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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/162

3:00 p.m., November 8, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	D. C. Templeman, Temporary
	P. Péterfalvy, Temporary
	V. Rousset, Temporary
	M. Z. M. Qureshi, Temporary
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	
	Jaafar A.
	R. Fox, Temporary
A. Kafka	
	S. King, Temporary
	H. Fugmann
M. Massé	L. Leonard
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	J. E. Rodríguez, Temporary
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
V. Wall, Assistant

Also Present

African Department: A. D. Ouattara, Director; D. J. Donovan, K. G. Dublin, C. Enweze, E. K. Martey. 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. Exchange and Trade Relations Department: E. H. Brau, H. Hino. IMF Institute: Di Weiting, Participant. Legal Department: Ph. Lachman, S. A. Silard. Research Department: D. J. Goldsbrough, C.-Y. Lin, T. A. Wolf. Treasurer's Department: D. Berthet, J. E. Blalock, J. C. Corr, D. Gupta, W. E. Hermann, M. F. Melhelm. Bureau of Statistics: Shao Z. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, S. Ganjarerndee, J. Hospedales, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, Bo T., G. D. Hodgson, O. Isleifsson, A. R. Ismael, Z. b. Ismail, J. A. K. Munthali, M. Rasyid, J. Reddy, M. Sarenac, A. J. Tregilgas, B. D. White, Yang W.

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

The Executive Directors continued from the previous meeting (EBM/85/161, 11/8/85) their consideration of the staff report for the 1985 Article IV consultation with the People's Republic of China (SM/85/266, 9/27/85; and Cor. 1, 10/1/85; and Sup. 1, 11/4/85). They also had before them a paper on recent economic developments in the People's Republic of China (SM/85/272, 10/24/85; and Sup. 1, 10/25/85).

Mr. Jaafar said that Mr. Zhang was correct to caution against too great expectations for the progress and pace of the ongoing reform. The results in the agricultural sector had been remarkable. However, in the urban sector where economic relationships were far more complex, China lacked the necessary expertise and experience to carry out effectively the transformation from a centralized to a more market-oriented economy. Therefore, in the coming years the authorities should implement their plan for reform in a more gradual manner and continue to temper it with a degree of pragmatism. The comments by several Directors on the risks attached to a slower reform process were well taken; however, there was much to be said in favor of running the momentum of reform to achieve growth in the target range of 7-10 percent.

Recent developments in two key areas--rising demand pressures and price reform--called for caution, Mr. Jaafar continued. The excessive buildup of demand pressures in the economy since 1984 urgently needed to be brought under effective control. The growth of the various economic aggregates had been too rapid for the system to accommodate adequately. There was evidence of shortages, bottlenecks, and price pressures, which, if not addressed quickly, could threaten both domestic and external stability.

Greater flexibility in the price system was necessary in order to provide accurate information for resource allocation, Mr. Jaafar went on. However, it would be a mistake for the authorities to deal with upward surge in prices with tighter controls because that would only serve to distort and aggravate the shortages and bottlenecks. Inflationary pressures and expectations would need to be addressed through other means.

Any reform in prices should apply as well to the exchange rate mechanism in order to promote external competitiveness, Mr. Jaafar stated. Progress had already been made; the yuan had significantly depreciated in the previous two years in both real and nominal effective terms. Yet, the response of exports was not clear; the disappointing results could not be explained completely by foreign market barriers to China's exports, even though they continued to exist. Perhaps the answer lay more in terms of the external competitiveness that probably had yet to be attained. He would appreciate the staff's evaluation of the authorities' latest exchange rate measure.

The sharp rise in wages by 20 percent in 1984 and by 18 percent in the first half of 1985 was cause for concern because it would affect external competitiveness and because it was not reflective of the increase of the cost of living or of productivity. He would like to know whether those rates of wage increase were a one-time reflection of the reform or whether they would continue to rise as strongly in the coming years.

The authorities needed to develop as quickly as possible the institutional setup and instruments for conducting macroeconomic policies, Mr. Jaafar commented. There was much to be said for constraining the pace of the real sector reform to the progress made in building the framework for an effective macroeconomic management. The importance of that fact was clearly demonstrated by the recent developments in money and credit, a lack of adequate financial infrastructure having led to an excessive creation of liquidity, particularly in the first half of 1985. Financial reform should include strengthening and rationalizing the various financial institutions and should provide a clearer definition of their respective functions. Furthermore, the quality and timeliness of financial data were also essential in order to facilitate analyses and monitoring. It was important also to inject some degree of flexibility in the interest rate structure so as to reflect the cost of funds. In spite of the recent move to increase interest rates, it was not yet apparent that there was enough flexibility in the system. For example, credit in many areas was evidently still allocated, and at highly subsidized rates. In general, he was pleased to note the progress made in strengthening the financial infrastructure, but the pace and scope of the reform were difficult to assess from the staff reports.

The need to curb growth and domestic credit was no longer in doubt, Mr. Jaafar stated. The Board had tentatively and cautiously called the previous year for restraint on account of the rapid structural changes taking place in the economy that had required a larger volume of liquidity than at present. However, it was currently difficult to justify a rate of growth of credit of either 36 percent for 1984 or 43 percent for the first half of 1985, with real income growing at 14-15 percent and prices from 3-10 percent. He noted that the authorities had introduced some measures to control the use of enterprise liquidity for investment purposes. Those and other measures, such as higher interest rates and tightening of credit control, should be encouraged. He was pleased that the authorities were prepared to introduce additional measures if necessary. Nevertheless, it was difficult to see how a growth target of 18 percent for 1985 could be achieved, if domestic liquidity had been 43 percent for the first half of 1985, without calling for a drastic cut in the second half. Such a stance appeared to be contrary to the objective of achieving a "soft landing," and it would be helpful to know if there had been a recent change in policy.

The narrowing of the overall budget deficit that was currently envisaged for 1985 was welcome, Mr. Jaafar continued. However, the authorities should consider a budgetary surplus as a more appropriate stance of monetary restraint in 1986. If expenditure could be as restrained as the authorities intended, a budgetary surplus could easily be realized on account of the improved revenue performance under the various tax reforms. That option should be kept in mind in 1986, especially if demand continued to be overexcessive.

An issue of immediate concern was the need to restore external balance, Mr. Jaafar said. Although China's reserve position could be regarded as comfortable by international standards, a sharp drop in reserves from about $15.5 billion in 1984 to an estimated $9 billion in 1985 was too drastic and clearly not sustainable. Therefore, he understood the authorities' recent move to curb imports to halt further deterioration in the reserve position. However, he hoped that that move was only a temporary and expedient means to obtain more time until domestic demand restraints and more flexible exchange rate policies had taken effect. In that light, he was pleased to observe a definite sign of slower growth. Nevertheless, in the medium and long terms, it was difficult to see how a turnaround in the balance of payments position could be achieved unless there was a sharper upturn in exports and a more realistic increase in imports. That fact, in turn, underscored the need to maintain price competitiveness as well as a strict policy of demand restraint at home.

Mr. Rye remarked that China had long held a fascination for outside observers and at present was the focus of intense interest on account of its economic reform, the progress of which might be nearly as significant for the outside world as it was for China itself. The issue of gradualism was central to that progress in both the short-term macroeconomic context and the long-term process of change and reform. The short-term objective was "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." However, as desirable as a "soft landing" was, it could not always be readily achieved, and a rough early landing was better than a crash landing later.

The Chinese economy had recently exhibited all the symptoms of excess demand, Mr. Rye continued. In fact, he wondered if the statistics in the staff papers fully reflected the pressures on the economy. One of the problems of "an economy in transition" was to understand what the figures meant. In that light, inflation might be particularly suspect. A recent article had asserted that taking hidden price rises into account, the Chinese inflation rate could be something like 20 percent. He wondered what the staff view was.

Moreover, the sharply adverse revisions to the staff estimates for the 1985 balance of payments--Supplement 1 to SM/85/266 showed a revision of the current account deficit in the second half of 1985 from $1 million to almost $5 billion--suggested that the pressures of excess demand had been underestimated, especially since the bulk of that revision was due to imports, Mr. Rye stated. The authorities had already moved to counter the problem, but the question was whether they had gone far enough. Supplement 1 had also noted that "the authorities are presently considering tightening monetary conditions further through increase in the rate of interest on lending to the specialized banks and in reserve requirements." Some such tightening appeared desirable; however, he was aware of the difficulties of pursuing effective monetary policies in China's present transition phase. The staff had shown the instability of the monetary measures and the necessity for building upon the far-reaching changes in the monetary system that had already been put in place. Nevertheless, the argument for further monetary measures at the present time was a strong one. In that light, he noted that the monetary targets of the authorities were still likely to be exceeded and that some interest rates still appeared to be negative in real terms. Of course, they would be all the more so if there were indeed serious hidden inflation problems. In the long term, consideration should be given to some use of the budget as a countercyclical instrument, for which the circumstances of the previous year or so would have been particularly propitious.

