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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/161

10:00 a.m., November 8, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	M. Lundsager, Temporary
	H. G. Schneider
B. de Maulde	S. de Forges
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
A. Kafka	
	T. A. Clark
	H. Fugmann
M. Massé	L. Leonard
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
	H. Alaoui-Abdallaoui, Temporary
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
V. Wall, Assistant

Also Present:
IBRD: L. E. Hinkle, Western Africa Regional Office. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; K. Enders, M. G. Fiator, S. M. Nsouli, L. Schmitz. Asian Department: Tun Thin, Director; P. R. Narvekar, Deputy Director; H. Neiss, Deputy Director; T.-S. Boxall, M. J. Fetherston, D. J. Robinson, K. Saito. Central Banking Department: L. M. Koenig, Deputy Director; T. J. T. Balino. European Department: P. B. de Fontenay, Deputy Director; P. C. Hole. Exchange and Trade Relations Department: E. H. Brau, H. Hino. Fiscal Affairs Department: E. A. Conrad. IMF Institute: Youba Ba, Di Weiting, Participants. Legal Department: Ph. Lachman. Research Department: D. J. Goldsbrough, C.-Y. Lin. Western Hemisphere Department: E. Wiesner, Director. Bureau of Statistics: A. C. Bouter, Shao Z. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. K. Doe, L. P. Ebrill, S. Ganjarerndee, J. Hospedales, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, Bo T., R. Fox, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, L. Hubloue, O. Isleifsson, A. R. Ismael, J. M. Jones, S. King, M. Rasyid, J. Reddy, J. E. Rodríguez, V. Rousset, C. A. Salinas, M. Sarenac, A. A. Scholten, B. D. White, Yang W.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Massé as Executive Director.

2. MALI - STAND-BY ARRANGEMENT

The Executive Directors considered a request from Mali for a 17-month stand-by arrangement in an amount equivalent to SDR 22.86 million (EBS/85/241, 10/3/85).

The staff representative from the African Department said that the authorities had taken the measures envisaged in the program in support of which Mali was requesting the proposed stand-by arrangement. In addition to measures that had been adopted in August 1985, official retail prices for cereals had been increased, and electricity and water tariffs were being adjusted to conform to the letter of intent. On November 1, 1985 the prices of coarse cereals had been raised by 52 percent, to CFAF 95 per kilogram, and the price of paddy rice had been increased by 32 percent, to CFAF 165 per kilogram. On November 6, 1985 the Council of Ministers had decided to increase the electricity tariffs of the National Power Company by an average of 35 percent and the water tariffs by an average of 200 percent. The authorities had also decided to raise the electricity tariffs of the Sélingué Dam Authority by 26 percent, as of November 8, 1985.

Mr. Alfidja made the following statement:

> Despite the adverse effects of the severe drought on different sectors, significant progress was achieved in restructuring the economy of Mali over the last few years. However, in light of the structural nature of the difficulties confronting the country, the Malian authorities are furthering their efforts aimed, inter alia, at establishing a firm basis for economic growth within the framework of an adjustment program in support of which they are requesting Fund financial assistance.
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> During the program period, real GDP is forecast to increase on average slightly more rapidly than in 1984, reflecting not only the beneficial impact on agricultural output of anticipated clement weather conditions but also of measures to stimulate supply. In this context, the producer prices of cotton, coarse cereals, and rice were raised in June 1985, and the Government has adopted a schedule for the liberalization of the marketing of paddy rice as indicated in the letter of intent.
>
> Concerning public enterprises, building on the achievements made earlier, the Government of Mali took further actions in the context of the present adjustment program.

To strengthen the financial situation of SOMIEX, the prices charged by this enterprise for the supply of several goods and services were raised in August 1985, and the further reduction in the number of its personnel is being considered. To the same end, the domestic fares charged by Air Mali were raised in August and the retail prices of coarse cereals and rice sold by OPAM were substantially increased, effective November 1, 1985. Water and electricity tariffs were also substantially adjusted upward. A rehabilitation plan for the privatization or liquidation of several public enterprises with the assistance of the World Bank is under way. On this subject of restructuring public sector enterprises, I must reiterate the comment that I made last May during the Executive Board meeting on Mali on its considerable economic and social consequences, regarding employment in particular. Consequently, it would be unrealistic to expect the Malian authorities to be oblivious to these problems in making decisions in restructuring this sector--in particular the pace at which it will be carried out.

In the fiscal area, the aim of the authorities is to improve the consolidated budgetary position of the Government by achieving a small surplus (excluding foreign-financed investment expenditure) in 1986. This objective is to be reached by the combined effects of revenue-enhancing and expenditure-restraining measures. As regards the former, in August 1985 the Malian authorities increased the tax base for custom duties as well as the import duty rate applicable to cereals and cereal products. They have also reintroduced the sales tax on these products. In addition, the increase in the prices of petroleum products is expected to contribute to revenue growth. As stated by the staff, efforts to collect outstanding taxes will be stepped up. On the expenditure side, the policy of restraint on the wage bill and financial assistance to students in the form of scholarships will continue. The ongoing efforts to strengthen the procedures for monitoring and controlling spending growth--in particular by avoiding expenditure overruns--are also being pursued.

In the external sector, better weather conditions in 1986 are expected to contribute favorably to the domestic food supply situation and lessen the need for imports. This prospect, together with increased export earnings principally from cotton and livestock, will cause the external current account deficit to recede. The overall balance of payments position is also expected to improve because of the aforementioned expectations on the current account situation, as well as on a prospective better outturn of the capital accounts.

To alleviate the debt service burden, which is expected to worsen during the next few years, my Malian authorities are actively negotiating a rescheduling of the country's debt with Mali's creditors. In addition, new loans on nonconcessional terms will be avoided.

To conclude, I would like to reiterate the commitment of my Malian authorities to take steps to progressively put their economy on a sound footing as outlined in the staff report and the accompanying letter of intent. However, for these efforts to be successful, Mali, like many other countries in my constituency, will need substantial and sustained financial and technical external support. My authorities are hopeful that this assistance will be provided in a timely way and in an amount commensurate with the need of the country.

Mr. de Maulde stated that in the previous three years Mali had implemented strong adjustment policies supported by two stand-by arrangements in addition to the technical and financial help from the World Bank. During that period all the performance criteria had been met, largely because the policies of the program had been observed and Mali had entered the West African Monetary Union in June 1984. Furthermore, progress had been made in reducing the imbalances inherited from the late 1970s and early 1980s. For example, the deficit on consolidated government operations had been reduced from 4.5 percent of GDP in 1981 to 1.9 percent in 1984. During that same period, the losses of public enterprises had dropped from CFAF 11 billion to CFAF 4.4 billion. In addition, the deficit on the current account of the balance of payments had been reduced from 10 percent of GDP to less than 6 percent. Concurrently, a number of measures had been taken to improve the performances of public enterprises and to promote agricultural production. Those improvements had provided the basis for the soundness of the program presented to the Board that day.

There were the usual macroeconomic provisions in the program relating to demand management, Mr. de Maulde continued. The stipulations regarding public finances, however, were very tight, because the overall position of government operations, excluding foreign-financed investment and grants, was scheduled to move from a deficit of 1.9 percent of GDP in 1984 to a balance in 1985 and to a surplus of 0.8 percent in 1986. In fact, a number of revenue and expenditure actions had already been put in place in order to attain those targets. The special component of the program was the broad set of supply-side measures. They addressed three issues--rationalizing public investment, restoring realistic price mechanisms, and restructuring the public enterprise sector. Furthermore, those measures looked deeply into the microeconomic problems of various companies; for example, their prices and their staffing. In a number of cases, explicit reference had been made to World Bank studies, recommendations, and programs. Therefore, the program should be kept in mind for discussions of Fund-Bank cooperation. In effect, Mali was a good example of the argument that microeconomic and macroeconomic issues were too closely interrelated to be discussed in isolation. However, the important point was the needs of the borrowing country rather than abstractions on the respective fields of competence of the Fund and the World Bank.

He would like to hear more about the contribution of the World Bank to the rehabilitation of the economy of Mali, Mr. de Maulde went on. He wondered when disbursement would be made of the World Bank's sector loan to public enterprises, since the staff report had indicated that negotiations would be concluded before the end of 1985. He also noted that Mali's policy reform actions were perfect examples of what the Special Facility for Sub-Saharan Africa had been set up to finance.

Mr. Alhaimus said that Mali's current adjustment program was a step forward in addressing the country's serious economic and financial imbalances. Mali's track record in adhering to adjustment programs had been a good one, as had been demonstrated during the previous two Fund-supported programs in the period 1982-85. Strong adjustment measures had been carried out on a broad scale to tackle structural imbalances and to ensure external financial stability. Considerable progress had been made despite drought conditions; nevertheless, as expected in such a poor African economy, serious economic and financial imbalances persisted, and the momentum of adjustment had to be maintained.

The current program was appropriately designed to continue demand restraint and ease structural imbalances, Mr. Alhaimus continued. Barring serious setbacks such as drought or adverse global conditions, the realistic program should achieve its objective of a balance of payments viability by 1988 if adjustment efforts continued. The envisaged 2.6 percent economic growth rate was an improvement over preceding years, although it was only equal to the population growth. The program policy measures included a number of steps in the fiscal field designed to balance budgetary operations in 1985 and to realize a surplus of 0.8 percent of GDP in 1986. That goal was realistic because it only required an improvement over an already small deficit in 1984 following a previous fiscal adjustment. Although the magnitude of domestic arrears was uncertain, the intention was to eliminate them, and a specific ceiling had been set to avoid further accumulation. However, if the magnitude of arrears turned out to be less than the present ceiling, would a reduction be made accordingly? Monetary policy would appropriately remain consistent with balance of payments and budget targets: interest rates would stay in line with those objectives, as present levels were positive in real terms.

The staff paper had projected that crop credit would increase significantly in 1986 based on "the expected improvement in weather conditions in 1985 and 1986," Mr. Alhaimus remarked. He wondered how the staff could be so certain of such prospects. In addition to the measures already taken by the authorities, a wide range of adjustment was contemplated in pricing, marketing, and public enterprises. Although it was undeniable that those measures would contribute to financial stability, he shared the concern of the authorities regarding the economic and social consequences of restructuring public sector enterprises, especially the impact on employment. However, he noted the steps to strengthen development through the implementation of a comprehensive system of investment programming in cooperation with the World Bank.

Notwithstanding the projected improvement in 1985 and 1986, external imbalances would remain large, Mr. Alhaimus commented. The current deficit would continue to be significant, at 13.3 percent of GDP, and the country would still be dependent on grants. The overall balance would be affected by the expected increase in external debt service obligations. The continuation of such difficulties underlined the need for Mali to move forward in its adjustment efforts.

Mr. Goos said that he supported the proposed stand-by arrangement with Mali. The measures envisaged under the arrangement offered good prospects for building upon the quite encouraging progress achieved under the previous two stand-by arrangements.

The external situation of Mali has remained difficult for various reasons, all of which called for sustained adjustment efforts, Mr. Goos continued. Those efforts should comprise continued financial restraint and further liberalization of the economy, most notably in price controls and marketing arrangements. Nevertheless, while the contemplated measures, as well as those already implemented, were welcome, he was concerned that the authorities might pursue too gradual an approach to liberalization. In fact, he was surprised to note that even the staff perceived only a need for gradual liberalization of the comprehensive system of price controls. That assessment was difficult to reconcile with the one that price rigidities were the major factors contributing to continuing economic and financial imbalances. Perhaps the staff could clarify that conflicting point. Otherwise he had no difficulty with the measures envisaged in the program.

