whether the staff and perhaps the authorities are being too optimistic about China's capacity to expand exports continually at rates in excess of 10 percent a year. The staff should comment on its more favorable medium-term balance of payments forecast and indicate whether a more likely outcome for the balance of payments might be something between the two scenarios

described in EBS/86/230. If so, the authorities would need to be even more careful in their management of domestic demand to keep the demand for imports within reasonable bounds.

Another concern is the term structure of the external debt. While the authorities' recent efforts to improve China's external debt structure are welcome, one can reasonably argue that further action is required in this area, particularly to reduce the proportion of short-term commercial loans to total debt. The authorities would be well advised to rely to the fullest extent possible on concessionary financing within the external borrowing portfolio. New short-term commercial debt is to be avoided as much as possible.

With respect to price and wage reform, the authorities have already made remarkable progress in deregulating food prices and agricultural prices, and in permitting an increasing volume of enterprise transactions to be conducted outside the economic plan at flexible prices. As the system has become increasingly decentralized, the role of flexible pricing policy will take on that much more importance. I am therefore encouraged by the plan to introduce the major new package of price reforms in 1987. I urge the authorities to include adjustments of prices of energy and raw materials for industrial use as part of this program. Only when the prices of intermediate goods as well as final consumer goods are allowed to reflect relative scarcities will the planned reform become fully effective. Similarly, I support the authorities' intention to link wages more closely to productivity, provided that the enterprises are constrained by realistic financing limits.

On the whole, this first credit tranche stand-by arrangement is a pragmatic way for the Fund to help the authorities to implement their planned economic reform. I am happy to see Fund resources used in this matter, and I strongly hope that the authorities will be able to meet their aims under the arrangement.

Mr. Fugmann made the following statement:

The staff paper (EBS/86/230) includes a list of points emphasized during the previous consultation discussion which provides a useful background for the present report and today's discussion. I encourage the adoption of this practice of clarification for as many consultation reports as possible in the future.

Over the past years, the Chinese economy has undergone dramatic changes. It has been opened to the outside world, with a significant expansion in foreign trade and an increased use of

foreign capital as a result. Through profound changes in the nation's economic structure, and rather successful economic policies, China has achieved rapid growth. The administration has displayed a remarkable readiness to execute timely responses to emerging macroeconomic imbalances. One overall measure of the success of these policies is that the annual growth rate of GNP averaged 9 percent during 1979-85, three times the average growth rate of developing countries. China's future growth prospects are very promising.

The economy has once again come under pressure, and the authorities have responded by tightening fiscal and monetary policies, by devaluing the renminbi, and by strengthening controls over wages and investment. These measures have, to a large extent, already brought the situation under control. However, a firm implementation of the adjustment program is needed to put the economy on track and make it possible to continue the modernization and reform policies in a medium-term framework.

The economic reforms already undertaken and the forthcoming ones may well inject uncertainty into fiscal planning and reduce the scope for tightening the fiscal stance. Nevertheless, fiscal policy does play an important role in the stabilization efforts and should therefore be implemented with determination.

The authorities' 1987 budget goals of promoting macroeconomic adjustment and continuing the reforms of the fiscal system are welcome, and we encourage the authorities to maintain a tight fiscal stance. Strict control over fixed investment and price subsidies is required. The plans to review the tax system to increase revenues, improve incentives, and promote technological transformation appear well advised. Additional details on the planned measures would be helpful.

It is apparent that a further reduction of monetary growth will also be needed in 1987. The authorities have made good progress in developing the monetary system, including the monetary instruments and control techniques. Given the tradition of inflexibility and the inexperience of the parties involved, a rather pragmatic approach seems to be warranted. Of major importance will be rates of interest that better reflect the scarcity of capital and that can be employed increasingly to allocate resources. Therefore, the measures taken by the authorities to this end are most welcome. Recent policies on the specialized banks are a good example of such measures. Developments in this area should be harmonized with the reforms of the external sector.

As a part of the overall financing situation, external financing has increased in importance along with progress of the economic reforms. External debt has grown rapidly in recent years. Experience in other countries has shown how easy it is to slide into excessive or unproductive borrowing, especially when domestic enterprises and planners are not sufficiently conscious of investment costs or are not held responsible for poor decisions. Therefore, although China's debt and its servicing costs are still modest by international standards, a case exists for cautioning against a too-rapid growth of foreign debt.

Of special concern is the large share of short-term debt in total foreign indebtedness, which may limit the economic policy options open to China. As a primary measure, the authorities are now improving the debt management systems. One additional approach would be to encourage direct foreign investment in China. In addition to providing foreign nondebt-creating capital, the example of--and competition from--foreign companies could help domestic firms to identify weaknesses in, for example, management, product design, or material supply.

In addition to reducing the external payments deficit through demand-management measures, the authorities must achieve substantially faster export growth. In the somewhat longer run, China will need to change the composition of its manufactured exports, as markets for its textiles and clothing, in particular, are likely to be growing slowly. Therefore, China will need to make a major effort to expand exports of machinery and metal products, among other things.

With a view to strengthening the viability of exports, we also welcome the authorities' intention to continue the reduction of administrative controls and thus to encourage the play of market forces. The price and trade reforms of recent years have made it possible to use the exchange rate to influence foreign trade. We endorse the exchange rate policy as it has been applied so far, and I am glad to learn that it will be pursued in the period ahead.

Increasingly the usefulness of exchange rate policy also requires further strengthening of the linkages between domestic and international prices. One prerequisite is greater flexibility in the domestic price formation system. Substantial progress has already been made in decontrolling prices, but much still needs to be done. Further headway in this direction could be impeded by chronic shortages of many goods. However, price decontrol should not be postponed until rising production has eliminated most of the shortages. In fact, increases in individual prices could eliminate specific shortages by stimulating supply and

reducing demand. The major package of new price measures, intended for implementation in early 1987, will be an important step toward reaching a proper pricing system. However, I wish to reiterate, as I have done in discussions of other centrally planned economies, that in the pricing area as well as other areas in the domestic economy, the pace of reform should proceed uniformly with the pace of reforms on the external front.

Recent developments have provided encouraging evidence of the authorities' determination and capability to pursue their goal of stabilizing the economy. The Fund should support these endeavors by approving the requested stand-by arrangement. In addition, the Fund should be prepared to provide China with the technical assistance that is needed in the promotion of its economic development.

Mr. Kafka made the following statement:

This chair warmly supports China's request for a first credit tranche stand-by arrangement. The authorities have made extensive reforms since 1984. As others have noted, the speed at which direct control over the economy was reduced exceeded that at which macroeconomic controls were tightened, which made economic management difficult in 1984 and at the beginning of 1985. There are examples of similar developments in other countries. Under conditions of less than full competition and excess demand, price liberalization in the absence of rationing or allocation is apt to result only in inflation, lack of wage discipline, and inefficiency. The authorities have reacted by reducing expenditures and restricting credit. The overall budget deficit has been reduced to only 0.5 percent of GDP in 1985-86. Money supply growth was more than halved, and retail price growth was slashed by two thirds from the growth of a year earlier, to 3 percent for the 12 months ended in June 1986. The authorities provided pragmatic answers to the policy problems. Moreover, the authorities have not lacked courage, demonstrated notably by their decision to depreciate the currency as necessary, although in China, as elsewhere, the results of devaluation have still not materialized fully.

The corrective measures that began to be taken in late 1985 with the tightening of fiscal and monetary policies are now culminating in the program for which this first tranche stand-by arrangement is requested. Of course, a part of the problem facing the Chinese authorities cannot be solved with macroeconomic measures, namely, how to adapt relative prices to a greater extent to those prevailing in the world market with a minimum disturbance to production and without excessively abrupt changes in income distribution.