The authorities should vigilantly maintain the competitiveness of China's industry, Mr. Rye continued. On the face of it, the devaluation of the real exchange rate--about 25 percent since late 1983--appeared to be more than adequate, but that would not be true if the rate of inflation was considerably higher. For China, calculations of the real exchange rate were likely to be even less meaningful than they were for most countries. He hoped that the recent intensification of direct import restraints would be temporary, and he welcomed the authorities' intention to move to a managed floating system as of January 1, 1986. That would give them flexibility, but it would not in itself solve any problems. The authorities would need both the capacity and the confidence to move the rate quickly in response to developments.

It was of central importance to China's development prospects to give greater weight to the price mechanism, Mr. Rye commented. That fact had been stressed by the staff and fully acknowledged by the authorities: in fact, the Chinese Premier had called price and wage reforms "the two major tasks in the reform of the economic structure this year." He noted that the staff had cautioned that the pace of price reform raised "political and tactical considerations." However, if reforms were to be implemented gradually, then it was to be expected that the problems they addressed would be overcome only gradually. Perhaps outside observers should not be too dogmatic because China was indeed breaking new paths.

The staff report said "China has not found it altogether easy to simultaneously achieve the triple objectives of system reform, output growth, and economic stability," Mr. Rye stated. Of course, the important thing was not the difficulties but that the authorities were determined to continue to pursue the objectives and that the commitment to reform remained undiluted.

He noted the relative modesty of China's external trade objectives, Mr. Rye said in closing. Perhaps the staff might comment on whether more was possible. It was, however, necessary to keep in mind that the achievement of China's long-term economic objectives required not one set of conditions but two. No matter how effectively the Chinese authorities pursued their macroeconomic objectives and the process of reform, their efforts would not meet with success unless the external environment was sufficiently favorable. Therefore, he joined the staff in hoping that China's efforts were not thwarted by protectionism.

Mr. Abdallah stated that he fully supported the proposed decision.

Mr. Salehkhou said that since the previous Article IV consultation, China's economic and financial performance had been mixed. In response to the sweeping reforms implemented since 1979 and strengthened in the past three years, real GDP growth had continued at a high rate with a strong performance in both the agricultural and industrial sectors, a significant recovery of investment, and generally a higher living standard. However, the early signs of macroeconomic imbalances observed in the previous Article IV consultation had been confirmed in the last quarter of 1984 and the first half of 1985; the turnaround of the deficit in the external current account had led to a substantial drawdown in China's strong international reserves, and the expansion of domestic demand and price liberalization measures had resulted in shortages and inflationary pressures.

The authorities had reacted appropriately to the recent deterioration in the external position and the acceleration of price increases, Mr. Salehkhou continued. They had implemented a number of measures aimed at slowing significantly the expansion of domestic demand and at adhering more closely to the planned objectives, all the while maintaining the overall momentum of the economic reforms. Some of those measures had already had a positive impact on China's performance in recent months. The macroeconomic imbalances had clearly signaled an overheating of the economy and the unsustainability over the medium term of current trends with respect to prices, output, and the balance of payments. More importantly, the imbalances indicated that the pace of structural transformation of China's economic and financial system had had to reckon not only with the country's tremendous potential but also with the residual effects of three decades of administrative management. It was necessary to take a realistic view of the time needed to prepare the economy for market instruments and the productive entities for direct responsibility. It was encouraging to note that as the authorities took further steps to reaffirm their commitment to reform, more emphasis was being put on the appropriate pace in order to preserve China's price stability and strong reserve position.

The staff had not given enough attention to the centrally planned character of the Chinese economic system when it had recommended more comprehensive price and financial reforms and more efficient resource allocation, Mr. Salehkhou commented. The authorities had made it clear that the objective of reform was to complement the planning system and effect an orderly transition to a system based on indirect management and greater flexibility. The concept of efficient resource allocation did not necessarily mean yielding to market forces, especially in a socialist economy in which policies were aimed equally at output growth and at the equitable distribution of income, rational resource utilization, and improved living standards.

The recent decline in China's international reserves should be kept in perspective because they remained at a rather comfortable level and because the current account deficit was to a large extent due to the expansion of imports of equipment and spare parts to sustain and strengthen the domestic productive base, Mr. Salehkhou stated. Concern with the external position should be more with the stagnation of exports caused by protectionist tendencies than to the excessive domestic orientation of output, which had not been altered by recent foreign investment. In the Seventh Five-Year Plan, the authorities had already announced a number of measures that would correct such imbalances and help promote exports. Those measures included, in particular, a further depreciation of the currency and the adoption of a flexible exchange rate policy as well as greater autonomy for foreign trade agencies and favorable treatment of foreign direct investment in a number of special zones. While the exchange rate policy and direct responsibility of state enterprises should strengthen China's competitiveness, a lasting improvement would also depend on its ability to adapt its educational and training systems to the new conditions of the economy.

The strengthening of market-oriented policies had enhanced the role of monetary policy in monitoring the macroeconomic targets, Mr. Salehkhou continued. That role had been steadily increasing and, judging from recent developments, it had been used to check the unsustainable expansion of demand. The measures implemented in that regard included a significant tightening of credit controls, higher interest rates, greater surveillance of investment, and cutbacks in budgetary outlays. Furthermore, the authorities were being encouraged to complement the demand-management measures by adopting a surplus budget. In that connection, while it was necessary to monitor closely the excessive expansion of overall demand and credit, fiscal policy should deal less with the fiscal deficit, which had been traditionally low, and more with the efficient use of capital outlays. That practice would be more in line with China's state of economic development and with the need for adequate infrastructure to attract productive investment.

It was essential that China maintain its prudent debt management policy, Mr. Salehkhou noted. The decision to make the People's Bank of China responsible for the coordination and monitoring of all external borrowing was a positive step, as was the emphasis on attracting foreign capital for joint ventures and direct investment aimed at a greater transfer of technology and development of export industries. Maintenance of adequate reserves and adherence to the 15 percent ceiling on external debt service should also ensure that the debt would not be allowed to become an excessive burden at a time of greater opening up of the country to the outside world.

Mr. Fugmann said that he was in broad agreement with the staff appraisal. If the Board was to appreciate the intricacies of economic policymaking in planned economies, the cooperation of the Chinese authorities--as well as Mr. Zhang's buff--should serve as an example for other member countries with the same type of economy.

The results delivered by the economic and social reforms that the authorities had initiated in 1979 were impressive, Mr. Fugmann continued. The sweeping changes that had taken place had unleashed previously subdued economic forces and initiated the strong economic growth that had seen the Chinese economy expand by some 60 percent in real terms from 1981 to 1985, admittedly beginning from a relatively modest level. The Chinese authorities were to be strongly commended for their commitment to introduce a more market-oriented system into their planned economy. The continuation of liberalization and fundamental changes was certain to provide encouraging results in the years to come.

An effective price system was fundamental and indispensable if resources were to be allocated efficiently and if economic agents were to be provided with the best possible signals of demand and supply conditions in individual markets, Mr. Fugmann went on. That process would involve realistic exchange rates and interest rates, and he was pleased to note the substantial reforms that China had made in those areas as well as in those designed to link rewards to individual efforts.

A liberal trade policy would benefit China, Mr. Fugmann commented. In order to link international prices with those faced by domestic producers and consumers, the authorities must implement reform of the foreign trade system and liberalization of the foreign exchange system in concert with the domestic reforms. That process was essential if China was to reap the full benefit of domestic reforms. Thus, he would like to underscore the need for the pace of reform on the domestic and external fronts to proceed uniformly. Given the concern expressed over recent price developments, he wondered whether the staff could provide an estimate of the proportion of the acceleration in price increases attributable to price liberalization.

The Chinese authorities had set themselves some ambitious long-term growth targets, Mr. Fugmann said in closing. Without the continuing economic reforms that had taken place, the achievement of those targets would have been unthinkable.

Mr. Zecchini remarked that developments in China since the previous Article IV consultation had demonstrated the correctness of the staff's analysis and the appropriateness of its policy recommendations. The main issues had not changed from 1984 to 1985: the necessity to exercise caution in the monetary area, the prospects for foreign exchange reserves and debt, and the appropriate pace of the structural reforms. However, new elements had emerged. The growth of monetary and credit aggregates had continued briskly during the first part of 1985, well beyond what was justified from a medium-term viewpoint. The ensuing growth in domestic demand had created tensions both on the price level--the inflation rate in 1985 was currently estimated at 9 percent, against 3 percent in the previous year--and in the foreign accounts--imports had grown at the unprecedented rate of 61 percent in dollar terms during the first part of 1985. Those developments underscored the fact that an active macroeconomic management was becoming more and more necessary, even while the Chinese economy proceeded further along the path of structural reform and developed its potential.