Mr. Mtei said that he supported the request of Mali for a third stand-by arrangement. In the previous two stand-by arrangements dating back to 1982, the authorities had demonstrated their determination to undertake difficult but necessary adjustment measures. They had adhered to all the measures agreed upon in the programs and had made full drawings under the stand-by arrangements that had taken them a long way to strengthening the underlying economic and financial situation. Rates of growth of GDP had turned positive in 1984, while the deficits in the budget and the current account had been considerably narrowed. Unfortunately, however, imbalances had continued, owing in large part to adverse weather but also to incomplete reforms in the areas of public finance, public enterprises, and price and marketing liberalization. The proposed program demonstrated the authorities' determination to continue their ongoing adjustment effort in order to achieve a sustainable balance of payments surplus by 1988, eliminate the budget deficit and payment arrears, and accelerate the rate of growth of income to 3.5 percent in 1986 from 1.7 percent in 1985.

Some areas of the program were of significant long-term value to Mali, Mr. Mtei continued. From 1986 onward, the incorporation into the budget of externally financed projects would enable the authorities to obtain a long overdue analytical picture of demand variables and their sustainability in the country, and would facilitate continuing demand management policies. Closely related to that exercise was the ongoing inventory of arrears and the establishment of a monitoring system in order that once ascertained, arrears could be eliminated under the present adjustment program. In the same way, the authorities would be in a position to keep abreast of re-emerging arrears and to take appropriate measures. Yet another commendable feature of the program was the Fund-assisted preparation of a comprehensive tax reform, geared to eliminate the deficit and stimulate the private sector. The institutionalization of that reform within the the framework of annual budgets should be a source of continuing economic revitalization.

The close collaboration between the authorities and the World Bank in Mali's adjustment efforts should be encouraged, Mr. Mtei went on. In the previous adjustment programs the assistance of the World Bank had been very important in the agricultural and the public enterprise sectors. The implementation in 1986 of a large public enterprise sector project--involving policy, institutional and operational aspects, and the possibility of privatizing or liquidating some of those enterprises--would be of long-term advantage to Mali.

There was also a useful role for the World Bank in the formulation of the new development plan covering 1987-91, Mr. Mtei said in closing. The adjustment program provided Mali with a chance to liberalize the price and marketing system in the agricultural sector in order to stimulate domestic production and improve the allocation of resources.

Ms. Lundsager said that the measures recently implemented by the Malian authorities indicated their commitment to continue their adjustment effort. A smooth adjustment effort would facilitate the process of resource reallocation that in the longer run would permit a return to strong economic growth and a sustainable external payments position. If achieved, the targets of the new program would consolidate the real economic gains made under the two previous ones, notwithstanding the adverse affects of the drought in 1983 and 1984.

She strongly supported the measures designed to increase the productive capacity of the economy by strengthening incentives to private producers while reducing direct government control over them, Ms. Lundsager continued. The tax reform planned for 1986 was especially welcome, since Mali's high tax rates had weakened incentives for income-generating production and savings. Increases in producer prices would stimulate an adequate producer response and point to the time when producer and consumer prices could be freely set by the market. It had been pointed out that the authorities were considering a gradual price liberalization, but she had some reservations about too slow a pace of adjustment. With

Mali's limited resource base, full decontrol of prices would provide the environment needed for rapid and efficient producer response to changing local and world market conditions.

Price decontrol was related to the reform of public enterprises, particularly those involved in marketing, Ms. Lundsager went on. So far, steps had been taken to liberalize rice marketing and to rehabilitate some of the public utilities. She noted that the World Bank and the authorities were to conclude negotiations soon for a program that would include some privatization as well as rehabilitation in the public enterprise sector. She encouraged rapid progress in those two areas of price decontrol and public enterprise reform, and she welcomed the inclusion of a clause for an evaluation of such progress in the review. The scenarios for the medium term highlighted the importance of strong producer incentives both for export and domestic consumption.

The adjustment in the fiscal area that had occurred in the previous programs was welcome, but significant additional adjustment would be required to ensure attainment of a sustainable budgetary and external position, Ms. Lundsager commented. She noted the efforts to inventory and eliminate arrears as well as the tight control currently exercised over expenditures. However, the containment of the 1986 wage bill required administrative reforms in the personnel area, an area in which adjustment had fallen somewhat short in 1984; therefore, the authorities should be cautious in granting wage increases following the catch-up adjustment early in 1985. Furthermore, a more modest amount of spending on scholarships, combined with a firmer stance on government recruitment, would support the authorities' efforts to reduce the scope of government control in Mali. In the long run, reducing the size of the fiscal sector would provide better prospects for growth and employment. The World Bank was providing welcome assistance to improve investment budgeting, including accounting for recurrent costs and ranking of projects, which should contribute to a more rational plan and pace of development.

The authorities had managed well the conversion of the currency into the CFA franc following Mali's entry into the West African Monetary Union, Ms. Lundsager noted. The rate of inflation had dropped following the return of improved weather conditions, and interest rates on small savings deposits were currently providing a positive real return. Those developments were welcome because the expected doubling of the national savings rate in 1986 would have to come from private savings.

With its growth and balance of payments adjustment dependent on the agricultural sector, the baseline scenario for the medium term in Mali underscored the fragility of the economy, Ms. Lundsager continued. She also questioned the reason for the assumption that private transfers would grow over the next few years. The fragility of the medium-term outlook and the budgetary difficulties related to Mali's debt servicing obligations led her to endorse the level of Fund access being requested. Even with the extensive debt relief being granted by bilateral creditors, Mali would continue to face difficulties in meeting its debt servicing obligations. Therefore, only a modest amount of Fund credit should be used, given the nonconcessional nature of the funds. She also hoped for continued extensive World Bank involvement both for policy advice and concessional financing.

The first performance test date preceded the program's date of approval, Ms. Lundsager said in closing, and she wondered if end-September performance criteria had been met.

Mr. Suraisry stated that Mali had achieved considerable progress in its previous adjustment program and that all the performance criteria had been met. However, because of the persistence of a severe drought in 1984, not all the program's objectives had been attained. Thus, notwithstanding the progress that had been made, Mali continued to face fiscal and external imbalances that were exacerbated by structural rigidities and rising debt service payments. The proposed program addressed those imbalances and aimed at creating the right conditions for restoring financial stability. However, it was important to note that stability was not likely to be achieved in the program period. Continued adjustment measures beyond the program period were essential, and, therefore, Mali would continue to need the support of the Fund and the World Bank.

The economic strategy of Mali correctly combined firm demand management policies with supply-side structural measures, Mr. Suraisry continued. The authorities should further reduce the fiscal deficit, maintain a restrictive credit stance, and manage their external debt cautiously. In addition, those policies should be supplemented by measures to increase the growth prospects of the economy, particularly in the private sector. The price and marketing system needed to be further liberalized, the public enterprises rehabilitated, and development planning strengthened. Those measures should result in an expansion of output that was critically needed to reduce the economy's large imbalances. To their credit, the authorities had made commendable efforts in those areas.

A number of commendable fiscal measures had been taken to enhance revenues and reduce expenditures, Mr. Suraisry went on. Nevertheless, further measures to restrain expenditures, especially with respect to the wage bill, were needed. In addition, the program envisioned measures to further improve tax administration and strengthen expenditure control. The Government had accumulated a considerable amount of extrabudgetary arrears and was owed tax arrears. Therefore, the authorities should identify and eliminate all arrears and not allow any spending without budgetary allocation, a restriction that would help restrain expenditures and prevent the emergence of additional arrears. The planned establishment of a government investment budget would also go a long way toward strengthening public finances.

The present reform of the public enterprises needed to be continued, Mr. Suraisry commented. The recent increase in prices and the reduction in the staff of some enterprises were commendable. He particularly welcomed the rehabilitation of the parastatal sector sponsored by the World Bank. Given the pervasive role of public enterprises in the overall economy, the rehabilitation would boost Mali's growth prospects in addition to strengthening public finances.

Those reforms must be accompanied by a general liberalization of marketing and pricing policies, Mr. Suraisry noted. The liberalization of prices would increase incentives, improve the allocation of resources, and increase output in general. Recent price increases were in the right direction, and he looked forward to the results of the study on the implications of relaxing the price control system.

The implementation of those policies, together with continued credit restraint, should strengthen Mali's external position, Mr. Suraisry remarked. Given the projected increase in Mali's debt service obligations, the external position should all the more be strengthened, especially since the implementation of the proposed program should facilitate the rescheduling of debts.

The projected strengthening of Mali's external position underscored the need to enhance the mobilization of domestic resources, Mr. Suraisry continued. If the investment rate was to be maintained, there was no alternative but to increase domestic savings. He was pleased to note that the staff projected a doubling of the savings rate in 1986. He wondered what the sources were for the projected increases.

Mr. Alaoui-Abdallaoui said that despite a severe and prolonged drought, Mali had been able to implement successfully its two stand-by arrangements with the Fund. However, Mali's economic and financial imbalances remained of serious magnitude, especially regarding price rigidities, the public enterprise sector, and the large fiscal deficit with its expanding external side. The authorities had demonstrated their determination to tackle those difficulties and to adopt the harsh policies required.

He supported the proposed decision, Mr. Alaoui-Abdallaoui stated, but he questioned the small amount of access under the program considering Mali's record of cooperation with the Fund, its balance of payments need, and the comprehensive program supported by the requested stand-by arrangement.

The staff representative from the African Department said that, under the program, economic growth in Mali was projected to increase from about 1.3 percent in 1984 to 1.7 percent in 1985 and to 3.5 percent in 1986. When an economy was heavily dependent on weather conditions affecting agricultural output, it was difficult to project economic growth with certainty. However, present information indicated that weather conditions had improved substantially, and the growth target for 1985 should be achieved. In terms of policies, the program placed considerable emphasis on creating the conditions for achieving sustained economic growth and encouraging private sector economic activity. For one thing, the program emphasized the development of systematic public sector investment programming, which should allow an improvement in public sector resource allocation.

The program also emphasized an improvement in price incentives, the staff representative continued. A number of measures had been taken in adjusting regulated prices. In addition, there was an emphasis on the liberalization of pricing policies and marketing policies. The program contained plans to restructure the tax system with technical assistance from the Fund, to reduce the burden of taxation on the modern sector, and to enhance price incentives. In addition, the allocation of credit to the productive sectors of the economy was being emphasized under the program. In fact, the government sector would be using much less bank credit than in the past. That development reflected a reduction in the budget deficit, which would release real resources to the private sector. Furthermore, the program included a reform of the public enterprise sector, which should contribute to an improvement in its efficiency.

Because of reduced inflation and Mali's entrance into the West African Monetary Union, there had been an increase in real interest rates, which should, in turn, contribute to an improvement in the savings ratio, the staff representative stated. Mali's membership in the West African Monetary Union meant that it would maintain a liberal exchange and trade system, which should encourage a more rational allocation of resources. Thus, overall measures in the program aimed at improving conditions in general for achieving a sustainable rate of economic growth over the medium term.

Under the program, it was expected that the wage bill would be frozen in nominal terms in 1986, the staff representative went on. The programmed freeze in the wage bill would be achieved partly through economies generated from tighter control on disbursements of personnel salaries following the census taken to identify all existing personnel in the government sector. Furthermore, the authorities would limit merit increases and restrain recruitment.

The authorities were preparing a study of extrabudgetary arrears, and an inventory was expected to be completed by the end of November, the staff representative remarked. With technical assistance from the Fund, the authorities were also developing a monitoring system to avoid the re-emergence of such arrears. The progress made in reducing arrears would be an issue of the first review of the program, and at that time specific ceilings would be set for their elimination. Ceilings had already been set on identified treasury arrears.