Nevertheless, I have no doubt that this is going to be a successful stand-by arrangement, as this is one of the rare instances in which the staff states that there is no major area of disagreement between it and the authorities. Both agree that emphasis must be given to stabilization, particularly to reduce investment, which has increased excessively in the past two years to the unsustainably high level of 38 percent of GDP. The proposed reduction of investment by 2 percentage points of GDP for 1987 will no doubt signal the beginning of a return of investment levels to a healthier path. To strengthen control over investment, all investment plans since 1986 have been included in the Government's projections, whether these plans pertain to collectives, private units, or individuals. A commendable degree of flexibility in policymaking is reflected in the decision to allow bank loans to be granted for capital construction projects not included in the state plan--but only as long as enterprises are able to pay a 30 percent interest rate, which is high in real terms.

The authorities are beginning to use the instrument of bankruptcy on a trial basis as a tool for modernization and to increase efficiency. It is ironic that a socialist economy is reintroducing the tool of bankruptcy just when too many capitalist economies seem to be replacing it by the principle of socialization of losses. At the same time, the authorities are beginning to use more active social security policies, which will become necessary as the possibility of bankruptcy is introduced. A social insurance system has also been introduced on an experimental basis, funding pension and unemployment benefits through a pooled insurance fund. A system of social insurance is a key condition for greater labor market mobility, and I would be grateful if the staff could elaborate on the new experimental system.

I wish that all the balance of payments medium-term scenarios had been presented in full, rather than only the one that the staff thinks will be realized. I found the chosen scenario to be too conservative, as it does not require net borrowing from commercial banks after 1987, which might curtail real growth unnecessarily. The staff could usefully comment on this topic.

Ms. Bush made the following statement:

We welcome the trend in the Chinese economy away from direct planning and controls, as the shift has formed the basis for a growing and more prosperous economy. It also appears that the authorities aim to align rates of investment more with savings rates. We concur with this intent and recommend that investment reflect appropriate utilization of resources in an efficient manner, as this will help to relieve pressures on the external

accounts. In addition, we think that the emphasis on investment is important. Like Mr. Lankester, however, we believe that sustainable growth levels can be influenced by the efficiency of investment and the return that that investment can generate in order to be more self-financing, thereby relieving pressures on the external accounts. However, investment is important for growth and has been stimulated by the relaxation of controls and the trend away from direct planning, a trend that we support.

In the meantime, the process of reform continues to move forward, and is easily recognizable. The staff papers clearly show the extent to which the change has occurred with regard to the sources of rural income, the formation of agricultural prices, the sources of industrial output, the type of wage compensation used, the system of retail trade, and the mechanism for conducting foreign trade. These reforms have shown that the potential for real growth in China is quite high, as evidenced by real growth rates--exceeding 12 percent in 1984 and 1985--but such high rates of growth have contributed to the need for some correction of the external accounts. The authorities have commendably tackled the external imbalance problem at an early stage. However, the external problem has been caused in part by the investment boom that China has been experiencing.

Reforms in labor compensation and increased labor mobility should play an important role in facilitating the absorption of the labor force that has been growing on average by 3 1/2 percent a year in the period 1982-85. The authorities have made welcome progress in linking compensation in the Government to the degree of responsibility of the employee and to performance, and in linking compensation in part of the enterprise sector to enterprise profitability. For most newly hired employees, fixed-term labor contracts are being used instead of lifetime employment guarantees. However, the persistence of lifetime employment for a large share of the work force will probably continue to impede labor mobility. Substantial retraining efforts could help alleviate this impediment, which will be necessary if the economy is to respond to changing economic conditions and opportunities.

In a broad sense, freedom of movement of relative prices will be important in the efficient allocation of resources. Some progress is being made on wage rates, exchange rates, interest rates, and prices for goods and services. However, the continuation of low prices for energy and some raw materials, and of subsidized consumer prices, tends to distort production and consumption patterns. Therefore, we look forward to the set of new price reform measures expected for early 1987. Stronger linkages between domestic and international prices can be particularly important in terms of the balance of payments outlook, and as a means of making exchange rate adjustments more effective.

Agricultural and urban reforms in recent years have increasingly placed financial resources in the hands of households and enterprises rather than in the banks of the state. This has created a need for a better system of financial intermediation to facilitate capital mobility. Interest rates as a monetary and pricing tool have begun to play a more important role in the allocation of capital as a result of efforts to maintain positive real deposit rates and the recent increase in rates charged by the People's Bank of China to the specialized banks. Moreover, the eventual liberalization of the pattern of loan rates charged by the specialized banks should help to provide a test of the efficiency of bank-financed investment. We strongly support the continuation of a tighter credit stance through 1987, as embodied in the economic program being supported by the requested stand-by arrangement. We also support recent innovations in financial markets.

The most striking fiscal development in recent years has been the cutback in the role of the state budget in intermediating financial flows, with the ratios of revenues and expenditures to GDP having fallen by more than 8 percentage points each between 1978 and 1986. The recent limitation of the budget deficit to about 1 1/2 percent of GDP has helped to contain domestic demand and to make overall credit policy more effective. We look forward to the outcome of the present review of possible tax reforms. As the structure of the economy and sources of income shift, it is natural to expect a corresponding reorientation in the tax system.

The combination of restrained monetary and fiscal policies and a flexible exchange rate should help lay the basis for a more sustainable external position than that experienced in 1985-86. In fact, on the assumption that the economic adjustment and reform policies embodied in the 1986-87 program are continued, the staff's medium-term basic scenario indicates that sustainable balance of payments and foreign debt positions are well within reach. However, the alternative staff scenario that assumes that these policies are not pursued suggests much less favorable debt and debt service ratios by 1990. Clearly then, *debt management policy must be given considerable attention.* The authorities are tackling the fiscal imbalances generally without the reintroduction of direct controls; we would welcome staff views on the new regulatory regime and on administrative requirements that are in place for direct investment. We are glad that the authorities are continuing an array of important structural reforms, which have shown good results in the economy.

Given China's good performance under the 1981 first credit tranche arrangement, the planned restraint on domestic financial policies as embodied in indicative ceilings and benchmarks, and

the authorities' clear determination to persist in their structural efforts, we support this new first credit tranche stand-by arrangement request.

Mr. Péterfalvy made the following statement:

I wholeheartedly support China's request for a stand-by arrangement.

China is clearly implementing an economic reform program of historical significance and consequences. As the authorities have stated, this economic reform program has the "overall objectives 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." Consequently, the most important aim of Article IV consultations and the present stand-by arrangement should be to contribute to the success of this economic reform program.

It is imperative for the authorities to note that past experience with centrally planned economies shows that the two systems--one based on administrative targets and the other operating with market mechanisms--cannot coexist for too long in an economy. The methods of one system may weaken the effects of the methods of the other. The often contradictory impulses emanating from any combination of the two systems may not be able to orient either the economic policymakers or the economic units. In agreeing with the comments of Mr. Goos, I also think that the confusing signals and the lack of appropriate instruments may have made a large contribution to the serious slippages in China in 1985. In this context, unrealistic economic policy decisions may be taken, new disequilibria may appear, new bottlenecks may develop, and according to the worst economic scenario, the reform process itself may be discredited temporarily. I should like to draw the attention of the Board and the staff to this possibility. The seemingly endless debate in our circles, namely, whether we should adopt a gradual approach to reform or support rapidly moving comprehensive programs of systemic reforms, must be handled accordingly.