The staff's policy recommendations on the monetary front currently leaned more to the cautious side than they did in 1984, Mr. Zecchini continued, and for good reasons in view of recent developments in financial aggregates, prices, and the balance of payments. Growth rates of monetary aggregates were expected to be reduced by more than half by the end of 1985. It was difficult to judge whether those projections were likely to be met in view of the radical changes taking place in the financial structures. On the one side, the authorities had recently taken a number of institutional measures that were conducive to a better monetary control. Those measures included the definition of the functions of the People's Bank of China as the central bank, the introduction of a system of reserve requirements with a uniform coefficient, and greater flexibility of interest rates. On the other side, the pattern of financial flows in China was undergoing rapid transformation, with a substantial increase in private savings being channeled through the financial system. That growth made it difficult to make accurate predictions of the financial flows and their relationship to GDP growth. However, the overall changes currently under way in the Chinese financial structures were definitely in a positive direction, even accounting for the temporary overshootings or technical difficulties that were occurring in the process.

The outlook of the foreign account was more critical, in view of the strong increase in import demand that was currently taking place, Mr. Zecchini commented. The medium-term scenario showed that the likely growth of imports through the end of the decade would mean a sharp expansion of foreign indebtedness, even under favorable assumptions of export growth. The staff's figures clearly indicated a trade-off between the pace of economic reform and the deterioration of the external financial position considered acceptable in the medium term. The authorities would be well advised to improve the conditions of that trade-off by laying the basis for a strong expansion of exports, which in particular required an active management of the exchange rate. Moreover, the authorities' intention to attract increased foreign direct investment was well conceived; given the favorable situation of the fiscal accounts, consideration should be given to the possibility of eliminating the 10 percent tax on profit remittances by joint ventures.

The economic management of the Chinese authorities in recent times had been on the right track, Mr. Zecchini said. The integration of the economy with that of the rest of the world would provide great advantages to China and its trading partners. Nevertheless, the challenges for the

Chinese policymakers remained formidable, the most pressing of which was the prospective deterioration of the external financial position and the need to strengthen the export-oriented sectors. In that light, domestic price reform as well as financial and exchange rate policies would have to play an increasing role.

Finally, Mr. Zecchini commended the authorities for eliminating the internal settlement rate, as recommended by the Board during its discussion of the previous Article IV consultation. He supported the proposed decision.

Mr. Doe stated that he concurred with previous speakers that the steady improvement in the Chinese economy, both in terms of the rise in GDP and in the standard of living, was remarkable. The achievement was an indication of generally sound economic policies. The reforms in the agricultural sector and in the decision-making process of public enterprises, together with readily available bank credit, had led to the rapid expansion of output experienced in recent years. While impressive, that economic performance had also brought to the fore some serious problems--in particular, increased demand for inputs as well as consumer goods and the resultant rise in prices and weakening of the external sector position. However, it was reassuring to note that the Chinese authorities had recognized the seriousness of those problems and were taking actions to overcome them.

The termination of the requirement of mandatory purchases of grain by state enterprises and recent measures that encouraged interregional trade would greatly enhance the efficiency of the economic system, Mr. Doe continued. Furthermore, the implementation of a more restrictive credit policy--in particular, the upward adjustment of interest rates and the restraint on the wages and salaries of employees of public enterprises--constituted appropriate steps forward. He urged the Chinese authorities to persevere in that direction.

The increased flexibility in the pricing of a larger number of commodities was welcome, Mr. Doe went on. He noted that the pace of reform in that area would, in fact, be quickened. Furthermore, the authorities had successfully maintained the fiscal deficit at a fairly low level in relation to GDP. Pressures for higher expenditures, especially wages and subsidies, should be controlled in order to improve public sector savings and restrain aggregate demand growth.

As a result of the sharp fall in international reserves that had occurred in mid-1984, the Chinese authorities had taken a number of measures to control imports, Mr. Doe commented. However, since import restrictions applied only to consumer goods, foreign reserves could possibly drop further in 1985. In light of those prospects, the Chinese authorities were to be commended for maintaining their commitment to opening up their economy. In addition, the recent depreciation of the yuan should also help to improve the competitiveness of China's exports.

The Chinese authorities' intention to gradually reform their economy and open it to the outside world was welcomed, Mr. Doe said in closing. Understandably the scope and pace of the implementation of the reforms must take into account the specific characteristics of the Chinese economy. He supported the proposed decision.

Mr. Sengupta said that China was engaged in an experiment from which much could be learned. Mr. Zhang had described it as a search for "the most appropriate combination of the market mechanism and the central planning of the economic and social development," and neither the experience of the centrally planned economies nor that of the private enterprise market economies provided the conclusive indication of the most efficient way of pursuing those objectives. He would like to quote Mr. Zhang further in order to highlight a point without which one could misinterpret the whole intention of the Chinese experiment. "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."

One of the earliest tenets of economic socialism was that decentralized decision making based on the market price mechanism was not essential for efficiency or for achieving "socialist" objectives, Mr. Sengupta recalled. However, a practical problem cropped up in cases in which an algorithm for a flexible price mechanism could not be found in the real market places of those economies. That problem was that while prices had a role in allocating resources, they also determined the distribution of income between different factors of production within particular periods as well as between different periods. In a dynamic system those factors were interrelated, and whereas the price mechanism had an effect on the efficiency of resource allocation, one should not ignore the issues relating to distributional and intertemporal factors.

The lessons to be learned from the Chinese experiment were extremely important, even for countries like India, Mr. Sengupta commented. Both countries had mixed economies where the private sector dominated not only agriculture but also large sections of industry, and where markets functioned effectively in all areas. They might not always function efficiently, but very few market economies did, because the duly elected democratic government planned the development of the economy according to priorities of production that were not necessarily established by market demand and supply but that were dependent upon the existing distribution of purchasing power, income, and assets. In a sense, a fully planned economy like the Chinese system had an advantage over the inadequate, partial planning systems like those of India, because the control variables were more manageable. Nevertheless, the problems were similar--how to devise a decision-making system on the basis of decentralized prices that would achieve a resource allocation, both present and future, that would achieve the objectives of the society as perceived by the government; of course, those objectives were different from the ones dictated by the free play of market forces. It was the dilemma of choosing between a physical control system and decisions based on price signals. If a proper tax subsidy mechanism could be devised that could turn market prices into a set of signals that would allocate resources in the desired direction, then one would have shifted entirely to the price mechanism as an instrument of decision making. However, the fact was that such tax subsidy mechanisms could not be devised easily. The art of decision making therefore lay in experimenting with a price mechanism that would approximate a set of shadow prices corresponding to the set of objectives without necessarily knowing precisely the magnitude of those prices. That process was a matter of trial and error, and it could not be hastened by appealing to some preconceived notion about the role of market prices irrespective of the distribution of income and assets.

All those issues were relevant in China, and no dogmatic recommendations should be offered; the authorities should be allowed to experiment in a cautious, gradual manner, Mr. Sengupta commented. For instance, the question of the exchange rate in China was basically one of finding an appropriate accounting index, and it was pointless to emphasize adjustment of exchange rates or even unification of exchange rates. It was not the exchange rate that was important, but the final prices received by export producers and import users. As long as those prices were determined by foreign trade, exchange rates affected only the profitability of foreign corporations. There should be an attempt to have domestic relative prices correspond to international prices for the sake of efficiency, provided that the tariffs and subsidies set for both final goods and intermediate products were consistent with the planning objectives and flows of foreign resources. It would be sufficient if there was an appropriate directional change in exchange rate policy, a fact that was also relevant in considering the appropriate response to the recent deterioration of the balance of payments in China. The authorities were correct in not depending on tariff and price policies to control imports, because in the short run the certainty of the effect of a control variable was more important than fine tuning the prices of imported goods.

The point to note was that the Chinese economy was extremely high in savings, Mr. Sengupta continued, maintaining a rate of investment of between 30 percent to 32 percent in recent years. Indeed, the domestic savings rate had financed not only that rate of investment but also a substantial part of the foreign trade surplus. A 7-8 percent growth rate in gross domestic production, implying an incremental capital output ratio of 4-4.5 percent, had not been surprising. In a poor economy like China, such a high rate of savings undoubtedly had been made possible by a substantial decrease of consumption demand. The first effect of any kind of shift toward the market mechanism would be a large increase in consumption demand. That demand would be reflected in the short term in imports, which would be difficult for China to contain. Similarly, it was difficult to believe that China would be able to control the demand for credit by varying interest rates and not controlling the volume. Since credit determined the production of different sectors, it was essential that China should continue its credit rationing and credit planning. The appropriate approach was not to abolish credit planning but to look for a proper mechanism both in terms of the quantum of credit available as well as its cost to different sectors.