Several speakers had stressed the importance of developing an appropriate investment budget and incorporating that into the regular budget process, the staff representative commented. Such a measure was necessary to strengthen public finance management and economic analysis.

For that purpose, the Fund had provided technical assistance early in 1985, and progress had been made on a draft investment budget for 1986, which would be considered at the time of the first review.

There was a need to restructure the tax system to provide greater incentives to the private sector, and the Fund had also provided technical assistance in that regard, the staff representative noted. The Fund report to the authorities had recommended restructuring import duties to favor the productive sectors, eliminating certain taxes, increasing certain import duties, reducing the minimum income tax for enterprises, reducing the tax on the wage bill of enterprises, increasing write-offs for depreciation, and modifying the turnover tax. These reforms would also contribute toward generating additional employment in the private sector.

A few Directors had emphasized the importance of not taking too gradual an approach to the liberalization of pricing and marketing, the staff representative went on. The authorities had indicated their commitment to a steady and determined process of pricing and marketing liberalization, and they were preparing a detailed study of the current pricing and marketing system. The study was being prepared in the context of the current stand-by arrangement, and it was expected that at the time of the first review specific measures to liberalize pricing and marketing policies would be agreed upon. In fact, notable progress had already been made. For instance, private sector transactions in cereals had been fully liberalized toward the end of 1984, and paddy rice produced in the Office du Niger would be fully liberalized by the 1986/87 marketing season. The Office du Niger would no longer be required to sell specified quantities of paddy rice to the cereal marketing agency at set prices. Under the program, a number of regulated prices had been increased, and a degree of automaticity in the adjustment of transportation tariffs and petroleum prices had been introduced.

Inquiries had been made about the progress in the comprehensive reform of the public enterprises, the staff representative noted. The World Bank would send a mission to reappraise the reform of the public enterprises at the end of 1985, that would coincide with the first Fund review mission. The purpose of the reform program was to determine overall improvements that could be made in the public enterprise sector--to prepare specific rehabilitation programs for key public enterprises, to undertake viability studies for a number of other public enterprises, and to plan the privatization of some public enterprises. With regard to the employment effects of the reform, the adjustment program provided incentives for an increase in private sector activity, which would increase the employment opportunities for the growing labor force in the country. The higher savings ratio for 1986 was also expected to come primarily from the private sector through increased economic growth in the agricultural sector. That increase would be reinforced by the increase in real interest rates during 1985-86. In addition, projections indicated a growth in private transfers over the medium term as a result of the improvement in the economic environment and the entry of the country into the West African Monetary Union.

One Executive Director had inquired whether Mali had met the performance criteria at end-September, the staff representative from the African Department said. Information received thus far indicated that the ceilings with respect to treasury arrears, external arrears, and external borrowing had been observed. Monetary data for end-September 1985 had not yet been received; however, data received recently for end-June showed credit performance to be in line with the projections of the staff report.

The staff representative from the Exchange and Trade Relations Department stated that the access amount requested under the program seemed consistent with access criteria for a country in circumstances such as those in Mali. The stand-by arrangement was for SDR 22.8 million, 45 percent of quota over a period of 17 months, which involved annual access of 30 percent of quota. Under that degree of access, Fund credit to Mali would still rise over the program period from the current 136 percent to 142 percent of quota. In the medium term, Mali's balance of payments was highly vulnerable, and the country was not in a position to service an appreciable amount of additional, and rather expensive, external debt. Furthermore, in order to help carry out the adjustment process in Mali, the Fund expected to be involved over the next two or three years, and Mali would need further access.

The staff representative from the World Bank said that progress on the rehabilitation project for the public enterprises had been good. Most of the issues that remained to be resolved for the rehabilitation project concerned institutional arrangements about how the Government could most sensibly manage the sector while leaving to the enterprises the maximum autonomy to conduct their own affairs. The upcoming World Bank mission would determine specific issues concerning Air Mali, the Office of Post and Telecommunications, SOMIEX, and the organization of the energy sector. Negotiations were expected to be completed in early January. At present, it appeared that there would be a combined IDA-Special Facility for Sub-Saharan Africa credit for approximately $45 million. However, the full extent of the debt of some of the enterprises was not known, and therefore the credit amount could not yet be precisely determined. The upcoming mission would look into that point.

Mali was indeed eligible for the Special Facility for Sub-Saharan Africa, the World Bank staff representative continued. Its eligibility was based on a combination of having a current Fund program and a series of sectoral adjustment loans from the World Bank. The World Bank was planning to provide considerable financing complementary to the Fund program. Currently, lending of approximately $55 million was envisaged from the Special Facility for Sub-Saharan Africa, which would be committed in the remainder of 1986. It would include approximately $35 million for the public enterprise rehabilitation project, together with $10 million of IDA's own resources, and another $20 million for the Office du Niger, making a total of $30 million for that project. The Special Facility for Sub-Saharan Africa resources were in addition to Mali's access to the regular IDA-VII resources of approximately $130 million over the three-year period. The World Bank had a fairly large program with Mali, and it was involved heavily in a policy dialogue with Mali. The program complemented the Fund's program well.

Mr. Alfidja said that Directors should keep an open mind on what had been called too gradual an approach to liberalization until the report of the forthcoming discussions between the staff and Malian authorities was available. He suggested that in that report the staff should fully present to the Board the understanding reached between the authorities and Mali's aid donors about the commitment of both sides toward implementing the so-called gradual approach to liberalization. He was certain that the report would show that despite some problems, the Malians had fulfilled their undertaking.

The Chairman said that he would like to add a footnote to the issue of Mali's level of access. Mali's debt service ratio was climbing rather quickly--13 percent in 1984; 19 percent in 1985; and 22.7 percent projected for 1986. The Fund itself was becoming a very heavy creditor in that country, with payments to the Fund in 1986 accounting for some 9 percent of Mali's total exports of goods and services.

Mali was a case in which the intertwined microeconomic and macroeconomic programs of the World Bank and the Fund were somewhat of a model, the Chairman continued, because the activities were very specific. The cooperative efforts of both institutions were helping the country to move forward.

He was disappointed that Air Mali had not been liquidated by the end of June 1985 as planned, which was a breach of the understanding that had been reached with the authorities as Air Mali was still operating at a loss. He was confident that the new deadline of end-December 1985 would not be breached. The authorities should find a way of operating the airline with a partner and without losses, or they should close it down.

Executive Board then took the following decision:

1. The Government of Mali has requested a stand-by arrangement for the period from November 8, 1985 through March 31, 1987 in an amount equivalent to SDR 22.86 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/241, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8122-(85/161), adopted
November 8, 1985

3. PEOPLE'S REPUBLIC OF CHINA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation for the People's Republic of China (SM/85/266, 9/27/85; Cor. 1, 10/1/85; and Sup. 1, 11/4/85). They also had before them a paper on recent economic developments in China (SM/85/272, 10/24/85; and Sup. 1, 10/25/85).

Mr. Zhang made the following statement:

The staff report on the 1985 consultation, together with its supplement, presents an excellent and comprehensive description of the Chinese economic situation and policies during the period under review. My authorities appreciate the high quality and the balanced approach of the staff's analysis and are pleased at the consensus between their views and those of the staff. Since the staff report provides a very detailed analysis of the current situation and prospects, I shall concentrate my remarks mainly on some broader aspects of the implementation of the reform. It is in this context I shall refer to the short-term problems of economic management and the recent proposal concerning the long-term management of the economy.

Process of Reform

As explained in my statement of last year, the overall objectives of the reform are to increase considerably the autonomy of the enterprises, to bring about a continuous but gradual extension of the role played by the market forces within the general framework of state ownership as the predominant means of production, and to guide society by planning toward the achievement of socialist goals.

The achievement of these goals requires a steady improvement in productivity and in the overall efficiency of the economy. At the present stage of development, this improvement cannot be attained without a marked shift away from mandatory planning and the implementation of plans by direct administrative controls toward indirect methods of macroeconomic planning and their implementation.

Greater reliance upon macroeconomic methods of control is, however, not tantamount to the introduction of a system relying on the unrestricted operations of market forces. Official statements indicate that the planning in the socialist market economy of China should be implemented both by mandatory directives and by indirect guidance of the economy by macroeconomic methods. The proposal for the Seventh Five-Year Plan (1986-90) expresses the view that "...in socialist economic management a certain amount of administrative means will always be indispensable." Indeed, according to the same document, although the essence of the reform is to reduce the use of administrative methods, yet to insure the orderly transition from the old to the new system, some administrative methods must be temporarily reinforced. Thus, one of the most important problems to be solved at present and during the period of the Seventh Five-Year Plan is to find the most appropriate combination of the market mechanism and the central planning of the economic and social development.

Neither the past experience of the centrally planned economies nor that of the private enterprise market economies provides any conclusive indication on the most efficient way of using these approaches. The experience of the centrally planned economies shows that, while the mandatory direct planning and management facilitated a rapid recovery in the initial period of planned development, it became an obstacle to sustained growth at later stages. But the experience of free market economies indicates that one cannot rely on the spontaneous play of the market forces to achieve balanced growth, full employment of resources, and an equitable distribution of income. The recent Chinese experience points to the fact that the rational way of using the market mechanism is to place it under an umbrella of central planning exercised largely by macroeconomic means.

My authorities fully realize that the transition from the mandatory microeconomic implementation of plans to the macroeconomic methods cannot always proceed on an unwavering course. The pace of implementation of the reform has to be determined in conjunction with changes in a general economic situation, and this may in some cases impose the need for a temporary slowing down or even of some retreat from the results already achieved. Only actual experience can show what is the proper combination of macroeconomic and microeconomic methods at each stage of the reform.

In analyzing the problems facing the Chinese authorities in the process of the economic reform, one must bear in mind the fact that a whole generation of managers of enterprises and planners has grown up under a system of direct control in all aspects of economic activity. Only recently have they been placed in conditions where they have had to assume personal responsibility for decisions relating to quality and quantity of output, employment, wages, utilization of profits, and investment of their enterprises. The awareness of the great difficulties of adaptation to the new conditions is reflected in the emphasis placed on the need for technical, psychological and intellectual re-education necessary to develop the spirit of genuine entrepreneurship required by the autonomy of the enterprises.

The increased responsibility applies not only to the managers but also to workers in all fields of economic activities. In this context a much closer link needs to be established between achievement and remuneration. While this may result in some increase in differentiation of incomes, this is not considered as a retreat from socialist principles, according to which for a long period of socialist development the income distribution should be based on the relative contribution of individual workers to the social product. Steps have been taken to gradually eliminate the existing "egalitarianism," which disregards the differences in the contribution of individuals, and additional measures will be adopted to prevent the possible emergence of income polarization among the different social groups.

Short-term problems of economic management

In recent years, the Chinese economy has experienced increasingly rapid growth and considerable structural change. At first, the rapid growth was mainly on account of the reforms implemented in the agricultural sector since 1979. More recently, industrial output growth began to contribute as the focus of reforms switched to the urban economy. The increased autonomy granted to state enterprises under the urban reforms, coupled with ready availability of bank credit and another bountiful harvest, led to a further acceleration in the growth of national income, beginning in the second half of 1984. While a high rate of economic growth is one of China's major economic objectives, it became clear by the early part of 1985 that the rate of expansion of demand and output had become excessive, leading to strains on raw material supplies, pressures to raise prices, and a weakening of the external payments position. To a very large extent, the severity of these imbalances was due to the narrowing of the scope of direct controls of the enterprises before the system of indicative planning and macroeconomic methods of control was sufficiently developed.