As during our discussion of the 1985 Article IV consultation with China (EBM/85/162, 11/8/85), it is still not clear to what extent the authorities have gone or intend to go in granting autonomy to the economic units, such as the state enterprises. A further comment by Mr. Dai or the staff would be helpful.

There cannot be any meaningful enterprise autonomy as long as the enterprises have targets determined by the Central Government; enterprise behavior will always tend to give preference to

the fulfillment of targets rather than to responding to profit motives. If the enterprises are given targets by the authorities, the authorities must ensure the existence of the conditions concerning raw materials, labor, prices, and markets needed to enable the enterprises to comply with these targets. The enterprises expect to be rewarded by sufficient financing, new investment possibilities, and increased salaries or bonuses, but not to be rewarded in terms of achieving profit from their activities. Thus, the enterprises will bargain with the authorities and do not care about adjusting to the prevailing market conditions. One cannot count on the possibility of implementing any serious bankruptcy procedure as long as the whole range of activities of the enterprises is not profit motivated and the centrally planned targets are not eliminated.

Similarly, in the absence of a clear profit motivation, it is not surprising that the authorities have pointed out that the decentralized investment decisions were not always soundly based. My question is whether the staff really considers that under the previous highly centralized system, the centralized investments were always soundly based, or more soundly based than in the present one; I doubt it. I think that Mr. Lankester has rightly emphasized the need to improve the preconditions for quality investments.

In a market-oriented economy, the most important economic instrument is the price system, and thus I welcome the authorities' intention of implementing major price reforms in 1987. I hope that the price reform will be more comprehensive than mere adjustments of the energy and raw material prices.

Again, the emphasis must be placed on the price mechanism. If both the prices and their adjustment are determined by the central authorities and prices are not allowed to reflect continuously the supply and demand situation in the market, new imbalances may reappear and new price adjustment decisions will be needed from the authorities. Accordingly, I am encouraged that the authorities are aware that much remains to be done to establish a price system to meet the needs of a reformed economy and that basic prices will be determined by the authorities only for major raw materials and daily household necessities. It would be interesting to know, however, how these basic prices will be determined and adjusted, and how the flexible prices will be able to play an orienting role if centrally determined targets remain in force for several major items.

In this context, I must note that the authorities' fears of inflationary pressures would be fully justified if the price reforms are not implemented as a part of a comprehensive package

of measures that will allow the authorities to use macroeconomic controls such as monetary instruments, the tax system, foreign trade regulation, exchange rates, and the like.

I welcome the intention of the authorities to implement further exchange rate adjustments, as warranted by the implications of price reforms and export performance. This approach, linking the exchange rate adjustments to the price reform, is highly commendable. I hope that it reflects the results of our seminar on centrally planned economies and that it will be remembered in future situations as well. It should be remembered that if production is based on centrally determined targets, the enterprises are not profit oriented, and prices are arbitrary, then the usual exchange rate requirements of the Fund are meaningless for the most part and are rightly unacceptable to the authorities.

The Fund should have shown more interest in the systemic reforms of financial intermediation in China. It would be helpful to have some comments, not necessarily criticism, about the institutional makeup of the banking system. How do the authorities and the staff see it in the light of the evolving reform process? Was it not somewhat hasty to start the decentralization of the banking system by creating a few specialized banks instead of by introducing a competing network of profit-oriented, fully authorized commercial banks? To decentralize the banking system in a centrally planned economy was a revolutionary idea, but perhaps not enough time was allotted to the development of a coherent approach.

I understand that upon the request of the authorities, the World Bank staff is engaged in a fundamental study of the ownership mechanisms in China. The authorities are evidently attempting to solve one of the basic issues of the economic management system of socialist countries, namely, how to strengthen owners' motivations by means of market mechanisms. Other socialist countries are also debating whether the autonomy of the enterprises should include both the short-term motivation of the managers to increase profits and the long-term motivation of the owners to preserve and increase the assets of the enterprises. Additional discussion of this point by the staff or Mr. Dai would be helpful. I note that in other socialist countries it has been suggested that in the framework of socialist ownership of the means of production, a possible solution could be to transform the enterprises into joint stock companies and to create a stock market, among other things.

I should like to raise again the question whether for a reform-minded, centrally planned economy, we should not rely more on the reform aspects of its economic development. Should we not have included some of the reform objectives in the stand-by arrangement? Although we are now considering a first credit

tranche stand-by arrangement, should we not have established the precedent of including specific commitments on systemic reform policies of one of our major member countries? I must clarify, however, that performance criteria that are systemic in nature would not be added to, but rather would replace criteria on demand management. Staff comment on these questions would be helpful.

Mr. Kabbaj made the following statement:

I support China's request for a stand-by arrangement that is aimed at supporting the economic adjustment program for 1986/87. The program is well designed to reduce the macroeconomic imbalances, while the authorities continue to effect economic reforms. The reforms that have been implemented by the authorities since 1979 have made a drastic change in the nature of the country's system of economic management by giving more dynamism to the socialistic structure of the economy. The implementation of the reforms--including price, wage, and employment policies--reducing the scope of planning controls and providing further autonomy to households and enterprises, has made a significant *improvement in economic activity and in living standards*. Agricultural and industrial production has grown rapidly and substantial increases in personal income have been registered.

In spite of these achievements, the economy has inevitably faced some periodic problems as a consequence of the profound structural changes. However, the authorities were aware of the situation, and timely corrective measures--as outlined by Mr. Dai--were introduced to arrest domestic and external imbalances in the economy. The period since the beginning of the reforms has been marked by sharp swings in China's external position. In mid-1984, strong demand pressures resulting from lax financial and monetary policies, and further liberalization of trade and exchange restrictions, among other things, began not only to erode China's external position, but also to accelerate retail price inflation. The external current account registered a dramatic shift from a \$2.5 billion surplus in 1984 to an unsustainable deficit of \$12 billion, as imports rose by 60 percent and exports grew by only 5 percent. At the same time, the rate of retail price increases accelerated to 9 percent in 1985 from 3 percent in 1984.

The authorities responded impressively at an early stage to arrest the imbalances. The implementation of a set of measures--including interest and exchange rate adjustments, a tightened financial and monetary policy stance, and utilization of traditional administrative control over wages, investments, foreign exchange allocations, and import restrictions--was a step in the right direction to bring the economy back on track. In this

regard, investment outlays, which appeared to have exceeded the economy's capacity, were reduced to a sustainable level to mitigate the adverse effect of increased shortages and bottlenecks in the economy. A deceleration in output growth to 6.5 percent, a reduction of \$2 billion in the external current account deficit, and a significant decrease in retail prices, estimated at 5.5 percent for the year 1986, are indicative of the effective, successful implementation of the stabilization measures and of the satisfactory performance of the economy. However, much more remains to be done to consolidate and strengthen the progress achieved to date.

The external current account deficit is still unsustainable; deficit financing through borrowing largely on commercial terms with a short-term maturity remains an area of concern, although the situation has improved in 1986. The authorities' immediate, commendable objective in the context of the economic program is to reduce the current account deficit to 2.3 percent of GDP in 1987 from 4 percent in 1986. Steps taken in this regard, including further improvement in pricing and maintenance of the country's external competitiveness to strengthen non-oil export performance, while securing the imports needed to sustain economic growth, would help enhance the external position of the economy, reduce the need for borrowing from commercial banks, and limit the debt service ratio.