A substantial part of budgetary expenditure was devoted to price subsidies and income transfers to compensate for the impact of price increases, Mr. Sengupta commented. That fact was the direct consequence of the concern about income distribution and the effect of price changes that a planned economy necessarily exhibited. While excessive subsidization should be avoided because consumers would adjust in time to a demand pattern reflecting the relatively high costs of production, it was futile to ask for abolition of such subsidies as long as the distribution of incomes did not correspond with social objectives. In such a situation, undoubtedly the second-best option was to have production prices reflect the marginal cost of production and to provide for income transfers or consumer price subsidies.

Some Directors had urged the liberalization of foreign direct investments, Mr. Sengupta stated. Apparently, the Chinese authorities approved of that approach, although "so far not many of the projects established with foreign assistance had employed advanced technology, while some ventures were relatively low value-added assembly operations based on imported inputs and producing mainly for the domestic market." It was not clear what the basis was for the authorities to expect a change in the pattern of foreign direct investment. According to the current development theory, foreign direct investment was often advertised as the most efficient method of technology transfer, if not also of foreign savings transfer. If the Chinese authorities had been persuaded by that argument, it was worth noting that few countries that had developed at a high rate of technological progress had done so through foreign investment.

Mr. Qureshi stated that in 1985, China had maintained the twin trends that it had established in recent years--namely, strong growth performance, on the one hand, and the implementation of economic reforms for a significant structural and institutional change in the economy, on the other. Real national income, along with both industrial and agricultural output, had continued to grow rapidly while both domestic savings and investment had remained at traditionally high levels. Meanwhile, further steps had been taken in reducing the scope of mandatory planning and increasing the role of market forces, enhancing incentives, and promoting flexible prices. In steering the economy in those directions, the authorities had continued to show considerable flexibility, pragmatism, and determination. Furthermore, those qualities had again been demonstrated by the authorities in their timely response to recent adverse monetary and reserve developments.

The stance of budgetary policy had been commendably cautious throughout much of the current decade, Mr. Qureshi continued. Although expenditures had been growing strong, revenue growth had kept the budget deficit at a relatively small proportion of GDP. Nevertheless, the authorities were aware of the need to control expenditure growth further so that the deficit was not enlarged in years of relatively weak revenue growth.

The recent effort to slow down the growth in domestic liquidity was broadly appropriate, but might need to be strengthened in the light of developments in prices, Mr. Qureshi went on. The recent acceleration in inflation, increasing shortages, and the pressure on the balance of payments were indicative of excess demand. At a time when price reforms toward a market-determined price system were being implemented, a tighter rein on liquidity growth and an appropriately firm stance for demand-management policies in general acquired greater importance in keeping in check the buildup of inflationary pressures.

The policy of allowing a healthy reserve accumulation to take place in recent years when current account surpluses were being generated was prudent, Mr. Qureshi noted, since the accumulated reserves had served as a useful cushion in accommodating the recent pickup in imports associated with the liberalization process. Although China's reserve position remained relatively comfortable, the authorities recognized that the recent decline in reserves was not sustainable. They had appropriately recognized the need for greater flexibility in the exchange rate system to accompany the ongoing wage and price reform. Given that reform and the extent to which exchange rate changes were allowed to be transmitted to prices in the economy at large, appropriate flexibility in the exchange rate could develop into a significant tool of balance of payments management.

The attainment of a more rational and market-oriented pricing structure was being pursued by the authorities as central to the promotion of the efficiency of resource allocation, the improvement of public enterprise performance, and the enhancement of the effectiveness of macroeconomic policy instruments, Mr. Qureshi remarked. Several steps had been taken in that direction, and the authorities were aware of the need for further moves toward those objectives. Clearly, reforms of such fundamental nature required careful consideration of issues relating to the timing and sequence of individual measures as well as of the appropriate pace. In view of the critical importance of those issues to the eventual success of the reform, more in-depth analyses by the Bank and the Fund would be helpful in designing appropriate strategies.

In implementing price reforms, it was possible that the authorities might attempt to compensate consumers by means of wage increases for the losses that they sustained as a result of reductions in subsidies of certain key items, Mr. Qureshi continued. To the extent that the cost of subsidy matched the additional outlay, there might be no adverse impact on the budgetary position. In that situation, or even in cases in which there was an initial budgetary cost, the gains in efficiency and productivity derived from a rationalization of the price structure could be expected to benefit the budgetary position over time. In any event, it should be possible to estimate or analyze more systematically the relationship of those factors for the purpose of better and more informed decision making. The Fund or the Bank could provide useful analytical input in dealing with such wage and price policy questions.

It was encouraging to note from the recent World Bank Economic Report on China's long-term economic prospects that the authorities' goals of quadrupling output and raising per capita income from $300 to $800 between 1980 and 2000 were attainable, although ambitious, if current levels of investment and investment efficiency were maintained, Mr. Qureshi said. It had also been suggested that it might be possible to achieve those targets even with a lower level of investment--and thus a higher level of consumption--and also with a better sectoral balance if the role of the service sector was enhanced. That argument was appealing in view of the comparatively small service sector in China at present and the increased employment opportunities that an expansion of it would offer. Perhaps Mr. Zhang or the staff could indicate the authorities' views on that alternative strategy.

The Deputy Director of the Asian Department remarked that Directors had made a number of very perceptive comments, expressing many different views, about the pace of reform--namely, the cost of gradualism, of going too fast, of taking an approach to reform on a sectoral basis or on an economy-wide basis. He had also noticed the suggestion that the staff had had some predetermined preferences on the basis for its advice, but that was not true. Like everyone else, the staff was greatly impressed by the achievements of the Chinese authorities and people over the previous 30 years, which included the periods of both mandatory and comprehensive planning. Rates of economic growth had been achieved that were impressive by any international standard; tremendous progress had been made in reducing poverty and eradicating its worst features in terms of health and education. However, even before any staff advice had been given, the Chinese authorities had come to the conclusion that much of the progress had been based on a massive mobilization of material, financial and human resources, and intensive central planning, which in the future would not be able to yield the same results. Therefore, it had been their decision to reduce the role of mandatory planning. It had never been a question of whether to continue or drop mandatory planning but of finding the appropriate combination of mandatory and guidance planning. Currently, that combination was tilted in the direction of mandatory planning, but the authorities and the staff believed that the economy would benefit from moving in the other direction somewhat.

However, if one removed mandatory planning or greatly reduced its scope, a coherent replacement would be necessary, the Deputy Director continued. A whole new system of decision making would have to be introduced. If greater freedom were given to enterprises to undertake investment or to increase wages, then the enterprises had to be made financially responsible for the consequences of their actions. To date, that had not been accomplished to any great extent. One characteristic of planned economies was the so-called soft budget constraint. If state enterprises made an investment that led to a loss, it would be met somehow--for example, by extension of bank credit or by tax concessions. Therefore, if greater freedom was to be given to enterprises, they would also have to be made responsible for the consequences of their actions: serious reform must proceed on a variety of fronts simultaneously.

A variety of considerations argued in favor of introducing reform gradually; however, in that case results also would be gradual, which would not produce the political support that the reform process needed, the Deputy Director remarked. There was another side to the question of pace--namely, whether the Government's administrative machinery could handle reforms on a large scale. It was not easy to reach a confident judgment on the issue of the right pace for a comprehensive reform, and the staff was inclined to leave the decision up to the authorities.

A question had been raised as to whether monetary expansion was still not too rapid, the Deputy Director commented. The most recent available data showed that currency liquidity and credit were expanding at annual rates of 40-45 percent. However, that comparison was probably not a good one because those figures were inflated by the rapid changes that had taken place in the final quarter of 1984. In other words, the plateau on which the monetary expansion in 1985 was taking place was simply just higher because of the rapid expansion in the last quarter of 1984. Another way of looking at monetary developments in 1985 would be to compare them with the corresponding period in 1984. Such a comparison showed that liquidity had increased in the first half of 1985 by 4 percent against 7 percent in the first half of the previous year. Credit expansion presented, prima facie, a higher figure of 8 percent for the first half of 1985 against 2 percent in 1984 but, as explained in the staff paper, there were special factors operating. Currency expansion for the first nine months of 1985 was 5 percent against 10 percent in the corresponding period of 1984. Thus, there were clear indications that monetary expansion was in fact slowing down. Nevertheless, it was important to note that much of the monetary expansion usually took place in the final quarter of the year, and it was thus important that the expansion in the last quarter of 1985 would be small in order to ensure that inflation and the balance of payments position were brought under control and that the reform process would continue properly.

The Chinese authorities did not believe that interest rate policy by itself would ensure either adequate control over credit expansion or its proper allocation among sectors, at least not for a considerable time ahead, the Deputy Director continued. The direct quantitative control that the People's Bank exercised on credit expansion of the specialized banks would have to continue, but it was clearly not the most efficient instrument of credit control. It was costly in terms of resource allocation, and supplementing interest rates with other instruments of control would be useful, if not necessary. Of course, certain priority purposes for which the authorities wanted credit to be made available could be accommodated one way or another, as long as the scope of such priority areas was kept strictly limited.