My authorities reacted to the situation by introducing a number of measures designed to curb the expansion of demand and to guide the production of the enterprises along the planned path. These measures included a tightening of credit controls, higher interest rates on deposits and loans, cuts in budgetary expenditures, and stricter administrative supervision of investment. On the basis of available information, the growth of demand and output has begun to slow down in recent months toward more sustainable rates. The situation continues to be monitored closely, and the People's Bank is considering possible additional measures, such as higher rates on its lending to the specialized banks and increases in reserve requirements, to ensure that the growth of money and credit is brought under firm control. It should be emphasized, however, that the objective is to achieve a "soft landing" for the economy rather than to apply a sharp brake which might prove unduly disruptive to the gradual process of reform.

As a part of the process for greater use of indirect macroeconomic instruments, the role of monetary policy in regulating economic activity has been increasing significantly. At the beginning of 1984, the People's Bank was transformed into a separate central bank, with its commercial banking functions transferred to the newly established Industrial and Commercial Bank. Following a transitional period during 1984, when the ability of the People's Bank to control credit was still limited, the powers and independence of the People's Bank have been significantly strengthened in 1985 and will continue to be increased in the coming years. Improvements in the techniques of monetary control are continuing, with the incorporation of the People's Construction Bank into the framework of the credit plan beginning in November 1985. Work will begin shortly on the more complex exercise of incorporating the rural credit cooperatives. In this connection, my authorities attach considerable importance to the work that is planned during the first half of 1986 with the Fund staff to study further ways of improving the system of financial programming and monetary control.

As to the external sector, there was a significant change in China's external payments position from mid-1984. The current account moved into substantial deficit, while international reserves, having reached a notably high level following several years of balance of payments surpluses, began to decline quite rapidly. Apart from the rapid growth of domestic demand, this deterioration was also to a large extent the result of reform which granted increased autonomy to foreign trade agencies and to the enterprises entitled to deal directly with their foreign customers, in association with more liberal allocations of foreign currency and import licenses. In March of this year measures were undertaken to halt the deterioration of the current account balances. Stricter import licensing and exchange controls were applied; these, in conjunction with the measures taken to restrain domestic demand, were expected to slow the growth of imports.

The turnaround in the balance of payments position and the subsequent policy measures, both of which have attracted considerable international attention, need to be placed in a clear perspective. The decline in international reserves, while undeniably rapid, began from a level that had begun to attract comment as unduly high for a country at China's stage of development. Consequently, some decline in reserves, especially if the resources so made available were spent for productive purposes, should not provide cause for concern.

The tighter application of import licensing since March 1985 has had the greatest impact on imports of household appliances and automobiles, which, financed by the foreign exchange allocations of local governments and enterprises, had been increasing at extremely rapid rates. The intention of the authorities is to regulate imports at a sustainable level by means that avoid cancellation of existing contracts and consequent disruption of trading relationships. Indeed, the level of imports has remained high in recent months, reflecting the arrival of goods, notably capital equipment, for which contracts had previously been signed. Some decline in the rate of imports can be expected in the coming months as the backlog of existing contracts is cleared, and the amount of imports under new contracts is kept at a sustainable level.

Proposal for seventh five-year plan 1986-90

This Proposal, which was recently published by the Party Central Committee, outlines the policy strategy and objectives for China's economic and social development for 1986-90. In the Proposal, the highest priority is given to the economic reform in accordance with the view that improvement of the underlying structure of the economy through the reform should have priority over the fastest possible rates of growth. For this purpose, the Proposal distinguishes between two subperiods, 1986-87 and 1988-90. During the first subperiod, while the implementation of the economic reform will continue, the main emphasis of the overall policy is to be placed on the solution of the problems that emerged in 1984, that is, to overcome the imbalances. It is planned to complete all the basic objectives of the reform during the second subperiod of the Plan.

On the basis of the considerable progress already achieved, the reform will proceed to extend further the role played by the market mechanism in all fields of economic activities. Broadly, there will be a more extensive application of such economic levers as interest rate, taxation, and credit policies, to be associated with a further reduction in the scope of mandatory planning and an increase in the decision-making powers of enterprises. In this connection, the Proposal recognizes the important role that competition can play. There is the need to create conditions for competition between enterprises in selling their products and buying their supplies. At the same time the enterprises will be exposed to the consequences of the profits and losses of their operations. The penalty under such circumstances will include the removal of the management and even the closing down of the enterprise.

The reform of the price system, which is considered to be a major component of the current reform, will be accelerated. Measures will be undertaken to bring the relative prices progressively closer to the relative costs and to the supply-demand position of various commodities. Moreover, except for a few major commodities whose prices are to continue to be determined by the Government, price controls of staple consumer goods are to be systematically relaxed. Similarly, the proportion of government-determined prices of major producer goods will be gradually reduced.

It is visualized that the price reform will be basically completed by the end of this Plan. The wage reform, which will introduce a closer relationship between achievement and remuneration, is planned to move broadly together with price reform. But both reforms will have to proceed at a gradual pace and in a coordinated manner so that sharp changes in the overall price level and real wages can be avoided.

As to the external sector, the reform and the opening up policy are at the core of the present policy of economic and social development. In a sense these two policies are symbiotic, for neither can be effective and lasting without the other. It is planned that by the year 1990 the total value of imports and exports will increase by 40-50 percent. Measures will be taken to diversify exports, particularly as a way to increase the relative share of manufactured exports in total. At the same time, China will use more foreign funds in order to introduce into the country more advanced technology. Foreign funds will be used in a variety of ways, including joint ventures, cooperative enterprises with China, or direct investment for those which require intensive technology and are mainly intended to earn foreign exchange through exports.

In the Proposal quantitative targets are given only for a few economic variables. The GNP is planned to grow by 7 percent per annum, which is significantly less than the rate achieved during 1981-85. The volume of fixed investment, which is indicated only for the first two years of the Plan, is to be maintained at the level of 1985. The average level of consumption is projected to increase by 25 percent from 1985 to 1990. For the economy as a whole, the Proposal aims at a stable overall growth, coupled with a balanced development of the major economic sectors. These are to be achieved by continuing increases in efficiency, productivity, and economic benefits in the fields of production and exchange. For this purpose, the priorities and the pattern of production will also be changed accordingly.

It is visualized that, as a result of the planned increases of production during this Plan period, the Chinese economy will gradually reach a stage that will make it possible to go beyond the satisfaction of the basic needs of the population and to improve substantially the general pattern of their consumption and the quality of life.

Before concluding, I would like to make one more general statement regarding the reform. It has become evident that the recent unduly rapid rate of economic growth, the sharp deterioration in the current account balances, and the associated challenges for macroeconomic management as described above have raised in the minds of some observers a question concerning possible implications for economic reform. I wish to stress that the commitment by my authorities to reform remains undiluted; now that China has embarked on the planned path of economic reforms, there can be no turning back. At the same time, the pace of introduction of new reform measures will have to be tailored to the circumstances of the moment to ensure that major steps, such as further price and wage reforms, are taken against a stable economic background.

Mr. de Maulde said that the fact that the Chinese economy had recently been overheating was well recognized. Mr. Zhang had provided a convincing explanation: "The severity of these imbalances was due to the narrowing of the scope of direct controls of the enterprises before the system of indicative planning and macroeconomic methods of control was sufficiently developed." Consequently, the staff had recommended a strong tightening of monetary and credit policies, and Mr. Zhang had indicated that that development had already begun to take place. However, Mr. Zhang had not commented on a second recommendation, which was that some budgetary surplus would be helpful at the present time.

The Chinese authorities also reacted to the emerging imbalance of the external position by tightening import control through the licensing and foreign exchange allocation system, Mr. de Maulde continued. Such measures were obviously unwelcome, both from an international viewpoint and because they ran against the major policy goal of opening up the Chinese economy to the rest of the world. Nevertheless, it was necessary to realize that the measures were understandable, and perhaps even unavoidable, in the current Chinese context, which was to check effectively and quickly the decline in reserves. Still, it was important that they should be temporary in order not to put into question the credibility of the policy of opening up, which was the major ingredient of the Government's wide-ranging economic reform. As Mr. Zhang had stated in his comment on the forthcoming Seventh Five-Year Plan, "these two policies are symbiotic, for neither can be effective and lasting without the other."

The source of the present difficulties was certainly not the lack of reaction in the Chinese economy, Mr. de Maulde went on. On the contrary, the skills, ingenuity, and deftness of Chinese entrepreneurs were as remarkable at present as they had always been. The problem was that the authorities were confused, either by wrong signals or by the absence of signals. To establish the right sort of price mechanisms was the only way to achieve the efficient allocation of real and financial resources, which was clearly lacking in many areas. The authorities also needed to identify correctly and tackle bottleneck problems and develop the export base. The price reform was to be basically completed by the end of the forthcoming Five-Year Plan in parallel with the wage reform, even though both would have to proceed gradually in order to avoid sharp changes in overall price and wage levels. He understood the need for that caution; nevertheless, it might be even more risky to move too slowly because the temptation to resort to short-term administrative remedies to cope with structural difficulties might become difficult to resist, and that practice could jeopardize the whole momentum of the reform.

Tremendous structural and intellectual changes had taken place in the Chinese economy in a very short period, Mr. de Maulde stated. Because those changes have been accompanied by a remarkable growth in output as well as in an improved standard of living, the authorities deserved praise, encouragement, and support from the international economic community.

Mr. Fujino said that the Chinese authorities were to be commended for their continued and remarkable economic progress, which had been achieved through the implementation of bold economic reform. The growth rate of real national income since the inception of the reform had averaged 7 percent a year up to 1983. It had accelerated to 14 percent in 1984, and it was estimated to be 12.5 percent in 1985. Until 1984, that expansion of economic activity had been achieved without significant inflation or deterioration of external position. It was also noteworthy that per capita national income in constant domestic currency had expanded by 42 percent from 1979 to 1984, although in U.S. dollar terms real per capita income had grown by only 5 percent during the same period because of the depreciation of the yuan. It was gratifying to note that a nation that constituted 20 percent of the world's population had benefited from an increase in per capita income by more than 40 percent in the previous five years and that it had happened at a time when economic activity in many other developing countries had met with various difficulties. Furthermore, the reform, which had started in agriculture, had spread to industry and commerce with the same notable achievements. For example, the output of village-run industries had grown by 22 percent in 1983 and 53 percent in 1984, thus absorbing some of the traditional surplus labor in rural areas.

The authorities' commitment to further economic reform, which had been confirmed by their decision on the structural reforms in 1984, had again been endorsed by the Central Committee's proposal of September 1985, Mr. Fujino continued. In that proposal, the highest priority had been given to the economic reform. In fact, additional liberalizing measures had been taken on many fronts since the 1984 Article IV consultation. The fixed quota for grain procurement had been abolished, and a voluntary contract system had been introduced. In many state enterprises, managers had been given more independence in decision making, and their remuneration, as well as the total wage bill, had been closely linked to performance. The wages of government employees had also been restructured. The increased incentives accorded by those measures should contribute to further enhancing the efficiency of the economy, although a lot more remained to be done in rationalizing the wage structure and in providing mobility to the labor forces.

Progress had also been made in the all-important area of prices, Mr. Fujino stated. Because of the reform of the grain purchase system, the prices for grains had been unified, and they could be adjusted through negotiations. In addition, the state selling prices of nonstaple items had been raised. He welcomed those measures, which had provided more flexibility in prices, and he noted the cautious and pragmatic approach the authorities had taken in implementing the measures. However, in the important areas of transportation and energy--the scarcity of which caused major constraints on the economy and the prices of which were much lower than international standards--adjustment of prices had been slower than desirable.