The authorities have made substantial, impressive progress in decontrolling food prices and in permitting an increasing volume of enterprise transactions to be conducted at flexible prices, outside the plan. I share the authorities' view, however, that further steps should be taken in such areas as exchange and interest rates, as well as in the implementation of measures affecting prices of energy, raw materials, and consumer goods. The authorities have rightly stated that letting the prices of manufactured goods be determined by market forces would help forge a link between world and domestic prices of these commodities and would improve the allocation of resources. A significant contribution to price reform will come from the authorities' efforts to establish a link between wage and job responsibilities in government institutions and a link between wage and profitability in enterprises, and to broaden the scope of the contract system in lieu of the traditional system of lifetime employment. I fully agree with the authorities, however, that decontrol of the prices of manufactured goods and decentralization of investment responsibilities of enterprises are likely, in the present circumstances, to bring about excessive investment demand and lead to the use of resources in sectors that have been given less social priority. The situation fully justifies putting into place the traditional and the new policy instruments, including prohibition of certain investments and imposition of a 30 percent penalty interest rate on loans to finance projects that are not in the plan.

The authorities' cautious fiscal policy is envisaged to continue in 1986/87. However, in view of the projected slowdown in GDP growth and the possible reduction in revenues from enterprise profits, the scope for tightening fiscal policy appears to be limited. Nevertheless, it is to the authorities' credit that they have decided to introduce a number of measures, such as limits on central administrative outlays and local government expenditures and cancellation or postponement of lower priority investment projects, to reduce the deficit below the budgeted level to about 0.4 percent of GDP in 1986. The authorities' intention to maintain strict control on expenditures while considering further efforts to improve the tax reform in 1987 is welcome.

The authorities' restrictive money and credit stance is intended to continue to support the stabilization program. As with fiscal policy, the authorities' pragmatic approach to credit control during the transitional period, aside from enhancing the system of monetary management, appears inevitable if they are to restrain money and credit expansion. The authorities, taking into account the socioeconomic realities of China, have begun the process of economic and financial restructuring to organize institutions and infrastructure, and they are in a position to choose the most appropriate aspects of the various economic and financial systems available.

Mr. Kyriazidis made the following statement:

Structural changes in the economy of China in recent years have been impressive. The process of decision making in the productive sectors has been radically reformed. With the role of a newly emerging private sector strongly enhanced, living standards have been improving, and real income and output have been growing at a remarkable rate.

The economy, however, is still in a transition process, and although the direction of the process is clear, the authorities must make considerable efforts to raise efficiency to the level required to sustain the desired rate of economic growth while correcting the existing imbalances and averting the danger of creating new ones. One must recognize the seriousness and significance of the efforts of the Chinese authorities to achieve an adequate degree of stability in the face of difficulties inherent in the systemic changes that they are attempting to carry through, including the unavoidable time lags involved in the development of effective instruments of macroeconomic management appropriate to the new situation.

We fully share, therefore, the positive assessment of the program presented today, which appears to take account of the present limitations on economic management and to represent an appropriate and comprehensive package of policies that are compatible with a viable set of objectives. It deserves the Fund's full support, and we therefore endorse the proposed decision.

Although recent developments in the fiscal sector show that the authorities have taken effective action to reduce imbalances--as indicated by the fact that the fiscal deficit declined from 1.6 percent of GDP in 1984 to 0.4 percent in 1986 and is expected to decline further to 0.3 percent in 1987--some other developments should be a cause for concern.

Although total expenditure on subsidies has declined since 1981, expenditures to cover operating losses of state enterprises have increased drastically in the past few years: these subsidies quadrupled in 1981-85. In fact, they grew to 8 percent of total expenditure in 1985, compared with 3 percent in 1981, and are expected to increase further in 1986 to a level of about Y 30 billion (about 12 percent of total expenditure). This development is quite significant because it implies that the large increase in industrial production over the past few years has not been associated with an adequate increase in profitability. It would appear that the enterprise reform has not yet led to the desired reduction of cost and price rigidities in the state sector. Clearly, corrective measures are essential in this field if the operating losses of state enterprises are not to develop into an unacceptable burden on public sector finances. It would seem that the situation of state enterprises underlines the crucial importance of price reform.

On the revenue side, the efforts of the authorities to implement a comprehensive tax reform are to be commended. The introduction of an income tax, for instance, is certainly a step in the right direction, as is the shift toward a system allowing for incentives to production, improvement in resource allocation, and technological progress. However, these improvements should be weighed against their possible negative impact on total revenue, which might undermine progress toward overall fiscal equilibrium at a time when the priorities of the authorities lean heavily toward the elimination of macroeconomic imbalances. This remark is prompted by the negative effect that the changeover from profit remittances to taxation, as indicated by Table 16 in SM/86/260, appears to have had on revenue in 1985. A similar phenomenon may appear as the product tax is replaced by the value-added tax.

As for monetary policy, we should commend the cautious attitude of the authorities in managing monetary aggregates. Monetary aggregates were, in fact, brought back to a much lower

path of growth--total liquidity grew by about 18 percent in 1985 and will increase by 17 percent by 1986--after the sharp increase in 1984. This cautious attitude should be regarded as the appropriate one in the transition period the economy is facing.

We fully understand the difficulties of monetary management, given the reduced effectiveness of the standard instruments of monetary control in the face of pervasive price distortions and the inherently unstable, unpredictable money-demand function. We therefore agree with the authorities and the staff that indirect methods of control may have to be supplemented by direct intervention, such as the credit ceilings. However, the measures that the People's Bank of China proposes to take appear to be correctly oriented. In this respect, the decentralization of credit operations, the loan financing of investments, and the more active interest rate policy are particularly significant. However, the degree of success in enhancing the efficiency of the system and its contribution to a more efficient allocation of resources will depend on progress in other sectors, especially in the elimination of price distortions.

Indeed, price reform appears to be one of the most important elements of the program. Quite apart from all other considerations, it is an essential prerequisite both for the elimination of the fiscal burden deriving from the operating losses of state enterprises and for the effectiveness of the proper instruments of monetary control. It is to be hoped that the price reform measures envisaged for early 1987 will be sufficiently extensive to allow the price mechanism to play its proper role in correctly orienting economic decisions.

In the area of intermediation, however, some further attention is warranted. The huge number of bank branches--more than 50,000--combined with the current system of reserve requirement appears not only to impede the efficient utilization of funds, but also to limit the efficacy of monetary control.

The introduction in April 1985 of separate clearing accounts with the People's Bank of China for each specialized bank will certainly help to make the accounts more transparent and to prevent automatic access by the banks to the People's Bank of China, access that seems excessive and is insufficiently explained. I wonder whether the staff could shed more light on the reasons for this situation and on the steps the authorities are taking to correct it, including the possibility of shifting from a system of required reserves by branch to one of required reserves by credit institution.

With respect to external policies, although the balance of payments position appears to have improved significantly in recent months, we are particularly concerned about the reliance

of the authorities on import restrictions, which are also implicit in the first scenario of the medium-term balance of payments. We are also concerned about the consistency of import restrictions with projected real output growth.

As past developments show, the relation between import demand and output growth seems to be rather unstable. We wonder how the staff has been able to reconcile the balance of payments scenarios with the projected rate of growth.

The Chinese authorities have requested a first credit tranche stand-by arrangement while maintaining a substantial reserve position in the Fund. This is rather unusual. Perhaps the staff or Mr. Dai could provide some explanation of the authorities' rationale for this decision.

Mr. Nimatallah made the following statement:

I praise the authorities for their stance on three fronts: the determination with which they are reforming the economy of China; their progress in achieving a better allocation of resources, and thus in enhancing the efficiency of the economy; and their swiftness and flexibility in reacting to the recent, adverse surge in aggregate demand.