In that context, a question had been raised about the proportion of credit that was being given at preferential interest rates, the Deputy Director noted. He did not have the precise figures, but the proportion was not small. The efficacy of monetary policy would be more effective if the scope of such arrangements were reduced.

The issue of stimulating competition among banks had been raised, the Deputy Director went on. He wondered how increased competition could be reconciled with the present arrangement in which banks existed on a nationwide basis specializing in certain functions. Although the issue had not been discussed with the authorities, the ultimate objective could be to break down the walls of functional separation, generate competition among banking institutions, and develop a variety of banking and financial institutions in order to provide better and more efficient banking service to consumers and to improve the mobilization of savings. The authorities were moving in that direction. For example, the Agricultural Bank was currently being allowed to extend credit to an urban enterprise provided it had a subsidiary in the rural areas and was engaged in the business of promoting exports. Some of the specialized banks and investment and trust organizations were allowed to deal in foreign exchange, which previously had been a monopoly of the People's Bank of China. A few of the investment organizations engaged in foreign borrowing, and one organization, The China International Trust and Investment Corporation (CITIC), borrowed in Tokyo both through private placements and in the open market.

One Director had raised the question of the compatibility of the banking reform and the credit plans, the Deputy Director commented. In adapting the previous system to the new arrangements, the best answer was clearly to develop a new breed of bank managers. However, the problem was not as big as it appeared at first glance because the previous credit plans had not been rigidly observed. In fact, credit plans had been vastly exceeded, and credit had gone in directions not originally intended. In future the role of the credit plans was to be reduced. At present, instead of assigning credit quotas to each branch of each specialized bank as previously, the People's Bank of China was assigning a total quota to the headquarters of the bank, which in turn had the freedom to assign it to the branches. The branches were able to reallocate the credit quota among various enterprises, and bank managers were being encouraged to take a look at the creditworthiness of the borrower and to be prepared to refuse credit wherever appropriate. However, as in other centrally planned economies, there was, on the one hand, a hunger for investment brought on by the persistent and continuous shortages of final goods and services. On the other hand, because of the absence of the element of risk, there existed a soft budget constraint. Together with an accommodative approach to bank credit, that situation had led to rapid credit expansion in the recent past.

In discussions with the Chinese authorities, one was impressed by their great conservatism on the issue of fiscal policy, the Deputy Director noted. They were very conscious of the fact that a few years earlier the budget deficit had been rather large, and they were proud of the fact that the deficit had been sharply reduced and that despite great pressures for additional expenditures, there was a possibility of a surplus in 1985. The authorities did not like even the smallest deficit. One Executive Director had suggested a countercyclical fiscal policy for China; some others, of course, were of the view that fiscal policy should not be used for that purpose. Notwithstanding those views, the surplus in 1985, however small, would contribute positively to the overall stabilization effort. Apart from the question of deficits or surpluses in the fiscal position, there was need to increase the efficiency of expenditures, especially of capital expenditures.

As for the issue of subsidies, the Deputy Director continued, in the staff's view it was better to price a product properly and then to meet the increased cost of living needs that resulted by raising wages and incomes, a practice superior to keeping the product price artificially low. Such an arrangement would be more efficient from the point of view of resource allocation and probably also from the point of view of consumer welfare.

Wage increases in 1984 had been large in real terms, the Deputy Director commented. Currently, about 10 percent of state enterprises were under the reformed wage system, by which the total wage bill was determined on the basis of certain objective criteria, and within that framework the enterprises had freedom to allocate wage increases according to whatever criteria they chose. If the total wage bill exceeded the norm that had been set, then there was a progressive tax on the excess.

The issue of labor mobility was important from an economic and social point of view, the Deputy Director said. It appeared that the authorities were prepared to move away to some extent from the present rigid manpower allocation system in order to accommodate the preference of workers to move from rural areas to towns and cities. The authorities were also prepared to take into account the needs of enterprises in a more flexible manner.

It was difficult to say how much of the increase in prices in 1984-85 had been due to the price reform and how much to the excessive monetary expansion, the Deputy Director continued. In fact, it was not easy to separate the two even logically, and, therefore, a detailed study had not been made. Control over the price of certain commodities was being transferred from the Central Government to local governments, which, in turn, set prices on the basis of demand and supply, a situation affected by the intensity of inflationary pressures. On the whole, it would be fair to say that price reform was responsible for half the rise in the cost of living and monetary expansion for the other half. In response to a related question, he noted that on the basis of the proportion of the total household budgets spent on rents, it appeared that the direct effect of an increase in rents would probably be small.

A Director had asked how accurately the available price statistics reflected the state of the economy, the Deputy Director commented. The cost of living index was not a bad indicator of prices faced by the consumers. However, if one was looking to assess the level of excess demand in the economy, the price index was not a good indicator. There were also other indicators--anecdotal information about shortages, for example--but they could arise because of price distortions rather than overall excess demand. Therefore, one had to be careful in interpreting the information about shortages.

The staff report indicated the depreciation of the official rate of the yuan, the Deputy Director remarked. In 1981-84 there also had existed the internal settlement price, but because it was not considered an exchange rate, it was not shown in the chart. The internal settlement price, which applied to all merchandise trade and trade-related transactions, had been fixed in relation to the dollar at 2.8 since the end of 1981, so that substantial appreciation had occurred in effective terms. At the end of 1984, the internal settlement price was abolished, and all external transactions currently took place at the official rate. The official rate had depreciated substantially in 1984-85 and especially in the past two months. Some Directors had suggested that the exchange rate should not really matter in an economy like China's. In the classical form of the fully planned economy, the exchange rate would not matter since foreign prices would probably not be taken into account by exporters and producers. Furthermore, if the soft budget constraint prevailed, then enterprises took decisions without regard to prevailing prices. In China, the exposure of importers and producers to international prices had been increasing, although it was still small. The reform of the foreign trade system was intended to enlarge the scope of application of international prices and the exchange rate to exporters, importers, and producers. Since the budget constraint was also being gradually tightened, the exchange rate had become an increasingly useful instrument for managing the balance of payments. It was difficult to judge whether the extent to which the exchange rate had moved recently was adequate. What was needed was continued flexibility, a readiness to move the rate as circumstances warranted, which in fact was what the authorities were doing, and that was the right policy posture.

One Director had said that competitiveness was not just a matter of the exchange rate but that it ultimately reflected the general efficiency of the whole economy, the Deputy Director continued. The staff would fully agree. Exports could not be competitive unless the whole economy was efficiently run and the exchange rate was only one element. The authorities were fully aware that many of the major exports were not competitive at the moment; in fact, they had lost some competitiveness in the recent past. The entire lackluster performance of exports should not of course be attributed to lack of competitiveness. There were import restrictions abroad and excess demand at home, both of which were not fully reflected in prices and all of which had contributed to a decline in exports. After a rather good performance in the early 1980s, with reasonable expansion of manufactured exports even though there had been some loss of market shares, there had occurred in 1985 a 10 or 15 percent decline in the volume of manufactured exports. It was indeed appropriate to be concerned about competitiveness.

It was possible for China to have a larger increase in foreign trade than suggested by the Seventh Five-Year Plan proposals, the Deputy Director stated. It was necessary to bear in mind that Chinese plans for foreign trade had always been rather modest; actual export performance had exceeded planned amounts, as had imports recently. The staff had not had the opportunity to discuss the Seventh Five-Year Plan projections with the authorities.

The authorities had put a ceiling of 15 percent on the debt service ratio, and, indeed, reaching that number would represent a large increase in borrowing, the Deputy Director went on. However, the authorities did not intend to reach the 15 percent figure; they did not consider it as a target. There was no expectation of reaching that figure in the near future, and the staff had not suggested it as something to be aimed at. The staff was working with the authorities in developing a system of debt management, and a staff mission would be going to Beijing in the coming week. The intention was to place debt management in the perspective of medium-term balance of payments planning.

The foreign currency certificate system had been introduced four or five years earlier, the Deputy Director of the Asian Department said. The purpose was to keep Chinese nationals in the domestic market out of the market for certain goods and services that had to be provided to foreigners. Without an appropriate exchange rate and without imports having been priced properly, if the goods in that market were made available to domestic consumers, the demand for them would clearly be much too great. The foreign currency certificates were therefore introduced as a method of separating the two markets. Foreigners alone were supposed to receive and use them, and they were not supposed to use them for any purpose other than payments to hotels and certain stores. Of course, with the opening of the economy, those restrictions were being increasingly broken. The shortage of foreign exchange and the premium placed on imported goods together with their lack of availability had created the demand for them. The question was always raised as to whether the use of foreign currency certificates was proper, since they were made available to foreigners but not to Chinese citizens. Ultimately, however, it was a question of the premium on foreign exchange. If foreign currency certificates had not been introduced, there would have had to be some other way by which the markets could remain separate until exchange rates and prices had been fully reformed.