Even though economic reform was proceeding as planned and was bearing fruit, there had emerged substantial excess demand pressure within the economy, Mr. Fujino continued. Domestic credit had accelerated to 36 percent in 1984, and currency in circulation--individual demand deposits and deposits of enterprises--had expanded by about 50 percent. The rate of inflation had not reached that magnitude, but the authorities anticipated a nearly 10 percent increase in retail prices in 1985. The external current account, which had been in surplus for years, had turned into deficit in the first half of 1985, and the level of international reserves had declined markedly. Early in the year, the authorities had acted to slow the excessive growth in aggregate demand, and those measures were taking effect as far as monetary and demand growth were concerned. He could broadly support the policy direction of the authorities, although less dependence on administrative measures would have been desirable. In that connection, it was reassuring that the People's Bank would monitor the situation closely and was considering possible additional measures if the strong excess demand persisted.

Government revenues in the first half of 1985 were 26 percent higher than in the same period of 1984, and expenditures were 15 percent higher, Mr. Fujino remarked. The authorities could take advantage of the good revenue performance to achieve a fiscal surplus that would also be desirable in the current macroeconomic demand management perspective.

Along those lines, the long-term objective of budgetary balance might be advisable so that annual fluctuations of revenues and expenditures would not lead to an undesirable accumulation of government debt. One way to introduce such fiscal discipline could be to develop a full employment concept of fiscal balance. He would welcome further comment on that point.

Monetary policy and, more broadly, the monetary system itself had undergone major changes, Mr. Fujino went on, and the transitional difficulties had given risen to excessive credit creation, which, in turn, had been responsible for excessive demand growth. Action had already been taken to tighten credit, and the interest rates had been raised. The People's Construction Bank had been brought into the credit plan, and he agreed that the rural credit cooperatives should also be incorporated into that plan.

In a broader context, the monetary system was moving from one in which money followed commodities to one in which money played a more autonomous and active role, Mr. Fujino continued. Despite that change, the lack of financial responsibility by enterprises, which was caused by the inflexible price system, prevented monetary control from becoming fully effective. Indeed, if broadly defined, the interest rate was a part of the price system, and it could not fully function unless combined with the flexible movement of commodities. Therefore, he welcomed the intention of the authorities to broaden the flexibility of the price system in the Seventh Five-Year Plan covering 1986 to 1990. Introduction of a bankruptcy law for state enterprises was also a proper step toward stricter financial responsibility.

The transition from a system of state directives to one of independent decision making by enterprises in accordance with their own financial responsibilities posed a great challenge, and it would be some time before all the economic agents had become familiar with the new system, Mr. Fujino commented. Nevertheless, it was an irreversible process. The financial reform implemented since 1979 had allocated the specialization of central banking to the People's Bank of China and had provided some autonomy to specialized banks and their branches.

Deterioration in the current account balance and declining international reserves had forced the authorities to resort to such administrative measures as restriction on import licenses, strict foreign exchange allocations, and selected tariff increases in order to maintain the basic policy stance for the opening of the economy, Mr. Fujino remarked. Whereas the more orthodox demand management policy and flexible exchange rate policy would have been preferable, resorting to administrative measures was probably to some extent inevitable in the present stage of economic reform. He noted that tighter trade policy had not led to massive cancellations of existing contracts or other disruptions such as had been experienced on previous occasions. At any rate, the external trade system itself had been further liberalized. Two foreign trading corporations had been given powers to set selling and buying prices, and corporations were at present allowed to conduct foreign trade as an agent for end users or original suppliers. Thus, trading corporations could pass on international prices to end users and original suppliers, thereby strengthening the link between international and domestic prices. That link was a prerequisite for a flexible exchange rate to be fully effective.

Regarding external borrowing, there had been some diversification of the channels through the issue of bonds on the international market and loans agreed with the consortium of international banks, Mr. Fujino continued. That development was a welcome part of the general prudent policy of the authorities' foreign borrowing. The authorities' provision that the People's Bank of China coordinate and monitor all external borrowing was also a welcome development, and he hoped that the People's Bank would take full advantage of that to strengthen the external debt management system.

The Seventh Five-Year Plan, 1986-90, adequately continued economic reform with the objective of enhancing economic efficiency, and it envisaged an average economic growth rate of 7 percent, Mr. Fujino said. In order to attain that objective, an 8 percent growth in export volume was needed, and further efforts for export promotion would be essential. The World Bank staff report was particularly noteworthy regarding the long-term prospects in that it concluded that the authorities' targets to quadruple industrial and agricultural output between 1980 and 2000 were achievable if certain conditions were met. He felt that transportation and the level of energy production might be the most important constraints for such development, and he could not overemphasize the importance of early price adjustment and adequate investment.

Mr. Pérez stated that China represented a special and interesting case of how to improve a centrally planned economy by restructuring the decision-making process. It was clear that changes under way "represent a modification, not an abandonment, of the system of production for the pursuit of socialist goals under state ownership of the basic means of production." The Chinese authorities were seriously committed to the reforms, and no turning back would occur. As Mr. Zhang had said, "one of the most important problems to be solved...is to find the most appropriate combination of the market mechanism and the central planning of the economic and social development." Therefore, it was difficult to make economic judgments by applying the same criteria used to analyze countries with mixed economies.

Judging by results, the strategy that the Chinese authorities had implemented since 1979 was impressive, Mr. Pérez continued. Real national income had grown steadily and quickly during the previous five years, at 14 percent during 1984 and only a slightly lower rate was expected in 1985. Because of relatively low population growth, the sigificant increase in real national income had represented a substantial improvement in living standards, which was the Government's main economic goal. Hence, the Chinese authorities must be commended for their pragmatic approach and brilliant results, especially considering the economic context.

As was to be expected, accelerated growth had facilitated the eruption of bottlenecks, demand pressures, inflation, and external imbalances, Mr. Pérez stated. However, the problems that the Chinese economy was facing at present were not so grave as to represent a threat to the continuation of reform, particularly taking into account the sound elements on which the growth had been based.

Many far-reaching changes were taking place in the People's Bank of China that would have widespread consequences for the economy as a whole, Mr. Pérez continued. For example, more effective monetary policy should improve savings and investment management. Referring to the cash plan prior to 1979, the staff had said that "the distribution of output between consumption and investment goods was largely unaffected by monetary policy." That link should become more robust through better monetary management. Furthermore, monetary control would be increasingly important as a greater degree of monetization took place in the Chinese economy. In fact, the relationship between credit growth and inflation was still not very clear, which was due not only to the price control system but also to the scarcity of monetary instruments. Nevertheless, as the economy became more influenced by monetary events, the need for better and more efficient monetary control mechanisms would grow in importance. Therefore, the inclusion of the People's Construction Bank into the credit plan was a very positive development. A further improvement in the same area would be achieved through a better control of rural cooperatives. That control could eliminate overshooting credit ceilings and some important loopholes currently existing in the financial system. However, unless the price system achieved a greater degree of freedom and enterprises were given more responsibility for organizing their production according to efficiency, the scope for action in the banking system would be limited, and it would continue to play an accommodating role.

A deterioration in the balance of payments within the previous nine months was shown in the latest available information, Mr. Pérez went on. There had been an increase in imports of about 67 percent, clearly exceeding the projections. Exports had been virtually unchanged. Because of the difficulties of forecasting the evolution of external trade, some action was needed at present to limit the external deterioration. Export promotion, together with an appropriate exchange rate management, were key factors to sustainable growth in the medium term. In the meantime, until Chinese exports expanded sufficiently, the authorities were restraining imports by administrative measures. While that device was temporarily useful, it could never be an alternative for trade system reform and an export-fueled external balance. In other words, increasing competitiveness should be the highest priority, and therefore shifting to a managed floating system was most appropriate.

Foreign investment promotion was a basic step to opening the Chinese economy and attracting foreign capital, Mr. Pérez remarked. It was a step that would work hand in hand with an appropriate and cautious external debt management. He noted with pleasure that all those targets were implicitly contemplated in the Seventh Five-Year Plan.

Concentrating efforts in a few cities was consistent with a well-organized foreign investment promotion, Mr. Pérez continued. He wondered if perhaps Mr. Zhang could explain more extensively the criteria followed for choosing among the different cities and the type of investment that the authorities were trying to promote. The intention to shift agricultural-based growth toward a more industrial-oriented process was a step in the right direction. Nevertheless, that step should be accompanied by and coordinated with service sector improvement because services were still a weakness of the Chinese economy.

Mr. Schneider noted that the staff had made a relevant remark when it had stated that currently there were more differences between the centrally planned economies than between the market economies. Because of its size and importance in the world economy, China was one of the most interesting and promising of those economies. China had not only started its reform but had already reached the stage where the process had become irreversible. Therefore, it was expected that the process would follow its own inherent logic and proceed in accordance with the original blueprint.

It was an achievement of far-reaching theoretical and political significance that a centrally planned economy could speed up its development by relying on market principles, Mr. Schneider continued. The results had proved to be superior to those using the classical model of planned economies. The fact that the economic development in China would no longer be limited by the autarchic nature of the classical model meant that the Chinese economy would become integrated into the world economy. At the same time, however, that process would cause it to be influenced, positively or negatively, by the main trends in the world economy. Indeed, although the Chinese reform was not the most advanced among the centrally planned economies, China was poised to take the leading role as the result of the determination and courage of its authorities to experiment.

He did not want to imply that the reform was progressing without problems, Mr. Schneider went on. However, its problems were an unavoidable side effect of a difficult transition from a dirigist economy to an economy operating on market principles. That transformation, as was clear from the experience of other socialist countries as well, was more complex and time consuming than had been the case when those economies had introduced the dirigist model. In fact, many of China's problems stemmed from the uncertainties of which kind of market elements could or should be adopted at different stages of the reform, as well as from the coexistence of management methods of the old and the new models. As long as the two coexisted, the signals reaching the economic units might be contradictory and hence might produce a controversial outcome in the different economic sectors. That situation was reflected in the emerging imbalances in the areas of investment, production, and the external accounts.

One might draw the conclusion, therefore, that the reform should be all comprehensive and that putting the new system in place should be a single step, Mr. Schneider stated. However, that was impossible for various reasons. The authorities must harmonize the contradictory economic signals in a way that the economy might benefit from the reform without long-term distortions.

Despite temporary imbalances, the Chinese reform was irreversible because market methods had been playing an increasing role in the country's positive achievements, while the dirigist economy methods were being eliminated, Mr. Schneider continued. Some examples were the complete abandonment of the obligatory surrender of agricultural products, further radical curtailment of directive planning in industry--the first step, important from a systemic point of view, to change the intermediation system--and actions to unify the exchange rate. Most of those changes had been envisaged by reformers at the outset, but the authorities had recognized the need to accelerate in order not to nullify the results of the reform already implemented.

