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November 4, 1985

To: Members of the Executive Board

From: The Secretary

Subject: People's Republic of China - Staff Report for the 1985
Article IV Consultation

The attached supplement to the staff report for the 1985 Article IV consultation with the People's Republic of China has been prepared on the basis of additional information.

Mr. Saito (ext. 7365) or Mr. Fetherston (ext. 8761) is available to answer technical or factual questions relating to this paper prior to the Board discussion on Friday, November 8, 1985.

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PEOPLE'S REPUBLIC OF CHINA

Staff Report for the 1985 Article IV Consultation
Supplementary Information

Prepared by the Asian Department

Approved by P. R. Narvekar and Eduard H. Brau

November 1, 1985

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I. Introduction

This supplement is based on information which has become available since the issuance of the staff report (SM/85/266, 9/27/85). 1/ A supplementary staff appraisal appears on page 7.

II. Recent Developments

Domestic credit and money expansion have slowed down in recent months. At end-June 1985, domestic credit was still substantially higher (43 percent) than a year earlier (Table 1), but this was largely on account of the exceptionally rapid expansion in the fourth quarter of 1984. During April-June 1985, the increase in domestic credit was less than 4 percent. Much of this increase reflected higher onlending of budgetary funds by the People's Construction Bank under the policy of switching such funds from grants to loans. Credit extended by other specialized banks increased by about 1 percent, and loans of the rural credit cooperatives also increased only modestly. Taking account of developments in the first quarter--when domestic credit increased although a seasonal decline would normally be expected--the increase in domestic credit during the first half of 1985 was 8 percent, compared with 2 percent in 1984.

The year-on-year increase in total liquidity dropped sharply to 33 percent at end-June 2/ from 42 percent at the end of the first quarter. During April-June, when a small seasonal increase would normally be expected, total liquidity declined by about 1 percent. For the first half of 1985, the increase in total liquidity was less than 4 percent, compared with about 7 percent in the first half of 1984. Comprehensive data on money and credit for the third quarter are not yet available; however, the rate of increase in currency in circulation during the quarter was 9 percent, less than half that recorded in the third quarter of 1984, and broadly comparable with earlier years; the growth of individual deposits also moderated.

For 1985 as a whole, the authorities' original targets for the expansion of money and credit (about 18-19 percent) may be exceeded, in line with the faster-than-expected increases in real output and prices.

1/ Mr. Narvekar (ASD) visited Beijing during October 15-17, 1985.

2/ The emergence in the second quarter of a substantial difference between the rates of growth of credit and total liquidity reflects in part the operations of the People's Construction Bank. Domestic credit includes lending by this bank, but the budgetary funds which financed much of the increase in its lending during the second quarter appear as other liabilities rather than part of liquidity.

Table 1. China: Major Economic Indicators, 1981-85

(Changes in percent, unless otherwise indicated)

	1981	1982	1983	1984	1985	
					First half <u>1/</u>	Year <u>2/</u>
Real national income	5	8	10	14	15	12.5
Gross industrial production	4	8	11	14	23	18.5
Gross agricultural production	7	11	9	17	...	7.2
Public fixed investment	-10	27	13	24	40 <u>3/</u>	32 <u>4/</u>
Budget financed	-25	8	25	19	...	...
Extrabudgetary	5	40	6	28	...	...
Cost-of-living index	3	3	2	3	7	9.5
Wages <u>5/</u>	1	3	3	20	18	...
Overall budget deficit in percent of GDP	1.2	1.3	1.6	1.6	...	0.9
Domestic credit	13	12	15	36	43 <u>6/</u>	18 <u>7/</u>
Total liquidity	20	15	19	37	33 <u>6/</u>	19 <u>7/</u>
Exports (in terms of US\$)	19	2	-2	15	-2	-2
Imports (in terms of US\$)	-5	-19	11	28	61	47
Current account (US\$ billion)	1.3	5.7	4.2	2.0	-5.3 <u>2/</u>	-10.2 <u>2/</u>
(In percent of GDP)	(0.5)	(2.2)	(1.5)	(0.7)	(...)	(-3.7)
International reserves at end-year (US\$ billion)	5.6	11.8	15.4	15.5	10.0 <u>8/</u>	9.1
(In months of imports) <u>9/</u>	3.9	7.5	7.6	5.8	3.4 <u>10/</u>	3.0

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

1/ Percentage change from the first half of 1984, unless otherwise indicated.

2/ Revised official estimates, unless otherwise indicated.