Another staff representative from the Asian Department said that he would address the enterprise transactions of above-quota output. Under a May 1984 agreement, enterprises were allowed to choose their trading partners, both suppliers of input and recipients of output, and they were permitted to set prices among themselves. The regulations were being implemented in a step-by-step fashion beginning in a few large cities.

The only information on those activities thus far had come from the frequent press reports that enterprises were engaged in direct transactions among themselves.

All the cities chosen for promoting foreign direct investment were located along the coast and had previously established strong economic ties with foreign countries, the staff representative stated. The availability of the proper infrastructure was, of course, also a criterion. However, there was need for improvement in the infrastructure with additional investment, and priority appeared to have been given to some of those cities. Specifically, 4 major cities out of the 14 coastal cities had been given priority in providing investment. Enterprises that embodied advanced technology were given priority as well as those that helped to develop exports. However, actual developments had fared quite differently, and that had been noted in the staff report.

The proposal for promotion of the service sector, which had recently been issued in the Seventh Five-Year Plan, emphasized the need to accelerate developments in that sector, the staff representative remarked. Those measures included the transfer to collective units and individuals of some of the operations now carried out by state enterprises.

Mr. Zhang said that neither the past experience of the centrally planned economies nor that of the private enterprise market economies provided any conclusive guidance or indications to the most efficient way of carrying out China's intended reform. That fact was particularly true for price reform. His authorities knew that the spontaneous play of market forces would not lead to a balanced growth, full employment of resources, and equitable distribution of income, as required by their socialist economic development. Furthermore, under the opening-up policy, the relative prices in the international markets would not necessarily be a good indicator for official allocation of domestic resources. Besides, the so-called international relative prices were often distorted themselves. To have price reform follow strictly the relative international prices was bound to have serious repercussions for China's domestic economy. Therefore, in implementing price reform, both the speed and pattern of changes would have to be subject to some kind of administrative control.

To state another example, Mr. Zhang continued, investment and savings under the present reform would be enforced by direct central planning in order to achieve aggregate growth targets and the intended pattern of growth. The current reform involved much more than just choosing one or other of the macroeconomic models.

In implementing the Chinese reform, there were other tasks that had to be carried out, Mr. Zhang went on. There was shortage of adequately trained manpower and a lack of familiarity with modern management techniques required to run the economy efficiently. A related problem was the need for re-education in order to develop the spirit of genuine entrepreneurship combined with an appropriate professional attitude toward work as required by the autonomy of enterprises. In addition, China had to find the most appropriate combination of market mechanism and planning at each stage of its reform. The authorities had to become familiar with using modern macroeconomic levers as basic instruments for control. China still had to find the most efficient way to coordinate the development and growth of different regions for a country as large and varied as it was. The development of the relationship of the whole and of the individual parts had always been a problem. Finally, China had to import technology from abroad. It was necessary to select the most appropriate one and adapt it to the specific needs of China.

He was grateful for the illuminating and sometimes empirical and theoretical comments of the Executive Directors, Mr. Zhang said, although the present time was not the place to have a general discussion on those points. However, he was reminded of discussions in the early 1950s, at which time everyone tried to determine whether the Indian way or the Chinese way would lead to speedier industrialization. In any case, China had lived through its own experience; it had evaluated its successes and failures, and it wanted to carry out its own reforms completely. China knew what it was doing.

The Chairman made the following summing up:

All Directors were impressed by the continued rapid growth and change of the Chinese economy and by the authorities' courage and determination to pursue the process of economic reform. Indeed, economic reforms in recent years had brought about substantial gains in living standards as real national income had risen by a spectacular 60 percent since 1980. However, from mid-1984 macroeconomic imbalances had become evident. The growth of money and credit had accelerated, prices had risen rapidly, and by the first half of 1985 the balance of payments had moved into substantial deficit. Directors observed that the authorities had responded to these imbalances with measures to curb domestic demand and to restrain imports. There were signs that output growth was now being reduced toward more sustainable levels. However, the balance of payments had so far been slower to respond. At the same time implementation of wide-ranging economic reforms was continuing.

Directors agreed with the authorities' view that the rate of expansion of demand and output had become excessive in late 1984 and in the first part of 1985. Excess demand pressures had intensified and the faster rate of price increases, while in part attributable to price reform measures, had become a cause for concern. The authorities were, therefore, well advised to introduce corrective measures aimed at reducing demand and output expansion to sustainable rates. In the present circumstances of transition in the mode of economic management, it was understandable that these measures still involved a mix of instruments of different types. Directors noted that one of the most important problems to be solved by the Chinese authorities was the most appropriate combination of the market mechanism and central planning. Directors welcomed the increased use of macroeconomic instruments and stressed the need to develop additional instruments of a macroeconomic nature and to improve the effective application of such instruments.

There was a broad consensus among Directors that in the present phase, particular emphasis should be placed on the use of monetary and pricing policies and that the use of more direct administrative controls should be de-emphasized over time as the reforms toward the strengthening of the price and market mechanisms proceed and as more experience is gained in the use of these macroeconomic instruments.

Directors observed that excess demand pressures had been fueled by rapid expansion of money and credit, particularly in late 1984. The rapid economic growth and significant structural changes taking place made it difficult to judge the appropriate rate of monetary expansion with any great precision, but the rate certainly had been excessive. The rapid expansion had reflected an accommodative attitude toward credit requests and also some technical factors associated with the establishment in 1984 of the People's Bank as a separate central bank. In this connection, a number of Directors urged the authorities to strengthen recent efforts to enable the People's Bank to exercise effective monetary control. Directors were pleased to note that increases in interest rates and efforts to tighten the enforcement of credit ceilings had been followed in recent months by some slowing of the rates of money and credit expansion. All Directors believed that cautious monetary policies would continue to be needed, and a number of them advised the prompt implementation of increases in the rate of interest on People's Bank lending to the specialized banks and in redeposit requirements that were currently under consideration. Directors welcomed the decision to incorporate the People's Construction Bank into the credit plan, which should serve to improve the system of monetary control and noted that incorporation of the rural credit cooperatives would also be desirable.

Many Directors also stressed the role of fiscal policies in limiting excess demand pressures. They welcomed the authorities' intention to keep the fiscal deficit in 1985 at a modest level, and they also urged the authorities that the growth of public expenditure be kept under control. Several Directors believed that under the present circumstances a fiscal surplus might be appropriate. Furthermore, fiscal reform would become more important as the role of market mechanisms gained momentum in the economy.

Directors considered that the authorities had been justified in acting to halt the sharp decline in international reserves. They noted that for this purpose the authorities had relied principally on tightening import restrictions and foreign exchange controls. Although import growth had so far remained at a high level, reflecting a backlog of earlier orders, a slowdown could be expected in due course. Export performance had remained sluggish, however, and the outlook for the balance of payments was uncertain. Most Directors stressed the need for active use of demand management and exchange rate and pricing policies in place of direct controls to prevent the recurrence of a large balance of payments deficit. They observed that a strengthening of the balance of payments would depend, in particular, on efforts to promote exports, and, in this connection, they noted the recent loss of export market shares. They, therefore, welcomed the announcement of the adoption of a system of managed floating of the exchange rate as of January 1986, and they noted that a significant effective devaluation of the renminbi had already taken place in recent months. The authorities were commended for the abolition of the internal settlement rate at the end of 1984. Several Directors stressed the importance of research in foreign markets, quality of production, follow-up services, and other measures to promote and strengthen Chinese export performance. In a similar vein, several Directors expressed the view that the projected increase in exports under the Seventh Five-Year Plan, roughly in line with the growth of GDP, appeared somewhat modest.

Directors endorsed the authorities' cautious attitude toward external borrowing, noting that external debt and debt service had remained relatively low. They observed that it was important that the proceeds of foreign borrowing be used productively and, in this context, appropriate demand management and pricing policies should contribute to that objective.

Directors expressed appreciation of the progress made in implementing economic reforms. Following earlier extensive reforms of the rural economy, urban reforms had begun in earnest in 1984. Already there had been significant changes in the system of agricultural procurement and reductions in the scope of mandatory planning, while the first steps had been taken in the more complex process of reforming the price and wage systems. Much, of course, remained to be done, and Directors welcomed the evident commitment of the authorities to the reform process. Their determination to continue policies of opening up the economy to the rest of the world through strengthened trade, investment, and technology links was particularly encouraging. In this context, Directors took note of the Seventh Five-Year Plan, the priorities of which were to continue broad economic reforms, maintain macroeconomic balance, and improve product quality. Directors also endorsed the authorities' view of the key role of price reforms. For example, a number of Directors suggested priority should be given to the reform of key industrial sectors--including energy and transportation where present and prospective supply bottlenecks were most pervasive--and to reducing subsidies and strengthening links between domestic and international prices. These measures would need to be complemented by efforts to increase the role of market mechanisms, strengthen financial discipline for state enterprises, and liberalize the foreign trade and exchange control systems. At the same time the development of wages should be more closely linked to trends in output and productivity. The pragmatism and flexibility with which the Chinese authorities had already acted gave confidence that these tasks could be successfully achieved.