Given their determination to reform China's economy, the authorities are convincing potential foreign investors that the new approach to economic prosperity is permanent. I would only encourage the authorities to create more incentives to attract additional nondebt-creating flows. Of course, of particular importance among these incentives is a more attractive tax incentive.

Given their progress in enhancing the efficiency of the economy, the authorities are accelerating the realization of the two basic goals of the Seventh Five-Year Plan, namely, to further improve the standard of living and to maintain economic growth. However, further efforts should be made to make costing and pricing more realistic as markets develop further. I am impressed that the authorities plan to achieve the goals in the Seventh Five-Year Plan by developing markets for goods, services, and capital, with associated price reforms. The opening of the stock market is a testament to the serious intention of the authorities to let markets help allocate resources.

By their swift, flexible reaction to the adverse surge in aggregate demand, the authorities have shown their awareness that the economy, at this juncture of the transformation, cannot afford setbacks. Setbacks would be particularly costly at this stage for such a large country, because they tend to interrupt growth

and structural adjustment. The authorities might want to reinforce their tools of indirect control over the economy, in general, and aggregate demand, in particular. I am pleased to see that these tools are being strengthened, particularly in the money and credit area. I welcome the establishment of separate clearing accounts with the People's Bank of China for each specialized bank, because this will enable the authorities to improve their monitoring of developments on credit creation.

I am also pleased to see that the tax system is being reformed to take account of other changes in the economy. Furthermore, the exchange rate is playing a more effective role in restoring external balance. Strengthening these tools, however, does not mean that China should totally abandon its traditional tools of economic management. In Saudi Arabia, for example, the traditional tool of moral suasion is very effective in managing the economy. I am convinced that the program is appropriate for China and deserves support by the Fund. I therefore endorse the proposed decisions.

Mr. Alhaimus made the following statement:

Developments in the Chinese economy in recent years have been of special interest in view of the far-reaching, system-wide, structural reforms that have been introduced. The nature and extent of the structural transformation being attempted, and the sheer scale of the exercise, make the ongoing process of change both unique in character and momentous in import. The same factors make the task of economic management currently facing the authorities a novel and challenging one.

The focus of the systemic reform has been a reduction in the scope of direct planning controls and an enlargement of the scope of autonomous decision making by enterprises and individuals, and of the role played by prices and markets in influencing economic decisions. While the program for reforms is still in progress, the change already effected in the nature and functioning of the economic system is considerable; Chart 1 of EBS/86/230 provides a useful graphic illustration of this.

As the use of traditional direct instruments of economic regulation is curtailed, a need arises for a new framework of economic management that relies principally on indirect means of influencing the performance of the economy. This involves the development of macroeconomic policy instruments and the granting of freer play to price mechanisms. However, the transition from detailed microeconomic controls to decentralized macroeconomic management is a difficult, time-consuming task. It is this process of transition, and the difficulties associated with it, that have been a key factor underlying economic and financial

developments in China over the past few years. The overheating of the economy in 1984-85 reflected these difficulties in the transition from direct to indirect economic management. In particular, it pointed to the need for ensuring that the development and strengthening of the new framework for economic management, relying on economic instruments, is appropriately synchronized and coordinated with the relation of the traditional instruments of control. The easing of direct planning controls on the urban economy in 1984 was followed quickly by a sharp surge in domestic demand in the latter half of 1984 and in 1985, which resulted in an unsustainable acceleration of domestic economic activity, inflationary pressures, and the emergence of a large external deficit, the latter necessitating both a substantial buildup of external debt and a large drawdown of reserves. These reforms, by granting much greater autonomy of economic decision making to enterprises and individuals, generated a microeconomic stimulus that the overall macroeconomic policy and pricing framework was not yet adequately developed to handle.

The authorities' twofold response to the emergence of macroeconomic imbalances in 1984-85 has been quite appropriate. They have moved to strengthen the new framework of macroeconomic management through improvements in the instruments and techniques of macroeconomic management, a tightening of monetary and fiscal policy, and through implementation of a number of pricing measures, including interest rate and exchange rate adjustments. However, the authorities have displayed pragmatism in opting for the continued use of some more traditional instruments of regulation. This reflects their need to employ a mix of direct and indirect instruments of control until the new framework of economic management reaches a level of effectiveness that warrants fuller reliance on indirect, macroeconomic instruments.

The adjustment measures taken by the authorities in 1985 and 1986 have already had a significant impact on the macroeconomic situation. Domestic demand pressures have been contained, and on the assumption of present policies, the external position is expected to improve sufficiently in the near term to allow a substantial reduction in commercial borrowing and some buildup of reserves. The improvement in the external position in the current year is particularly creditable, given that receipts from oil exports, which in recent years have constituted almost one quarter of the country's total export earnings, are estimated to fall by one half as a result of the plunge in international oil prices. Indeed, but for the weakening of the oil market, China's exports could have reached a level in 1986 that would have obviated much of the need to resort to external commercial financing and to draw down reserves. Measures taken by the authorities to strengthen external debt management, both to keep the growth of debt within appropriate limits and to limit the structure of debt, are also noteworthy.

For the period ahead, the authorities are correct in regarding macroeconomic stability as an important condition for a sustained, successful pursuit of systemic reform and for continued economic growth. The priority given to stabilization--so as to reduce domestic and external financial disequilibria--in recent policies and in the economic program for 1986-87, in support of which a first credit tranche stand-by arrangement has been requested, is appropriate.

Mr. Dai has stated that the authorities are planning a major price reform in 1987. The emphasis that the authorities propose to place on price rationalization in the next stage of structural reform is in order. The importance of appropriate pricing arrangements has increased with the reforms that have been introduced in the economic system. First, the new system of economic management, based on the increasing use of macroeconomic instruments, as an alternative to direct planning controls, depends considerably on flexible price and market mechanisms for its effectiveness, including a closer relationship between international and domestic prices of traded goods. Second, with the greater autonomy in economic decision making now enjoyed by enterprises and individuals, it has become more important, from the point of view of efficiency of resource allocation, for prices to give correct signals as to relative costs and scarcities.

Some further reforms have been announced recently by the authorities. The press reported that on October 20, 1986, the authorities had announced another major step toward granting factory managers full responsibility for production and management decisions. Perhaps the staff can supply some further information on the scope of this latest reform action.

The financial program for 1986-87, to be supported by the requested stand-by arrangement, includes as benchmarks quarterly limits on net domestic assets of both the People's Bank of China and the banking system as a whole. As this contrasts with the normal practice in Fund-supported programs of placing credit limits on either the central bank or the banking system, but not on both, it would be helpful if the staff could explain the rationale for including both limits. Is it an exceptional arrangement, reflecting primarily the current transition in China's system of monetary management? Moreover, has adequate note been taken of the risk of inconsistency arising between the two credit limits on account of the difficulty of projecting the money multiplier or the relationship between the two limits? The staff correctly recommends a cautious approach to projecting the velocity of money and monetary targeting. However, the assumption of a constant velocity of money employed in the financial program for 1986-87 appears arbitrary and unsupported against the background of a significant movement in velocity in recent years and the structural changes taking place in the economy.

In EBS/86/230, it is stated that "the staff representatives stressed the need to support external adjustment through further tightening of the fiscal stance." In the same vein, the staff appraisal says "the staff would encourage every effort to secure further improvements in the overall budgetary balance." Given that the overall fiscal deficit is already estimated to drop as low as 0.4 percent of GDP in the current year, and is targeted to drop further to 0.3 percent of GDP in 1987, some elaboration of the staff emphasis on a further reduction of the fiscal deficit would be helpful. Finally, I support the proposed decisions.