3/ First three quarters.

4/ Capital construction investment only.

5/ Annual average wages of workers and staff in state-owned enterprises.

6/ End-June.

7/ Official targets.

8/ End-July.

9/ In terms of imports of the following year.

10/ In terms of 1985 imports.

The authorities are presently considering tightening monetary conditions further through increases in the rate of interest on lending to the specialized banks and in reserve requirements.

The budget deficit in the first nine months of 1985 was lower than originally envisaged. Revenue was 22 percent higher than a year earlier, while expenditure increased by 20 percent. For 1985 as a whole, the authorities' present objective is to avoid bank borrowing for budget financing; this would imply an overall deficit of 0.9 percent of GDP, compared with the budgeted 1.2 percent.

There are now clearer signs of a slowdown in the growth of domestic demand and output. In the third quarter, investment by state owned units was about 33 percent higher than a year earlier, compared with 44 percent in the first half. Growth of retail sales likewise moderated from 30 percent in the first half to 19 percent in the third quarter. Growth in industrial output slowed from 23 percent in the first half to 18 percent in the third quarter, and is projected at about 10 percent in the fourth quarter. Agricultural output is expected to increase by about 7 percent in 1985, significantly below the 17 percent expansion recorded in 1984. Growth of real national income, which accelerated to 14 percent in 1984 and 15 percent in the first half of this year, is now projected by the authorities at 12.5 percent for 1985 as a whole.

The rate of increase in retail prices ^{1/} rose from 5.6 percent in the first quarter to about 8 percent in the second and 9 percent in the third; the acceleration in the second quarter mainly reflected price reform measures. The authorities anticipate that the increase for 1985 as a whole will be just under 10 percent.

The current account of the balance of payments remained in deficit in the third quarter. Compared with the third quarter of 1984, exports were virtually unchanged while imports increased by about two thirds. The continuing rapid growth of imports reflects a substantial backlog of contracts, especially for capital equipment; the more restrictive application of import licensing since March has so far mainly affected imports of household appliances and automobiles which, despite their recent rapid growth, still account for a modest share of the total. The pace of new orders for capital goods and other imports has, however, slowed since March and is expected to lead to a reduction in the growth of imports in due course. Based on recent developments, the staff now projects a current account deficit of about \$10 billion (3.7 percent of GDP) in 1985 (Table 2).

International reserves declined by a further \$2 billion to \$10 billion (3.4 months of imports) in July, the latest month for which data are available. A further decline of about \$1 billion is projected by the authorities for the remainder of 1985.

^{1/} Compared with the corresponding period a year earlier.

Table 2. China: Balance of Payments, 1984-85

(In millions of U.S. dollars)

	1984	1985				
		Year		First Half	Second Half	
		Earlier Est. 1/	Rev. Est.		Earlier Est. 1/	Rev. Est.
Current account	2,030	-6,300	-10,250	-5,300	-1,000	-4,950
Exports, f.o.b.	23,905	24,000	23,400	10,800	13,200	12,600
Imports, f.o.b.	-23,891	-31,900	-35,150	-16,800	-15,100	-18,350
Trade balance	14	-7,900	-11,750	-6,000	-1,900	-5,750
Services (net)	1,574	1,200	1,100	500	700	600
Net unrequited transfers	442	400	400	200	200	200
Capital account (net)	-1,003	2,900	3,800	1,700	1,200	2,100
Medium- and long-term borrowing, (net)	734	1,650	...	...	...	...
Foreign direct investment (net)	1,258	1,650	...	...	...	...
Portfolio investment abroad	-1,721	-1,000	...	...	...	...
Other medium- and long-term capital (net)	-384	-100	...	...	...	...
Short-term capital (net)	-890	700	...	...	...	...
Errors and omissions	-932	--	...	...	...	...
Overall balance	95	-3,400	-6,450	-3,600	200	-2,850
Memorandum item:						
International reserves at end-period	15,516	12,116	9,066	12,028	...	...

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

1/ Estimates provided in SM/85/266.

The exchange rate for the renminbi has depreciated further in recent months from Y 2.91 per U.S. dollar at end-August to Y 3.18 per U.S. dollar as of October 29, 1985. In nominal effective terms, the depreciation amounted to 13 percent during this period; the index of the real effective rate is estimated to have depreciated by a similar amount.