Directors welcomed the improvements in statistics supplied for Fund publications and for the consultation reports. They supported the ongoing efforts of the authorities and of the staff to improve statistics further and to broaden the coverage of Chinese data in Fund publications.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to China's exchange measures subject to Article VIII, Section 3, in concluding the 1985 Article XIV consultation with China, in the light of the 1985 Article IV consultation with China conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 8125-(85/162), adopted
November 8, 1985

2. THE GAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINTS UNDER RULE K-1 AND RULE S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors gave substantive consultation to the matter of overdue financial obligations and the report and complaint under Rule K-1 and Rule S-1 with respect to the notice of failure by The Gambia to settle Trust Fund obligations (EBS/85/246, 11/4/85).

The staff representative from the African Department said that the staff had just received information from the Gambian authorities regarding recent policy developments and prospects. The authorities had indicated their strong desire to proceed with the planned introduction of the new flexible exchange rate system as soon as possible after the arrival in Banjul of the Central Banking Department advisor, who was expected to commence his assignment by the end of November. Regarding the first stage of the plan to reduce public sector employment, which affected temporary workers and vacant posts, the staff had been informed that the technical work on the matter was currently completed and that a report was to be submitted to the Cabinet for a decision the following week.

There had recently been some liberalization of rice imports because the private sector had sold some of them at prices significantly higher than the official price prior to price decontrol. The authorities had indicated that the Government would soon decide as to the exact level of rice imports by The Gambia Produce Marketing Board for purposes of holding strategic stocks and the conditions under which such stocks would be released on the market. Finally, the authorities had considered that while definite information was not yet available, their estimate of 60,000 tons of groundnut purchases in 1985-86 was almost certainly attainable and might be exceeded.

Substantial progress had been made toward closing the external financing gap, both during and after the London Donors' Conference, the staff representative continued. Based on relatively firm pledges that had been identified to date, the assessment of the staff, however, was that at the present time a significant gap would still remain. In the coming weeks, the staff intended to review, in light of information regarding the authorities' continuing contacts with donors, whether further assistance was likely to be forthcoming to close that gap.

The staff was raising with the authorities the possibility of a staff visit to Banjul sometime in late November or early December, the staff representative remarked. The purpose of that mission would be to review the implementation of the authorities' program, including the introduction of the new exchange system, the latest position regarding the financing gap, and the prospects and plans for becoming current with the Fund.

That morning the staff had received a communication from the authorities indicating their agreement with the proposal for that mission, the staff representative said in closing. The authorities had also stated that they had been in contact with commercial sources in order to seek possible financing to enable payments to be made to the Fund. They had informed the staff that the institution in question, however, had indicated that a necessary condition for the provision of such financing was that they would need to be satisfied that a stand-by arrangement with the Fund was likely to be in place shortly.

The staff representative from the Treasurer's Department said that two additional obligations had fallen due since EBS/85/246 had been issued. Total overdue obligations of The Gambia were SDR 5.1 million, and the figure for obligations overdue in the General Department in paragraph 2 of the draft decision should read SDR 4,462,498.

Mr. Abdallah said that at a special meeting that had been held in Seoul on October 10, the Board had given preliminary consideration to the Managing Director's complaint of The Gambia's overdue obligations to the Fund. The meeting had been attended by The Gambia's Minister of Finance and Trade who, by his presence and unequivocal statement, had underlined the importance with which The Gambia viewed the whole question of arrears. The Minister had declared that serious efforts were being made to become current with the Fund, and the previous day he had telexed a message to Mr. Mtei that reaffirmed his commitment to the Board.

The Minister had further emphasized that the buildup of those arrears was something that was deeply regretted by the Government of The Gambia, Mr. Abdallah stated. The authorities were determined to discharge those obligations as soon as possible. The Minister had recalled that termination of the stand-by arrangement in January 1985 had created a resource gap that had amounted to SDR 10.2 million. At the same time, access to commercial sources of financing had been curtailed, thereby making it virtually impossible to obtain short-term credit that would have eased temporary liquidity pressures and greatly facilitated the management of the economy.

The Minister had further recalled that on the previous occasion, April 1985, The Gambia had been able to discharge its overdue obligations to the Fund, Mr. Abdallah continued. However, the repurchase had been made possible only by diverting resources that had been earmarked for food imports following a disastrous crop failure in 1984/85. That move had been bold on the authorities' part, although the resulting problems had been mitigated to a certain degree by food aid that had subsequently been received. Nevertheless, the temporary disruptions in the food supply had serious social and political implications. The incidence served to illustrate how seriously the Government viewed its overdue obligations to the Fund and how far they were prepared to go in order to discharge them. Since The Gambia's last payment to the Fund in April, there had been no meaningful foreign exchange inflows arising from exports that would have allowed the Government to meet its obligations. The drought, which had adversely affected food production in 1984/85, had also affected the output of groundnuts, the country's main export.

In his telex, the Minister had asked Mr. Mtei to advise the Board that in his determined efforts to mobilize external resources in order to settle overdue obligations to the Fund, he had been able to secure bridging finance from commercial sources, Mr. Abdallah commented. However, to activate that arrangement, The Gambia had to reach full agreement with the Fund on an adjustment program. Discussions had been taking place between the authorities and the staff, and he had understood that good progress had been made. Efforts were continuing to secure donor assistance amounting to SDR 50.6 million. A substantial amount of the required aid had been identified from various sources, and the authorities were in further consultation with certain donors and would ascertain the position of those particular donors. The Gambian authorities had sought assistance from both the Fund and the World Bank in order to finalize the level of donor assistance that could be agreed upon as reasonably obtainable. That assistance should give rise to an adjustment program that was realistic and that commanded broad support within the country. In fact, the Gambian authorities had already begun taking appropriate adjustment measures in a number of key areas. They were introducing a flexible exchange system, liberalizing the importation of rice, and reducing the size of the civil service. Furthermore, there were indications that groundnut purchases in the current season would be higher than forecast. Therefore, the immediate prospects were more encouraging than they had been the previous month.

Directors should continue to show sympathy and should agree to the proposed decision, which called for a further review within a period of three months, Mr. Abdallah said in closing. The authorities would not view that as a period of grace, but would redouble their efforts to reach firm understandings with donors and the Fund that would lead to the elimination of all arrears.

Mr. Grosche stated that it was disappointing to note that since October 10 The Gambia had not made any payments to the Fund. He had difficulty in accepting the authorities' view that, in the absence of exceptional financing, an early settlement of the overdue obligations was not in prospect. He could not accept that view as long as the authorities still had such a long way to go in implementing a policy package of reform, particularly in the absence of a move to a flexible exchange rate system. Early action by the authorities was necessary, and he was convinced that if an appropriate policy package was in place, it would be easier for donors to provide additional aid. He was encouraged by the news from the staff and Mr. Abdallah, and only because of that was he prepared to accept the proposed decision.

Mr. Leonard remarked that he had noted the diligence of both the staff and the authorities in working out the means by which The Gambia could effect an adjustment and become current with the Fund. It was regrettable that in spite of those positive factors, The Gambia had accumulated further unpaid obligations to the Fund since the Board's previous meeting on the subject in Seoul and that there was no immediate prospect for correcting the problem. He saw no acceptable alternative to the Board's proceeding in the same way it had already done in similar cases. Therefore, he supported the proposed decision and endorsed the expectation that the three-month period would be used to find constructive ways to settle the overdue obligations.

He had a growing sense of unease about the proliferation of overdue obligations, Mr. Leonard continued. The Board needed to take another look at its response to the situation; an opportunity for that would be provided by the discussion of the six-month report on overdue obligations.

Mr. Doe said that the Gambian authorities had already implemented substantive fiscal, monetary, and price measures. Furthermore, they were negotiating a bridging loan, the proceeds of which would be used to clear the overdue obligations to the Fund. That negotiation should be satisfactorily concluded in the very near future, in order that The Gambia could implement more effectively an economic and financial program supported by the Fund. He endorsed the proposed decision.

Mr. Templeman stated that the update of the situation from the staff indicated that there was some progress on the economic adjustment front. Furthermore, he welcomed the new IMF mission going for further talks in the coming weeks. Also he welcomed Mr. Abdallah's reassurances about the determination of his authorities to try to eliminate overdue payments, but he regretted that no further payments had been made since the Board had last considered the case.

He could go along with the suggested three-month review, because it generally followed the previous timing in such cases, Mr. Templeman continued. However, it was necessary to take into account that there had been intermittent problems of arrears with the Fund earlier than the present series. The Board should also bear in mind that donors were being asked for assistance and that a Fund mission would be going soon to The Gambia with regard to the formulation and implementation of policy, particularly regarding the exchange rate system. Therefore, it might be useful to hold a review somewhat sooner than the three-month period that had been suggested. That review should not be seen as an attempt to penalize the Gambian authorities, but rather as a way to keep the Board apprised more promptly of the evolving situation.