Moreover, the authorities recognized that certain reform measures could be rather controversial in the sense that they might involve, at least for a short time, heavy social costs for certain sectors of the population, Mr. Schneider remarked. Nevertheless, the authorities had not hesitated to move ahead with political boldness, for example, on price reform. Price adjustments were a crucial part of the reform process. If prices were artificial and did not reflect the scarcity of goods or the signals from the world markets, they were not usable as orientation points either for the authorities or for the economic units. Under those circumstances, the economic reform might take a wrong turn despite all the efforts in other fields of the economy. Therefore, because China at present had full confidence in its authorities, a wide general consensus on price reform should be reachable, considering the positive results already brought about. The confidence held by the authorities was all the more important because further reform measures that had appeared ideologically or politically risky at an earlier stage would have to be considered soon. For example, the experience of other reform-minded centrally planned economies had made it clear that the introduction of a market-oriented financial intermediation system with a fully authorized network of competing commercial banks and a developed capital market was essential. Furthermore, the reform of the price system would require a corresponding reform of the wage and tax systems. Moreover, the long-term interests of the socialist enterprises should sooner or later be privatized. In fact, the legality of social ownership might have to be reconsidered.

Unlike other centrally planned economies, China was not burdened with sizable debts, Mr. Schneider said, and therefore the authorities were in an extremely favorable position to implement reforms as far as external balances were concerned. However, in the interest of the reform process and of maintaining the present momentum, it was imperative that China continue its policy of cautious debt and asset management. An increase in debt or diminished foreign reserves had always been used by opponents of the reform to question the external balances. Indeed, the Chinese reform and its economic developments were of such a nature that the Fund should play a major role in cooperating with the authorities, because the Chinese experience was of basic importance to all centrally planned economies.

Mr. Grosche said that he commended the Chinese authorities for unrelentlessly pursuing economic reform and opening the country to the outside world. Their efforts and determination to restructure entire sectors of the economy were impressive, particularly their intention to continue to increase the role of market forces in the economy. Policies already implemented had resulted in a substantial acceleration of growth in recent years accompanied by rising standards of living. The output growth of 14-15 percent recorded in 1984-85 was outstanding by any comparison. It demonstrated the vitality and dynamics of a country with a vast economic and human potential, which was progressively becoming free from restrictions and rigid planning and which was putting more responsibility into the hands of the individual and free enterprise.

Nevertheless, he was concerned as to whether the recent rapid acceleration of growth was sustainable, Mr. Grosche continued. Whereas the authorities' response to problems deserved to be commended, there was scope to put even greater emphasis on correction through market mechanisms rather than through direct administrative controls. However, he was aware of the difficulties of the complex task of transforming a rigidly planned economy and of opening up to the world a shielded country like China with its immense geographical size and population. An entire generation raised under a system of direct control would face new conditions.

Against that background, China's progress was even more impressive, Mr. Grosche went on, and if the authorities continued to pursue reforms in a flexible way, the country would soon be in a position not only to substantially raise its own standard of living but also to make a strong contribution to the expansion of world trade as well. He was in broad agreement with the staff's analysis and policy recommendations.

The authorities had made commendable efforts to correct the emerging imbalances, Mr. Grosche stated. Excessive domestic demand had been restrained by tightening credit, raising interest rates, and establishing ceilings on wages of certain enterprises. In order to increase investment, the increase in private household savings should be encouraged further by positive rates of interest on deposits. Perhaps the staff could estimate the relative share of total lending represented by loans with preferential lending rates. Despite the recent slowdown, growth of demand and output was still quite rapid; therefore, he wondered what additional measures were currently under consideration by the Chinese authorities to moderate further the pace of expansion. The authorities would be well advised to follow the staff's recommendations and take advantage of the good fiscal revenue performance to achieve a budget surplus. They should firmly resist pressures for higher expenditures.

It was understandable that the authorities would like price reform to proceed at a more gradual pace, Mr. Grosche continued. However, a more courageous approach might be warranted in order to correct the still existing mismatch between supply and demand and to overcome the various bottlenecks that had emerged for a number of goods and services. If enterprises were to be given more responsibility in decision-making powers and if competition among them was to be increased, it was essential that they be given more freedom to determine the prices of their products. In that regard, he was encouraged by the authorities' ambitious goals set in the Seventh Five-Year Plan.

The staff's view about a more flexible exchange rate policy had been well taken by the authorities, as reflected by their decision to introduce a system of managed floating beginning in 1986, Mr. Grosche commented. Nevertheless, he was concerned about the strong emphasis still being placed on import controls. Although he sympathized with the motives that had led to them, he hoped that they were only temporary, because a more permanent solution lay in adjusting prices and exchange rates appropriately.

He shared the authorities' concerns about the deterioration of the current account and the resulting decline in international reserves, Mr. Grosche remarked; therefore, the long-term strategy of export promotion was welcome. Recent export and import figures appeared to indicate a more favorable development in the external balance. However, China was still a low-income, developing country, one that was still building the necessary production potential to supply an almost insatiable domestic market while at the same time trying to develop a competitive international export sector. Therefore, it should make use of foreign capital and technology, which might necessitate current account deficits for some time. However, the important point was that the allocation of resources would be improved by providing appropriate signals to the economy. In that light, export promotion policies were necessary that would enhance efficiency and competitiveness while maintaining a flexible approach to the exchange rates.

Given the authorities' determination to maintain firm domestic demand policies, to gradually implement price reforms and to emphasize increased economic efficiency, the staff's medium-term balance of payments scenario, projecting an average current account deficit of $7-8 billion for the next five years, appeared to be realistic, Mr. Grosche continued. Because the scenario was based on improved export performance, it did not give rise for concern because under the assumptions, the ratio of reserves to imports would be maintained and the debt service would remain at quite manageable levels. It was important, in that regard, to improve the system of statistical data collection, especially exact data on foreign debt. Reliable data was essential for pursuing prudent borrowing policies.

Mr. Nimatallah said that caution was warranted in commenting on the Chinese economy because not only were he and the Board still learning about it but the economy was undergoing major changes. Nonetheless, it was clear that China had made impressive economic progress in recent years. The overall picture was one of high economic growth; moderate inflation; and, until end-1984, a strong balance of payments and reserve position. Those commendable achievements owed much to the authorities' planned strategy for economic reform. However, the recent real economic growth rates of 14-15 percent were unsustainable. It was probably more prudent to aim at lower growth rates that could be sustained. Consequently, he welcomed the slowdown in economic activity since mid-1984. The slower growth rate would enable the already implemented economic reforms to take hold, and the authorities could move ahead in a gradual manner with further reforms. Thus, the growth target of 7 percent per annum under the forthcoming Five-Year Plan was both appropriate and realistic.

Despite commendable progress made in some areas, short-term economic imbalances and long-term structural problems remained, Mr. Nimatallah continued. The authorities recognized those problems and in the immediate future their central policy objective was to contain the growth in aggregate demand to a level consistent with price stability and domestic and external equilibrium. A stable macroeconomic framework would facilitate further much-needed structural reforms. In a complex economy like China's, which was undergoing fundamental structural changes, neither the causes of nor the remedies for domestic imbalances could be unambiguously identified. In fact, a rapid expansion of credit and, to a lesser extent, growth in budgetary expenditures were important causes of present domestic imbalances. Therefore, in order to restore domestic equilibrium, financial policies needed to be tightened by the curtailment of credit expansion and a further reduction of the budget deficit.

Firm domestic financial policies would help relieve some of the pressures on China's balance of payments, Mr. Nimatallah continued. In order to reverse the decline in foreign reserves and to strengthen the external payments position, China's export capability should be strengthened. The authorities had recognized that fact, and they had recently implemented measures to enhance export competitiveness. However, those measures needed to be supplemented by more flexible exchange rates and domestic pricing policies. China would also need to have free access to the markets of its trading partners. Furthermore, China's balance of payments would benefit from increased foreign direct investment flows, and he encouraged the authorities to create the right conditions and incentives for such flows. One advantage of foreign direct investment was that it brought with it technological and managerial skills.

Beginning in 1979, the Chinese authorities had initiated various structural reforms to improve the functioning of the economy, Mr. Nimatallah went on. Progress had been made in several areas; for example, greater price flexibility and improved incentives had resulted in higher agricultural and industrial output. As the scope of mandatory planning was gradually reduced, further suitable price reforms should be instituted to ensure better and more efficient resource allocation. Further reform in those and other sectors should be implemented if the vast potential of the Chinese economy was to be fully realized. A number of those areas had been identified by the staff, which had also correctly argued for a more flexible pricing strategy for public enterprises and key industrial products, including those for energy. As the deregulation process moved forward, it would become essential to develop macroeconomic tools to facilitate the efficient management of the economy. There was also a need to improve financial intermediation to expand avenues for mobilizing domestic savings as per capita income grew.

The Chinese authorities faced the challenging task of raising the per capita income of the Chinese people from about $300 to $800 in the next 15 years, Mr. Nimatallah commented. For that ambitious goal to be realized, China needed to put in place sufficient capital formation for the coming years. Therefore, it was very important that the investment target under the forthcoming and subsequent five-year plans be fully implemented. Not only should slippages to lower levels of investment be avoided, but also more productive investment should be undertaken. The authorities might also need to explore ways of encouraging additional domestic savings to minimize the need for external borrowing--including further reforms of taxes, prices, and financial institutions.

He supported the proposed decision and felt that the prudence and pragmatism of the authorities was commendable, Mr. Nimatallah said in closing. The Chinese economy was moving in the right direction. The broad objectives of the Seventh Five-Year Plan indicated the authorities' intention to continue their gradual approach toward implementing economic reforms.

Mr. Clark commented that it was clear that the Chinese economy had made further significant progress in the previous year, largely reflecting the continuing policy reform implemented by the authorities. Output, investment, and real income had all grown strongly, perhaps excessively so. He would like to see a further extension of the program of reform, although given the size and complexity of the economy, he would be cautious about suggesting the exact speed or timing of additional measures. However, he understood the authorities' inclination toward a measured evolution of policies given the uncertainties about the impact of the changes already introduced and the lack of experience in operating with many of the new indirect instruments.

Despite striking achievements at the strategic level, a number of short-term imbalances had recently emerged, and if unchecked, they had potentially serious consequences, Mr. Clark continued. It seemed clear that while the rapid increase in liquidity was partly explained by the strong growth of income and the increasing monetization of the economy, it did not explain the whole story. However, excessive monetary growth no doubt provided part of the explanation for the acceleration of inflation in 1985. It was encouraging that the expansion of credit had slowed significantly in the second quarter and that the trend would probably continue in the third quarter. Nevertheless, the growth of money and credit in 1985 appeared set to exceed the authorities' target of 18 or 19 percent. Therefore, he was encouraged by the steps taken by the authorities to slow down credit expansion, and he noted that the Central Bank was considering further increases in the interest rates charged on loans to specialized banks. Increases in preferential interest rates to its positive real levels should also encourage moderation of credit demand and improve resource allocation. In the longer term, the authorities should continue their development of a more flexible credit system, relying to a greater extent on interest rather than on quantitative controls.

There had been a sharp deterioration in the current account since the middle of 1984, partly reflecting strong import growth, including some particularly large increases in imports of consumer goods, Mr. Clark went on. Moreover, exports had also performed less well than expected, leading to a decline in China's share of the world market for manufactured goods. The overall deterioration was not only attributable to the rapid expansion of domestic demand but also to weak competitiveness. He supported the staff's emphasis on the need to follow a flexible exchange rate policy. If changes in the exchange rate were to have their full effect on the behavior of domestic producers and consumers, it was essential that they be allowed to pass through to domestic prices rather than be reflected in the profits of the state trading enterprises.

He noted with concern that wages had risen by about 20 percent in 1984 and by only slightly less in the first half of 1985, Mr. Clark remarked. He was interested in the staff's view on whether those very large increases in real wages reflected a once-and-for-all catching up in response to the recent wage reforms or whether there was likely to be continuing strong wage pressures.