Mr. Reddy made the following statement:

This chair warmly welcomes China's request for a stand-by arrangement in support of its adjustment program, and I support the proposed decisions. I would also like to commend the authorities for their generosity and statesmanship in reaffirming their intention not to avail themselves of the resources under the structural adjustment facility so that other countries in less fortunate circumstances can benefit from them.

The performance of the Chinese economy in the 1980s has been impressive indeed, perhaps more so than that of any other member of this institution. During a period when the world economic conditions were hardly favorable, real GDP growth in China averaged 9 percent a year, resulting in per capita income growth of about 8 percent annually. While there is some uncertainty as to whether these high rates can be sustained in the future as the initial impact of the reform measures diminishes, it appears likely that the authorities' target of achieving a per capita income of \$800 by the year 2000 will be realized. One of the factors behind the rapid growth in per capita income is the success with which the authorities have managed to control population growth, and I hope that the Chinese experience will provide a useful lesson to other developing nations. In addition to achieving high growth rates, the authorities have succeeded in maintaining relative price stability during a period of rapid progress in price liberalization. It is heartening to note that of the 8.8 percent increase in retail prices in 1985, some 5 percent resulted from price reform measures. This fact illustrates that expansionary financial policies of the recent past did not result in higher inflation but instead led to higher rates of real economic growth and higher levels of imports. These facts also suggest that China has a tremendous absorptive capacity and a large unsatisfied demand for imports, and that a somewhat expansionary financial policy, coupled with higher inflows of long-term capital, would maximize economic growth. However, the authorities, as well as the staff, are concerned about the rapid accumulation of foreign debt, which is still at a modest level.

Preferring caution, the authorities have opted for less expansionary financial policies; I can go along with that viewpoint.

In prescribing instruments of economic management--particularly in China, where the economy is in a stage of transition--I see a great need for caution and modesty. The share of state units in total investment, production, and distribution is still large. There is no doubt that these activities can be and are best influenced by direct planning controls rather than by tools of macroeconomic management. Given China's present state of economic transition, it appears to me that the staff is placing undue emphasis on macroeconomic instruments. The authorities will need to rely on direct planning controls for some time, until much greater progress has been made in the decentralization, deregulation, and privatization of the production process. Until then, China's stabilization program should continue to employ more direct means of economic management.

Turning now to the external sector developments, I recall that a few years ago, the Executive Board advised the authorities to open up their import regime and to increase their imports. The Managing Director's summing up of that discussion (EBM/83/157, 11/21/83) included the following statement:

Indeed, the strong balance of payments had led to considerable reserve growth, which has given the authorities more leeway to pursue with determination their policy of opening up China's economy to the external world and to step up, albeit prudently, imports which could assist in raising the technological level of the Chinese economy and in supplementing domestic demand management.

Similar views were expressed in 1984 (EBM/84/162, 11/7/84), when some Directors saw scope for further expansion of imports. The experience of the past 24 months makes it clear that the authorities have followed the Board's advice and have indeed made tremendous progress in increasing their imports. As a consequence, their balance of payments has deteriorated. Now, the Fund staff is giving completely opposite advice to the authorities, namely, that they should reduce their imports. This great shift in policy advice from one end of the spectrum to the other illustrates some of the difficulties in making accurate forecasts on which to base policy advice, and such shifts can also affect the credibility of the Fund's advice to member countries. It now appears that the Fund's advice in 1983 and 1984 was somewhat erroneous, and I wonder if we may not be making a similar mistake again by advocating financial policies that are too stringent and are likely to restrict economic growth unduly.

One point on which the staff and the authorities agree is that the current account deficit of 1985 is not sustainable. The authorities have already responded by taking appropriate measures: they have tightened financial policies, increased tariffs on imported luxury items, eased export licensing, and depreciated the exchange rate. The measures taken thus far are substantial, and I believe that they will be adequate to restore a sustainable balance of payments position. In the staff's medium-term balance of payments projections in EBS/86/230, it appears that if the policies under the proposed program were maintained under the first scenario, then the current account deficit would decline to 1 percent of GDP by 1990 and the external debt service ratio would be kept within 9 percent. While I agree on the need for some reduction in the current account deficit and for an improvement in the debt structure, I wonder whether the achievement of a 1 percent current account deficit target would not be too ambitious, and whether it would not entail too much sacrifice in terms of growth. Given the development needs of China and the tremendous absorptive capacity of the economy, I believe that a somewhat larger current account deficit is both necessary and desirable, provided it is financed with longer-term capital flows. Staff comments on this point would be helpful.

The authorities have brought about marked improvements in public finance. Not only has the budget deficit been brought under control, but also the share of government expenditure in GDP has been reduced from 40 percent in 1970 to 30 percent in 1985. The overall budget deficit has been reduced from 1.6 percent of GDP in 1984 to 0.5 percent in 1985. The projection for 1986 is for a fiscal deficit of 0.4 percent of GDP, and the 1987 program aims at an even lower deficit of 0.3 percent of GDP. The authorities are uneasy about the desirability and feasibility of further reductions in the state budget deficit in the short term, but the staff seems to feel otherwise. I support the position taken by the authorities, since major efforts have already been made to reduce both expenditures and the budget deficit to low levels. This chair will neither be disappointed nor alarmed if the program targets on the budget deficit are not met.

I agree that the tightening of credit policies was appropriate, although caution must be exercised so that legitimate credit requirements for priority investments are satisfied, in order to avoid excessive slowdown of economic activity. The authorities have noted rightly that to initiate monetary targeting now, when major reforms are being implemented, would be a futile exercise. Even a number of industrial countries with relatively more stable rates of velocity of money have abandoned monetary targeting as an instrument of economic management. The staff has argued for a lower monetary target, but I would hesitate to be too dogmatic and could go along with the viewpoint of the

authorities. While I welcome the current review of the interest rate structure, I believe that the scope for monetary policy will increase only in an environment of greater decentralized decision making on production, consumption, and pricing. Until then, the scope and effectiveness of monetary policy will remain somewhat limited.

Finally, I welcome the structural reforms that have already been implemented and those that the authorities intend to implement in the near future. In particular, I welcome further reforms in the pricing of energy, raw materials, and consumer goods; the reforms in wage policy geared to linking wages to productivity and enterprise profits; decentralized decision making and greater financial responsibility for state enterprises; and the recent measures to encourage foreign direct investment. I believe that these and other reforms will be crucial to achieving the objectives of the Seventh Five-Year Plan.

Mr. Rye made the following statement:

The past year has again been one of impressive change in China: change in the structure and the management of the economy, as the authorities continue to implement widespread economic reforms, and change in the country's economic performance, as reflected in the return to a more sustainable rate of growth, the turnaround in the balance of payments, and the notable reduction in the rate of inflation. The authorities have adopted a pragmatic and determined approach to economic reform in recent years. Despite the difficulties that these reforms have posed for economic management, this approach has largely corrected the adverse developments of 1984-85, while continuing the steady reform process.

The program before us today continues this blend of shorter-term stabilization policies and more complex structural reforms, and its support constitutes a productive use of Fund resources. I agree with the authorities that priority should continue to be given to the elimination of macroeconomic imbalances. As Mr. Dai has stated, "what we really need is a coordinated and steady growth, rather than too fast a growth." I note with interest the emphasis on curbing investment, which has been running high indeed. Some restraint is clearly necessary, but this seems to be a difficult area to handle at this transitional stage of China's economic development, and I wonder whether there may not be some risk of overdoing the constraint in areas that may have longer-term potential for growth. Any comments from the staff or Mr. Dai on this subject would be helpful.