On October 22, 1985 the following communication was received from the authorities:

"In view that the Chinese yuan has been adjusted substantially since 1984 and also on account of the present price and wage reform in process, more flexible exchange rate arrangement is desirable. Therefore, China has decided that the original peg of yuan to a basket of currencies will be replaced by the "managed floating" beginning from January 1, 1986 and may be reclassified as such by the Fund."

III. Seventh Five-Year Plan

On September 23, 1985, a party conference adopted the Central Committee's proposal outlining broad objectives and policy strategy for the Seventh Five-Year Plan (1986-90). The proposal forms the basis on which the State Council is to draft the plan document, which is scheduled for consideration by the National People's Congress in the spring of 1986.

According to the proposal, priority is to be given to continuation of economic reforms, maintaining macroeconomic balance, and improving product quality. Growth of total agricultural and industrial output is targeted at about 7 percent (compared with an average of over 10 percent estimated during the current plan period, 1981-85), and growth of real GNP at just over 7 percent. ^{1/} Emphasis is placed on further development of agriculture through improvements to the responsibility system and increases in the role of market forces, on expansion of consumer goods industries and residential construction, and on development of the service sector through relaxation of restrictions on collective and individual activity. Priority will also continue to be given to projects in the energy, transport and communications, and raw material producing sectors. Energy policies include a coal output target of 1 billion tons per annum by 1980, efforts to improve conservation, and rationalization of energy prices through gradual upward adjustments.

^{1/} The Seventh Plan will be the first to include a target for growth of real GNP, official statistics on which have recently begun to be compiled.

Further changes in the system of economic management are to be introduced with a view to improving the economic performance of enterprises, expanding the role of markets, and gradually reducing the scope of direct controls over economic activity. Improvements in enterprise performance are to be fostered by streamlining administrative control of enterprise activities, reducing the scope of mandatory planning, exposing enterprises to competitive pressures, and reform of personnel policies. The development of a more market-oriented system is to be facilitated by removal of barriers to direct trade between enterprises and in particular by price reform. Price controls on consumer goods and most services are to be relaxed; for major producer goods, the proportion of output sold at state-fixed prices is to be gradually reduced, while fixed prices are steadily raised toward the level of market prices. Prices charged by major public utilities and services are to remain under state control.

In the area of domestic financial policies, the proposal stresses the need to strengthen the role of the People's Bank in controlling credit and foreign exchange and in supervising the operations of the specialized banks. Subject to this supervision, the specialized banks will be permitted greater freedom to compete with each other and to establish a money market; at the same time, they are expected to tighten loan approval procedures and accept greater responsibility for lending risks. Fiscal policies are to be geared to maintaining macroeconomic balance, further improving the tax system, and strengthening the financial responsibilities of local governments. Budget-financed investment will be directed mainly toward infrastructure projects, with other forms of investment by enterprises guided by interest subsidies and other types of financial assistance.

The proposal emphasizes the importance of foreign trade in China's future development--total trade is to increase by between 40 and 50 percent during the plan period--and stresses the key role of higher export earnings. Efforts to promote exports include establishment of export processing zones, awards for outstanding export achievement and, in particular, greater use of pricing and exchange rate policies. On the import side, priority is to be given to high technology items, while large-scale imports of raw materials and consumer goods to sustain excessive domestic demand are to be avoided. Policies to increase China's attractiveness for foreign direct investment are to be continued, along with further reforms to the systems of foreign trade and foreign exchange management, including exchange rate adjustments based on movements in domestic and foreign prices.

IV. Staff Appraisal

The thrust of the appraisal in the staff report is not affected by recent developments. However, these developments have focused particular attention on the short-term economic situation and on the balance of payments deficit.

The authorities' short-term domestic objective remains a "soft landing," implying a gradual slowdown to a sustainable rate of economic expansion. Such a rate is considered to be in the range of 7-10 percent, compared with the 14-15 percent growth recorded in 1984 and the first half of 1985. Already, there is evidence that the economy is slowing down in response to the measures taken earlier this year. Growth of demand and output is still quite rapid, however, and additional monetary measures currently under consideration may therefore be needed to ensure macroeconomic balance.

The import restraint measures and the recent slowing of domestic demand expansion have so far had little impact on the balance of payments, and reserves have declined markedly further. Although a slowdown in imports is likely, a further decline in reserves can be expected during the remainder of the year. The staff agrees with the authorities' view that the decline in reserves needs to be halted. In this connection, the staff would again emphasize the need to promote exports and would encourage the use of demand management and exchange rate and pricing policies as instruments of balance of payments management. The recent indication from the authorities of their intention to pursue more flexible exchange rate policies is welcome.