The authorities intended to ensure that the debt service ratio remained below 15 percent, Mr. Clark said. Given the low level of the ratio at present, and the rapid export growth envisaged in the staff's medium-term projections, a debt service ratio of 15 percent implied a large increase in outstanding debt. Could the staff confirm whether that inference was correct? While some rise in the debt service ratio was no doubt manageable, he would encourage the authorities to monitor carefully their foreign borrowing to ensure that it was directed to suitably productive projects.

There was no doubt that a remarkable pace of change had been sustained over the previous few years, Mr. Clark continued. The results of that change were striking to anyone who was fortunate enough to have visited China recently. Moreover, the full impact of the measures had probably not yet been felt. There were inevitably problems in managing change on such a large scale, notably that of keeping developments in different parts of the economy in reasonable balance. Furthermore, it appeared that China might be experiencing difficulties at present in the matter of balance--for example, if the demands placed on the transportation and communication infrastructure by the expansion of other sectors were not satisfactorily met. That was only one particular aspect of an underlying need to strengthen interlinkages in the economy so that each sector could respond promptly and adequately to developments in other sectors. Increased price flexibility had an important role to play in that process, especially the need to ensure that the prices of energy and public services better reflected their resource cost. He also noted that while there had been a general shift toward indirect controls, recent policy adjustments had at the margin relied heavily upon direct measures. He hoped that as the range of instruments available to the authorities increased, their experience in using them would improve and indirect controls would become more important in regulating the economy.

Mr. Massé said that China had taken enormous strides in the previous six years in transforming its economy and raising living standards, especially in the rural areas. The 14 percent increase in real output achieved in 1984 was remarkable. Such a growth rate demonstrated the potential that had lain dormant within the Chinese economy for some time and that was just beginning to emerge. The economy's various demand pressures included a much more rapid rate of inflation from 3 percent in 1984 to 9 percent in 1985 and the increase in imports and the decrease in reserves. He welcomed the various steps that the authorities had taken to slow credit expansion and raise interest rates. Provided that those and a number of other measures were applied firmly and consistently, the authorities' objective of a "soft landing" should be possible. However, the events of 1984 raised a number of fundamental questions about the policy tools currently available to the authorities and the responsiveness of the economy to policy changes. For instance, the balance of payments had been slow to react to a slower rate of domestic demand expansion; reserves were only now beginning to restabilize; the rate of inflation had continued to accelerate; and economic growth had continued at a pace which would make supply bottlenecks all the more acutely felt.

The key problem was that some aspects of reform had sped far ahead of others, Mr. Massé continued. In particular, a more flexible approach to price formation had lagged behind the freeing of the economy in other respects. Indeed, until prices were allowed to adjust continuously to reflect changes in relative scarcity, better resource allocation and improved macroeconomic management would be hard to achieve. Since excess demand for imports was largely centered on capital goods, a meaningful compromise might be to emphasize changes in key raw material and capital goods prices, which would simultaneously dampen import demand and encourage efficient investment. In particular, energy prices should not be excluded from consideration. However, he welcomed the price reforms already planned for agricultural goods, transportation, and housing rents. Furthermore, the measures already taken in 1985 to reduce the number of products covered by state mandatory planning were continuing to shift decision-making power to the enterprise level. There was a need to link wages more closely to output so as to strengthen individual incentives.

Further institutional changes would be required in the financial field in order to make monetary policy more effective, including stricter control of all lending institutions by the People's Bank, Mr. Massé went on. However, significant price increases might have to be contemplated as controls of various kinds were removed and rents and tariffs were raised. He welcomed any information the staff could supply on those changes in the price index.

Fiscal policy had generally been appropriate, and the authorities intended to avoid bank borrowing for budget financing in 1985, Mr. Massé stated. There was even the possibility of a budget surplus, and whereas he preferred a more neutral budget, he would listen to arguments about the policy to manage budget surplus. The 50 percent increase in treasury bond sales in 1985 was impressive because it gave the authorities an added policy instrument. He noted the scarcity of monetary instruments in the economy and the need to develop new and better ones. The one caveat that he had on present fiscal policy was the large and increasing share of price subsidies, which currently represented 20 percent of all expenditures. As the price reform progressed, continuation of subsidies and administrative control of prices could only add to the budgetary burden and to the various distortions of the economy.

The authorities' cautious approach to foreign borrowing was wise, Mr. Massé remarked. To keep the debt service ratio below the planned 15 percent ceiling not only would require improved monitoring of external borrowing by the People's Bank but would also require measures to promote exports and, perhaps, a slightly different import strategy. He noted the import restrictions and the fact that, in principle, they should be considered in negative terms, although in the present circumstances they might be unavoidable.

The relatively weak export performance was due to protectionism, inadequacy of supply, and diminished competitiveness, Mr. Massé continued. However, in China's case, competitiveness undoubtedly meant more than just price competitiveness; it included factors such as the quality of exports and the ability to follow up on foreign sales. While a more flexible exchange rate policy would help to improve the price competitiveness of exports and dampen import demand, the necessity of such a move should perhaps be the object of further analysis before it was recommended. There had been a rise in the price of Chinese manufactures relative to the international price of such goods from 1981-84, but that did not mean that China still had an absolute competitive edge on prices. Supply constraints might be much more important in inhibiting the growth of export earnings. Other factors endemic to the reform process were also required for stronger export growth. For example, the adaptation of exported goods, especially manufactured goods, to the requirements of foreign buyers was also important, and the price and quality was likely to improve only as production methods were modernized and as managers became more acquainted with their foreign customers' specific needs.

It was important to note the item on foreign direct investment in the balance of payments, Mr. Massé commented. That item was also important for the growth of employment, and he would appreciate comments from the staff or Mr. Zhang on either the foreign exchange question or the competitiveness of exports.

China had set very ambitious goals for itself in recent years, which simultaneously demanded structural change, growth, and stability, Mr. Massé said in closing. Constraints had been encountered, but those only reinforced the need for further pragmatic reforms. In a 1981 visit to China, he had been struck by the fact that the Chinese authorities were committed to reform and intended to try out a number of market mechanisms in order to achieve their objectives. He admired the boldness of the path that the Chinese authorities had chosen, and he was convinced that the reforms that had been attempted and the policies that had been taken would increase the standard of living and the amount of influence that China exerted on world affairs.

Mr. Kafka stated that the growth and diversification achieved by China since the beginning of its economic reform was impressive. It was understandable that the Chinese authorities should wish to pursue the difficult process of substantially enlarging the scope of the market mechanism in that country in a gradual fashion. Indeed, anything else would hardly be imaginable, even though gradualism always had both advantages and problems. The problems were underlined by the staff's recommendation to correct as much and as quickly as possible the distortions of centrally determined prices. He was particularly impressed by the emphasis on the need for re-education not only for executives but for all levels of the labor force, as a condition for expanding market mechanisms and decentralizing responsibility. In that connection, he noted that maintenance of equipment appeared to have been somewhat neglected. That fact was true of developing countries in general, however.

Particularly noteworthy was the authorities' intention to avoid excessively sharp changes in income distribution as a result of the introduction of prices that reflected scarcities more accurately than at present and of remuneration that provided increased incentives for efficiency, Mr. Kafka continued. He wondered to what extent a price and remuneration system that promoted efficiency could be made compatible with an income distribution that preserved a greater degree of egalitarianism than was common in most market systems, as well as in Eastern European centrally planned systems. The incentive effects of high negative and positive income taxes--or taxes and income subsidies--had to be taken into account, but they would not prevent major income polarization, which, according to Mr. Zhang was really what the authorities wished to avoid.

He had one specific question concerning to what extent above-quota industrial production could be sold to other enterprises at prices different from those the state paid, Mr. Kafka went on. The staff appeared to suggest that there really was no limit on prices. If there was a limit, what would determine the choice of customer and source of supply for above-quota production?

The Chinese authorities had acted courageously and remarkably quickly on the excessive expansion of output and demand that had taken place toward the end of 1984 and in the first half of 1985, Mr. Kafka remarked. They had an adequate cushion of reserves, which, with their resolve, should make it possible for them to bring about a "soft landing." One of the tasks faced by the authorities was to deploy instruments of monetary control effectively, because they would increasingly replace the role of mandatory planning. He was not exactly clear about promoting competition among banks. How could that promotion occur when, nationwide, banks in China were sectorally specialized banking systems?

Short-term management of the external sector was obviously a crucial problem, Mr. Kafka commented. He agreed with the staff that use of restrictions was the only quick way to correct the balance of payments situation. However, that was not true only in the Chinese context. In China, as well as in other places, other measures that emphasized efforts in order to ensure balance of payments equilibrium were often more appropriate in the medium and long run. Furthermore, while China had not been profligate in incurring foreign debt, he welcomed its intention to improve debt statistics and debt management.

A particular feature of the Chinese economy was the existence of a special currency--yuan exchange certificates--Mr. Kafka continued. Many countries had exchange controls, but special currencies of one kind or another issued to tourists in exchange for foreign currency or receipts or remittances were found only in socialist countries. Whereas the option might have administrative and other advantages, it was also cumbersome. He invited comments on the practice.

It was interesting to learn that the Chinese reform plan had been divided into two stages, Mr. Kafka commented. He particularly noted the intention to encourage competition among enterprises, an essential part of making a price and incentive system work. Considering the size of the country, however, it might not be easy for many industries to avoid the appearance of local monopolies or oligopolies, especially in sectors that were not under central control. Other interesting aspects of the economic reform were that enterprises should be closed if they could not be made efficient and the proposal to develop a bankruptcy law for state enterprises, an example that should be followed by nonsocialist, as well as other socialist, economies.

The widening scope of market mechanism and of enterprise closure would bring to the fore the problem of unemployment, Mr. Kafka stated. It might be necessary for China to develop an institutionalized approach rather than rely on the family system to absorb unemployment, because one aspect of giving greater scope to the market mechanism might be a larger degree of internal migration of labor, despite the sensible attempt to limit it by creating greater incentives for industrial activity in rural areas.

Mr. Polak said that the Fund's consultations with China were always exciting because major changes took place from year to year which affected a population of more than one billion. The major economic indicators provided a synopsis of events rarely encountered--real increases well in the double-digit range, 40 percent for capital investment and 60 percent for imports, coupled with a single-digit range of inflation, although that could rise to 9.5 percent for 1985. Furthermore, China must be the only country in the world in which a major objective of economic policy was to slow down excessive growth. Nevertheless, a slowdown was an inevitable short-run objective after the demand explosion of the second half of 1984 and the early part of 1985, which had involved both consumption and investment and which had put intolerable burdens on the factors of production that were critically short in China--energy, transport, basic materials, and foreign exchange. Not surprisingly, those short factors were also generally underpriced in China.

The macroeconomic measures required to bring the 1984-85 imbalance between demand and supply under control were monetary policy and price policy, Mr. Polak continued. In addition, some tightening of controls, especially regarding import licensing and foreign exchange, were being applied in areas in which liberalization had been unduly abrupt and had got out of hand. Monetary policy must play a major role when a socialist government wanted to put greater reliance on indirect macroeconomic instruments. However, control over monetary policy had slipped in the final quarter of 1984, when the People's Bank was being split up. Nevertheless, a number of conversations he had had in China the previous month confirmed that considerable tightening had taken place recently. In principle, the separation of the central banking function from the commercial banking function of the People's Bank of China should be helpful in that connection, but there remained the question of how far market tightness would be allowed to affect credit allocation under the system of socialist planning, and he would like to hear the staff's and Mr. Zhang's comments. If the allocation of credit among individual enterprises was determined by the annual credit plan, would not the new commercial banks continue to perform what amounted to the bookkeeping function that the People's Bank of China had been performing previously? Would not the new People's Bank of China's supervisory function constitute "compliance auditing," as distinguished from "financial auditing," in the same manner that the prudent performance of banks was audited in the United States? He wondered if an enterprise manager would continue to be assured of the credits allocated under the annual credit plan as long as his firm complied with the parallel annual economic plan in terms of physical commodity flows. To make the new structure of the banking system effective would require a new generation of bank managers, just as Mr. Zhang had mentioned the need for a new generation of industrial managers. The new bank managers would need a sharp eye for the creditworthiness of enterprises on the basis of their profitability.