The reforms of the economic system proposed in the Seventh Five-Year Plan will build on the foundation created by the

stabilization policies. These measures, which include the key area of further major price reforms, as well as reforms of the financial structure and decision making of enterprises, wages, and employment conditions, external sector reforms, and greater use of indirect methods of macroeconomic management, will have a far-reaching impact on China's economic and social structure.

The proposed policies are obviously the result of careful consideration and much planning, and they seem both appropriate and sufficiently ambitious. However, we must not expect too much too soon. By their very nature, such measures will need to be implemented gradually. Moreover, there will have to be a substantial process of education of managers for the devolution of decision making to be effective. In this context, I would generalize a remark that I had made last year about handling a floating exchange rate--the authorities will need both the capacity and the confidence to move quickly in response to developments; no system can work effectively if its managers are either encumbered with too many restrictions or afflicted with excess timidity.

It is particularly encouraging that the authorities are prepared to respond flexibly to any special transitional macroeconomic problems that might arise from the use of a mixture of direct and indirect economic measures. The use of new macroeconomic instruments, prices, and markets to tackle economic imbalances is itself an integral part of the reform process. Finally, I support the proposed decisions.

Mr. Mwakani made the following statement:

I commend the authorities for maintaining their vigorous economic reform efforts. Those reforms have led in the past few years to a significant increase in economic growth and to an appreciable improvement in the standard of living of the Chinese people. The authorities have shown noteworthy determination and pragmatism in implementing measures aimed at expanding the decision-making process of individuals and enterprises, and at encouraging the development of market-determined prices.

Despite the progress achieved, these changes in macroeconomic management have also led to imbalances in the economy. However, it is encouraging to learn that the authorities are aware of, and concerned about, these adverse developments, and that they have taken steps to correct them. As a consequence, the rate of growth of real output has been halved in 1986 from its average recorded during 1984 and 1985. Nonetheless, this 6.5 percent growth rate is still enviable and will ensure a further increase in per capita income.

The authorities intend to take additional measures in the course of the coming year toward meeting the objective of full liberalization of the pricing policy. The envisaged measures seem appropriate, and I agree with the proposed gradual pace of implementation. Too fast a pace can frustrate the attainment of the authorities' policy objectives.

The new economic system is inevitably causing increases in prices. It is also giving more responsibilities to workers while removing their guarantee of lifetime employment. In the light of these considerations, the intention of the authorities to adjust workers' salaries appears appropriate. However, I would urge the authorities to keep their overall strategy under constant review so as to limit its inflationary impact on the economy.

The authorities have maintained the strategy of fiscal reform, particularly spending restraint, in 1986. As a result, the fiscal deficit is estimated to have decreased further. The authorities should be commended for their policy stance. Since the projected slowdown in output growth will cause a decrease in revenue expansion, the cautious approach to expenditure will need to be maintained.

The tightening of money and credit policies in the second half of 1986 was appropriate and should be maintained in order to reduce pressure on the balance of payments and to keep price increases under control. In view of the limited availability of monetary instruments and the weaknesses of financial institutions, the authorities have shown pragmatism in their application of credit policy. I would nevertheless urge them to continue their efforts toward developing better financial instruments to meet the demands of the increasing monetization of their economy.

Although a small improvement in the external current account deficit is projected in 1986, it is attributable in large part to the effect of administrative measures to limit imports. While the impact of these measures on the external accounts can lead to short-term gains, prolonged implementation will result in inefficiencies and a misallocation of resources. I welcome the authorities' intention to continue the reform of the trade system with emphasis on export promotion and maintenance of a flexible exchange rate policy. Finally, I fully support the proposed decision on China's request for a drawing in the first credit tranche, as I am satisfied that the measures described in the authorities' letter of intent can bring about the necessary improvement in the external position.

Mr. Abdallah made the following statement:

Previous speakers have already highlighted the dramatic changes taking place in the Chinese economy and the impressive growth rates recorded in recent years, associated with the new orientation of economic policy. The basic issue now is how the authorities can improve economic management in order to maintain the economy on a path of high growth with stable prices and a sustainable balance of payments position. This issue stems from the tendency of the economy to overheat, reflecting the rapid increase in demand that arose with the liberalization process begun a few years ago. The consequent pressures on China's balance of payments position have the potential of becoming a major constraint to growth in the future, and the authorities are right to emphasize the need to redress the situation.

This is not the first time since the inception of the reform movement that external payments problems have emerged. They occurred in 1979-80 apparently because of an ambitious investment program, but were corrected by stabilization measures in 1981, including sharp cutbacks in investment. The present scenario resembles that of the 1979-80 period; however, the adjustment policies seem to be tailored to have a more lasting impact.

A central aspect of this stabilization program is the key role assigned to the price mechanism, although China remains a socialist economy. Despite steps to reduce the role of the state in economic affairs, economic development is expected to take place within the framework of predominant state ownership. Here is another example of the "special case" in which the lessons learned might be instructive in the context of applying the basic market-oriented model. A point of added interest is the envisaged three-tier pricing system, which gives rise to questions about how the parts of the system interact, for example, in giving signals as to the determination of profitability or the definition of the relationship between the wage bill and productivity of individual enterprises.

Given the nature of the disequilibrium in China's economy, there can be no substitute for action in implementing fiscal and monetary policies, and I welcome the progress that the authorities have made toward strengthening the financial position of the Government. Fiscal policy in 1985 and 1986 has not appeared to be a major problem, and the projection for 1987 indicates that the authorities intend to continue with the prudent course that they have set. The staff has emphasized the need for further tightening of fiscal policy, but we should be careful not to overemphasize the issue of fiscal restraint. I feel that the authorities are doing enough on this particular front.

The medium-term strategy for the external sector will need to continue emphasizing an outward orientation, based on diversification of the export base, together with intensified efforts to attract foreign direct investment. It is important that the external debt situation be monitored carefully, with particular emphasis on curtailing the share of short-term commercial loans. Of course, concessional assistance from the international community could only help to strengthen the country's external payments position.

China's investment strategy seems to be a major cause of the domestic and external imbalances, and it would have been helpful had EBS/86/230 provided more information on the rationalization process now under way, particularly at the local government and enterprise levels. More details might have given an indication of what microeconomic steps are being taken to complement the implementation of macroeconomic policies. We might also have benefited from a more detailed assessment of the quality of investment already in place.

Finally, I have two general questions to raise. First, in the light of present conditions, I wonder how the staff views the assessment by the World Bank in 1985 of the long-term growth targets for agriculture, industry, and per capita income. Second, the loan disbursements from the World Bank for 1985/86 were about half the amount committed for this period, and I would like to know whether this is a reflection of the absorptive capacity of the economy, or whether it is attributable to administrative deficiencies. In conclusion, I strongly support the proposed decisions.

Mr. Jayawardena made the following statement:

Like other Directors, we are most impressed by two features of the recent economic outturn in China. First, the tremendous response of the economy to its liberalization is evidenced by high economic growth and substantial investment. Unfortunately, this has overheated the economy and weakened the balance of payments, and the authorities have now taken strong corrective action. China's continued commitment to the path of structural reforms in moving toward a more market-oriented economy is heartening. The payments outlook might have tempted the authorities to make a reverse move, but they have chosen the superior option in seeking timely Fund and external support to push ahead with the reforms. We are glad that China has chosen this path, which Mr. Dai has called the further development of a socialist system with Chinese characteristics.