It was accepted by the Chinese authorities that the evolving shift of responsibility to enterprises would mean greater reliance on the price-profit mechanism, Mr. Polak commented, and the staff had urged even further moves in that direction. Whereas a great deal of caution was appropriate on many points, there was one point on which there could not be much disagreement: as long as the prices of scarce basic resources--especially energy--were kept at uneconomic levels, increasingly price-conscious use of those resources by enterprise management would increase the economic waste of them and keep down China's pace of development. Whereas the gradualism that had been adopted for the adjustment of those prices might be of certain social or administrative advantages, its economic cost was high. In the broader area of price liberalization, one had to adopt a much more pragmatic approach. It was impossible to argue that in an economy guided by socialistic objectives any price liberalization was better than any form of official price control. For example, under conditions of less than full competition and some degree of excess demand, the freedom of enterprises to set prices might result mostly in cost inflation, lack of wage discipline, and inefficiency. Those effects had been witnessed in some socialist countries in Europe. By contrast, the Chinese system of central price setting on the basis of the average cost of production for all producers of a given product throughout China held the potential for incentives in the right direction, all the more so if enterprises could use their after-tax profits with considerable discretion. In that setting, much depended on what happened to loss-incurring enterprises that could not meet the average cost of production. If in fact they were closed down, the stimuli in the right direction would be powerfully reinforced.

The respectable results that the Chinese authorities had achieved in their pursuit of reform in recent years led him to encourage them to proceed at their own tempo and without too many preconceptions on his side as to the correct priorities of the various steps in the process of liberalization--steps that might have to discover experimentally as they went along, Mr. Polak continued. The mere transition to indicative planning and decentralized decision making in general was not enough. China was engaged in a long process of creating a completely new economic environment through increased financial intermediation and discipline and the accountability of enterprises. That environment would in due course effectively have to change the behavior of the administrative and economic agents.

He welcomed the importance that the new plan attached to export expansion and to opening up the economy to the outside world, Mr. Polak said in concluding. He also welcomed the new approach to the exchange rate. However, he questioned the modesty of the targets for trade, 40-50 percent increase over a five-year period, about the same rate as the planned GNP growth and probably not much more than the growth of world trade under optimistic assumptions. He hoped that from China's low starting point, its share in world trade and its ratio of trade to GNP would move forward in a dramatic way.

Mr. Dallara said that developments in the Chinese economy in 1985 were the subject of exceptional interest for a number of reasons. Overall economic performance had been impressive in a number of respects, and progress for a variety of reforms had continued. At the same time, a number of rather serious problems had emerged.

Nevertheless, the authorities' determination to pursue their reform efforts over the previous 12 months had been admirable, Mr. Dallara continued. Progress had continued during 1985 in a number of key areas: the shift from mandatory to indicative planning, further liberalization of both foreign and domestic trade arrangements, selective tax reform, increased responsibility for managers of state enterprises, gradual relaxation of price controls, more flexible interest rate and exchange rate policies, and an increased linkage of wages to the performance of economic units. He endorsed the reform strategy aimed at properly correcting any emerging macroeconomic imbalances, while shifting the mix of policies away from comprehensive controls toward greater use of market-oriented policies.

There were grounds for considerable debate about the pace of and priorities for economic reform, Mr. Dallara went on. While a gradualist approach appeared to be prudent and while a "soft landing" might be the best way to decelerate the recent excessive rate of growth of domestic demand, in certain areas the dynamics of change might dictate policy reform at a faster pace. However, he would concentrate his remarks on three key issues--the developments in monetary and credit policy, the appropriate policy response to recent developments in the external sector, and the proper pace of price reform.

It had become quite clear that the pace of domestic demand in the latter part of 1984, and so far in 1985, had been excessive and that monetary and financial policies had been too accommodative during the period, Mr. Dallara commented. On the one hand, strong domestic demand testified to the growth potential of the economy. On the other, it suggested that indirect tools of economic management needed to be developed and employed more quickly, more comprehensively, and more vigorously than had been the case to date; however, that process was currently under way.

Since the separation of the central banking and commercial banking powers of the People's Bank, the Bank had been endowed with many important tools of monetary management, Mr. Dallara went on. The array of monetary instruments currently available should enhance the ability of the authorities to control monetary growth and inflation, an important element in overall economic policy. However, two weaknesses of monetary policy had been apparent--the lack of full application of the rules to all banking institutions and some inadequacies in the enforcement of the rules. The rapid rate of expansion of domestic credit and of the money supply in

1984 and the first half of 1985 had fed the acceleration of the rate of inflation, currently reaching double-digit levels, and had contributed to a drastic turnaround in the current account of the balance of payments from a surplus of $2 billion in 1984 to an estimated deficit in excess of $10 billion in 1985. The problem with regard to monetary expansion appeared to be fully recognized, and measures had already been taken to deal with it; for example, the extension of credit limits and other reserve requirements to the People's Construction Bank and the increased flexibility in interest rate policy. In fact, the effects on construction were particularly interesting. Nevertheless, the banking rules should be further extended to the rural credit cooperatives, a policy that was under consideration, and preferential interest rates should be eliminated.

The fiscal policy of overall financial restraint presented few problems, since the authorities had limited deficits in recent years to a low level, Mr. Dallara commented. Nevertheless, the overshooting of revenue forecast for 1985 should lead to a fiscal surplus rather than to an offsetting increase in spending. At the same time, the authorities should continue their efforts to shift deficit financing arrangements away from bank finance toward the development of the government securities market, especially if the pace would be affected by the overall fiscal posture. Consumer price subsidies should be eliminated for reasons of efficient allocation of resources, particularly if they canceled out a favorable budgetary impact.

The rapidity and severity of the recent weakening of the balance of payments and international reserve positions was of particular concern in light of the need for strong export growth over a period of time, Mr. Dallara remarked. The rapid shift in the external position would perhaps provide justification for temporary restrictions on imports and foreign exchange availability and to the selective rises in tariff rates. However, that approach should be temporary since it was not consistent with longer-term objectives, and it demonstrated the urgency of developing and employing other tools of economic management more appropriate to the changing environment. He wondered if adverse balance of payments developments had caused the authorities to question the adequacy of financial restraint policies and pricing signals, including the exchange rate, when there was a lack of full pass-through of rate movements to relative domestic prices. For example, the real effective exchange rate had declined rather steadily since late 1983, and even in the prior period as well, although more gradually. In light of the latest, downward movements in the exchange rate, he wondered how the staff would characterize its adequacy. Of course, the rate could not be judged in isolation from the lack of full pass-through of exchange rate effects or from the existence of rather widespread trade and exchange restrictions. He welcomed comments on restrictions, the exchange rate, and the pass-through question.

The intent of the authorities to take advantage of all forms of international capital flows was appropriate, provided that it was done in a prudent fashion and that the imported capital was employed efficiently, Mr. Dallara continued. Those provisions would depend on an overall favorable environment for investment and on substantial freedom from inhibiting regulations. As to the type of investment that might be attracted, it should be recognized that efficient foreign investment was more apt to be interested in investment opportunities that depended primarily on China's natural comparative advantages than on artificial incentives. Of course, prudent management of China's external debt would be a factor. There appeared to be many opportunities for investment, and he encouraged the authorities to broaden the areas in which foreign direct investment was welcomed. He also urged the authorities to improve the debt data and to carefully manage the debt of the Government and of enterprises in a medium-term framework.

The price reforms were not scheduled to be completed until 1990, Mr. Dallara remarked. However, successful management of an economy in which market forces played an important role in effectively allocating resources was obviously highly dependent on relative freedom for pricing signals to reflect relative scarcities and economic opportunities. Some progress had been made along those lines, but a number of areas demonstrated that very little progress had been made. The gradualist approach to price reform through decontrol, decentralization of control, and adjustments in administered prices was understandable. However, slow and partial decontrol, not to mention different paces in different areas, might tend to create suppressed demand, bottlenecks of supply, inadvertent inventory buildups, and similar problems. Therefore, he supported the staff's suggestion for a more rapid pace and a more comprehensive scope for price reform. Priority should be assigned to such important prices as those of energy, key industrial inputs, and consumer subsidies, as well as for a broader pass-through of the effects of a flexible exchange rate policy, in order that divergencies between domestic and world prices were reduced and reliance on external restrictions was not sought in the future.

Wage reform and labor mobility were issues closely linked to price reform, Mr. Dallara noted. He welcomed the steps taken so far in parts of the industry, mining, and construction sectors to link the wage bill to economic performance and, in government, to specific job content. He was also interested in the new progressive tax on the excess of the wage bill of an enterprise above its norm. However, he would appreciate any information as to how the norm might be derived. Also, he welcomed any information on plans for increased labor mobility, because as the economy expanded, that factor would become more important to the complete realization of the growth potential of the economy.

Whereas there were some signs of progress, some problems had arisen in the Chinese economy since the previous Article IV consultation (EBM/84/162, 11/7/84), Mr. Dallara stated. Initial actions had been taken to reduce their severity, while continuing more fundamental economic reforms. The emergence of those problems was not altogether surprising, but it constituted a warning of the importance of promptly introducing more market-oriented policies in order to allow the authorities [in a position] to cope effectively. Economic policy management was never easy, even when the relatively free functioning of the market relieved governments of having to make decisions that they might not be well equipped to make. However, the gains in economic efficiency and the potential for innovation in future growth that arose from allowing market forces to work freely were worth the effort. He welcomed the assurances of Mr. Zhang's statement that the commitment of his authorities to reform was strong.

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

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Clark on the completion of his service with the Executive Board.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/160 (11/4/85) and EBM/85/161 (11/8/85).

5. CHILE - EXTENDED ARRANGEMENT - WAIVER OF PERFORMANCE CRITERIA

The Fund decides that Chile may proceed to make purchases under the extended arrangement notwithstanding that the target on net international reserves as of September 30, 1985 specified in paragraph 4(a)(iii) of the arrangement (EBS/85/122, Sup. 3, 7/16/85) was not met and notwithstanding that the intention with regard to the reduction of an existing exchange restriction by way of an increase by September 1985 in travel allowances contemplated in paragraph 4(a)(viii) of the arrangement was not carried out, provided that no purchases shall be made under the arrangement after December 16, 1985 if this increase in travel allowances has not been effected by that date.

Decision No. 8123-(85/161), adopted
November 7, 1985

6. TUNISIA - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Tunisia to not later than November 13, 1985. (EBD/85/282, 11/1/85)

Decision No. 8124-(85/161), adopted
November 4, 1985

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/20 and 85/21 are approved. (EBD/85/281, 10/31/85)

Adopted November 6, 1985

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/266 (11/1/85), EBAP/85/269 (11/5/85), EBAP/85/270 (11/6/85), by Advisors to Executive Directors as set forth in EBAP/85/266 (11/1/85) and EBAP/85/270 (11/6/85), and by an Assistant to Executive Director as set forth in EBAP/85/268 (11/4/85) is approved.

APPROVED: June 23, 1986

LEO VAN HOUTVEN
Secretary