Mr. Dai has remarked that price reform is the precondition for other reforms. We fully agree with this approach because the correction of price distortions better to reflect supply and demand is basic to all other reforms. The latent dynamism of the economy, evident since the reforms, should dispel any fears of emerging inflationary expectations. Of the other reforms, we would attach great importance to the creation of a more competitive enterprise system and an incentive-oriented reform of the tax system. There is an active debate within the country between those who favor quicker reforms and others who favor a policy of gradualism. The resolution of this question should be based on the special characteristics of the Chinese economy and on its capacity to adjust--rather than on a priori or theoretical grounds.

Of course, major problems arise when a country moves to a market-oriented economy and resorts to indirect macroeconomic regulation. For example, the authorities need to develop a timely, reliable information system of critical macroeconomic variables, and they need to have a good understanding of the interrelationships so that timely corrective actions can be taken without reverting to the easier path of regulation. Moreover, the authorities have to reorient a bureaucracy of managers that has grown up in the school of regulation and control and derives its authority largely from access to political power.

An example from the field of money and credit can illustrate this point. In view of the uncertain behavior of the velocity of money in recent years, monetary targeting could be a serious problem. However, it appears that the shifts in velocity are temporary, and velocity of money is assumed to be stable, an assumption that has to be embedded in any financial program that aims at balance of payments viability. While we note the arguments about the directional effects of different factors on velocity, we consider it best to treat the financial programming exercise as a test of the staff's ability to predict velocity in the face of ongoing economic reforms.

Let me further explain this point by referring to the quantitative quarterly benchmarks, or indicative limits, on certain monetary variables pertaining to credit and debt in the program. As these targets or benchmarks are not related to installment purchases, they could be interpreted as guideposts for action for the authorities in their macroeconomic management, particularly since the required balance of payments adjustment is substantial. However, if there is an over- or undershooting of the benchmarks, one must be cautious in drawing negative inferences, because it is difficult to predict short-term velocity with any accuracy, particularly when major economic reforms are being undertaken. Hence, the derived quarterly benchmarks on the basis of a stable velocity assumption could well prove to be off the mark. It is in this

sense that we consider the programming exercise as interesting, one that could well improve our understanding of the Chinese economy. The authorities should endeavor to evolve better yardsticks to evaluate the progress of an economy under transition.

A second example comes from the field of enterprise reforms. These enterprises were set up and have evolved over the years from the national objectives that were oriented more toward self-reliance, regional development, full employment, elimination of widespread poverty, and a host of other socioeconomic considerations. In a full-fledged market economy, many of these enterprises might never have arisen. Therefore, to expose them fully to market discipline in a short time might pose quite serious problems. Such problems occur even in more mature economies, perhaps even on a larger scale--such as the difficulties of structural adjustment that confront their senescent industries. Thus, the Chinese authorities may have to move cautiously. It might be necessary to provide budgetary subsidies to reflect the national or social obligations of the enterprises for a while longer so that they can move to a market-oriented accounting and pricing system. The danger of such subsidization is that it becomes entrenched. A policy of gradually diminishing subsidization might thus become necessary over a period during which the enterprises would have to adjust to a market system. This might also be a period when the managers can orient themselves to the new rules of the game.

Mr. Péterfalvy has suggested that the pace of specific commitment to reforms should form part of the performance criteria in Fund programs for planned economies. When this same point was made in the seminar on the design of adjustment programs in planned economies (Executive Board Seminars 86/3 and 86/4, 2/28/86), the then Executive Director from China cautioned us against this approach. What matters most is the country's commitment to reform, and progress could be seen in what it does and achieves, given the feasibility of progress. We should not try to push these economies onto unattainable reform paths, but rather should raise their commitment to reforms by well-studied, well-meaning advice.

We congratulate China for seeking Fund support at an early stage to tide it over a temporary setback, and we commend the authorities for their perseverance with most commendable, sensible economic reforms. Therefore, we warmly support the proposed decisions.

Mr. Donoso made the following statement:

Since the initiation in 1979 of a program of economic reforms, the Chinese economy has been experiencing important changes in the nature of its system of economic management,

while achieving a remarkable rate of economic growth and improving the living standards of its population. The figures on the key economic variables are quite impressive. During the past five years, real GDP has been growing, on average, at a rate exceeding 10 percent, while price increases--with the exception of those of 1985--have been relatively moderate despite the major deregulation taking place in the economy.

The dynamism observed in the response of the economic agents to the newly created conditions is most encouraging and certainly reflects the enormous potential of the Chinese economy. It is particularly remarkable that a developing economy is able to record savings equivalent to almost 35 percent of GDP, and is therefore able to invest at similar rates without relying excessively on foreign financial assistance. The ability of the Chinese economy to sustain such rates reflects its dynamism and potential, and represents a most important basis for the successful completion of the program of economic reforms and for achieving high rates of growth over the medium term, together with a reasonable balance in the external accounts.

However, some aspects of the reforms have moved ahead of others, and the reduction in the scope of direct planning controls as the mainstay of economic management has not always been fully compensated by the appropriate degree of development of indirect economic management based on macroeconomic instruments and price mechanisms.

A clear expression of these imbalances has been the instability observed in the current account of the balance of payments, which has experienced undesirable swings over the past few years. The authorities have taken a most appropriate step by deciding to launch a program, supported by the Fund, aimed at redressing the external imbalances through a combination of demand-management measures and a more flexible approach on the exchange rate policies.

Monetary expansion has clearly been one of the major causes of the emerging external imbalances and inflationary pressures over the past few years. Credit expansion has been excessive, increasing demand both for consumption and investment beyond the supply capabilities of the economy, and hence putting undue pressure on the external accounts. As a consequence, the inflation rate accelerated to almost 9 percent in 1985, and the current account shifted from its previous surplus into a deficit equivalent to more than 4 percent of GDP. In turn, these developments implied a further accumulation of external debt. Although external debt has almost tripled in the past four years, it still remains at a relatively comfortable level, with a debt service ratio below 8 percent.

This situation calls for caution and fast implementation of the needed reforms to enable the authorities to gain more control over monetary aggregates, in particular through the introduction of appropriate macroeconomic policies and indirect control instruments. We welcome the determination of the authorities to tighten money and credit policy during the second half of 1986 and their intention to persevere in such efforts through 1987, as well as the importance that they attached to the development of indirect monetary instruments.

It is encouraging to note the adjustment in interest rates charged by the People's Bank of China on lending to specialized banks. This measure, together with the general structure of positive real interest rates, should help enhance the resource allocation process, sustain China's high rate of savings, and slow the excessive rate of growth in demand observed in previous years.

We endorse the views of the staff that further improvements in the overall budgetary balance are needed, particularly through tighter control of expenditures and improvements in the tax system. Staff comments on the scope and magnitude of the proposed tax reforms would be helpful.

We welcome the recent devaluation of the renminbi in July 1986. A flexible approach to exchange rate policy remains essential to foster export diversification and to contain imports while domestic demand pressures are still strong. Finally, I warmly support the proposed decisions.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/179 (11/10/86) and EBM/86/180 (11/12/86).

2. EXECUTIVE DIRECTORS - ELECTRONIC DATA PROCESSING (EDP) SUPPORT

The Executive Board approves the recommendation that a small, shared computing facility be established for a trial period in order to assist Executive Directors in reaching decisions on their longer-term EDP requirements. (EBAP/86/277, 11/6/86)

Adopted November 10, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/234, Supplement 1 (11/10/86) and EBAP/86/275 (11/7/86) is approved.

APPROVED: June 30, 1987

JOSEPH W. LANG, JR.
Acting Secretary