The staff representative from the Legal Department said that there was no legal obstacle to initiating an earlier review, and that either the Chairman or an Executive Director could request it.

The Chairman suggested that since a mission to The Gambia was scheduled for early December, a meeting could be held to receive and discuss developments at that point.

Mr. Fox said that the Gambian authorities had taken some important steps to deal with the economy's problems and that on that basis the United Kingdom had contributed to the organization of the Donors' Conference in London. That meeting had resulted in pledges of financial assistance that would go a long way toward closing the financing gap as measured by the Fund. Moreover, there were reasonable prospects that further progress in that direction could be made in the coming few weeks. He therefore supported the proposed decision, but he preferred a three-month interval before the next review; although if an earlier review appeared useful, he could go along with that. The important point was to stress to the Gambian authorities that they must use any extra time to exert every effort to ensure that there were no slippages in the implementation of policy.

Mr. Chatah commented that it was unfortunate that The Gambia had not been able to settle its obligations to the Fund. However, he was encouraged by the updated information provided by the staff and by Mr. Abdallah's positive remarks. The measures taken by the Gambian authorities in the recent period were welcome, particularly in the area of pricing, and the authorities should be encouraged to pursue and broaden their corrective policies. He hoped it would be possible in the near future to put together a comprehensive policy program that could be supported by the Fund once the overdue obligations were settled.

Even a casual look at the state of the Gambian economy demonstrated clearly that it was an exceptionally difficult situation that could not be resolved over the short or medium term by corrective policy measures alone, important as those were, Mr. Chatah continued. The amount of arrears in the previous September had been more than two and a half times the total exports in 1984/85. There was no question that exceptional financial assistance would be needed if The Gambia was to begin to regularize its external payments position and thus allow the resumption of adequate development assistance that the country badly needed. A continuation of the present situation, with arrears being accumulated to the Fund as well as to multilateral development institutions, was bound to jeopardize a normal flow of assistance from such institutions. He wondered if the staff could provide a comprehensive analysis of arrears indicating those owed to multilateral institutions, to bilateral creditors, and to commercial creditors.

Mr. Winjholds said that he agreed with the views of the Executive Directors who had emphasized the need for strong measures to be taken by The Gambia. He had noted that willing creditors had stipulated that a stand-by arrangement be in place before bridging finance would be provided. However, such a program was not possible as long as there were arrears to the Fund. He wondered if there was a way out of that situation.

The staff representative from the African Department said that, broadly speaking, external arrears of The Gambia were approximately \$55-60 million, of which \$20 million was owed to the West African Clearing

House. Almost $20 million more constituted commercial arrears, in a pipeline that had existed for quite some time. Roughly $15-20 million constituted official debt service arrears. It had been difficult to monitor the state of arrears in The Gambia in the previous two years. In general, arrears existed to virtually all creditors. The debt owed to multilateral creditors constituted roughly half the total debt. At present, a World Bank debt team was in The Gambia to undertake a comprehensive loan-by-loan evaluation of the situation, which had not been done for some time. Their results would be available toward the end of November, and at that time there would be a precise picture of exactly what was owed.

As the staff understood the recent telex from the authorities, the commercial banks had made it clear that they would make funds available only when they were satisfied that a stand-by arrangement was likely to be put in place, the staff representative stated. The staff's past experience in such matters indicated that for bridging finance to be made available, fairly firm assurances would need to be present in the minds of the providers that there would be a viable, comprehensive, and fully financeable program which would be supported by a stand-by arrangement shortly. It was certain that lenders would be looking for as firm an assurance as possible.

Mr. Nimatallah said that he commended the authorities for their efforts. He noted that they were trying hard to put their house in order; eventually they would overcome their problems. Therefore, he could go along with the proposed decision. Nevertheless, he hoped that the authorities would intensify their efforts in the coming weeks.

Mr. Abdallah said that he could assure the Executive Directors that the current situation was a matter that was receiving the attention of the authorities at the highest levels and that they were working very hard to remedy it. The commercial banks who had offered the bridging finance were anxious that the Fund staff undertake its mission to The Gambia. It was his expectation that the staff and the authorities would reach full understanding. Consequently, he hoped that a stand-by arrangement would be in place by the end of the year, so that the donor funds could be released. In closing, he emphasized once again that the authorities were leaving no stone unturned.

Mr. Templeman said that the Board would be delighted if the scenario that Mr. Abdallah had suggested actually happened. However, he liked the idea that there would be a report to the Board when the mission returned. Of course, if there was to be a stand-by arrangement, its consideration would pre-empt any other meeting.

The Chairman stated that there would be a first report to the Board sometime after the mission returned in order that the Board would be fully informed. He also would request that Mr. Abdallah inform his authorities of the need to look carefully at the exchange rate system. One of the explanations of the weaknesses of The Gambia's situation was that export receipts were not channeled through the official system, a practice that perhaps led to an overstatement of the magnitude of arrears in relation to exports, because the statistics covered only officially recorded export receipts. The Gambia's exchange rate system and the permeability of its borders had a major impact on the degree of official recording of exports. If the authorities could show real determination to move toward a more realistic system, the difficulties would be easier to cope with.

Mr. Salehkhou commented that the loan to settle the arrears appeared to be a commercial loan, obviously on commercial terms. Therefore, he had a word of caution for the Gambian authorities and for the donors: he hoped that they did not make a bad situation worse by aggravating the problems of payments later on just to get out of the current difficulties. Perhaps the donors would be willing to consider extending some loans on concessional terms in order for The Gambia to be able to pay the Fund and clear its arrears and to be able to improve their general economic situation. He supported the three-month decision.

The Executive Board then took the following decision:

1. The Managing Director has reported under Rule K-1 and Rule S-1 of the Fund's Rules and Regulations to the Executive Board the facts on the basis of which it appeared to him at the dates of these reports that The Gambia was not fulfilling its obligations under the Articles of Agreement and submitted complaints and a notice on September 19, 1985 (EBS/85/221) in accordance with those Rules. The complaint under Rule K-1 was that as of September 19, 1985, The Gambia was not fulfilling its obligations relating to repurchases and the payment of charges in the General Department in the total amount of SDR 3,887,463. The complaint under Rule S-1 was that, as of September 19, 1985, The Gambia was not fulfilling its obligations to pay charges in the SDR Department in the total amount of SDR 99,946. Furthermore, the Managing Director added to his complaints a notice of the facts on the basis of which it appeared to him that, as of September 19, 1985, The Gambia was not fulfilling its obligations under Decision No. 5069-(76/72) with regard to the Trust Fund to repay disbursements and pay interest in the total amount of SDR 364,334. These facts, and the complaints and notice of the Managing Director, were communicated to the authorities of The Gambia on October 10, 1985.

2. Taking into account the further obligations of The Gambia that have become overdue since September 19, 1985, The Gambia's overdue obligations to the Fund have increased to SDR 4,462,498 in the General Department, to SDR 197,392 in the SDR Department, and to SDR 450,434 under the Trust Fund.

3. Having considered the reports of the Managing Director, the complaints and the notice, and the views of The Gambia, the Fund finds that The Gambia has failed to fulfill its obligations under the Articles of Agreement and the Trust Fund as stated in paragraphs 1 and 2 above.

4. The Fund regrets the nonobservance by The Gambia of its obligations and urges The Gambia to resume their observance forthwith. The Fund decides

(a) pursuant to Rule K-2 of the Fund's Rules and Regulations that The Gambia shall not make use of the general resources of the Fund until such time as The Gambia has become current in its obligations under the Articles of Agreement relating to repurchases and the payment of charges in the General Department,

(b) pursuant to Article XXIII, Section 2(b) of the Articles of Agreement to suspend the right of The Gambia to use SDRs it acquires after the suspension until such time as The Gambia has become current in its obligations to which that provision applies, and

(c) if The Gambia were otherwise eligible to make use of the general resources of the Fund, to take into account the existence of any overdue obligation to the Trust Fund in considering any request by The Gambia for the use of the general resources.

5. The Fund shall review this decision within a period of three months from the date of the decision.

Decision No. 8126-(85/162) G/S/TR, adopted November 8, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/161 (11/8/85) and EBM/85/162 (11/8/85).

3. SAUDI ARABIA - TECHNICAL ASSISTANCE

In response to a request from the authorities of Saudi Arabia for technical assistance in the formulation of policies for the promotion of the private sector in the context of the economic development strategy, the Executive Board approves the proposal set forth in EBD/85/283 (11/5/85).

Adopted November 8, 1985

4. EXTENSION OF SICK LEAVE FOR STAFF MEMBER

The Executive Board approves the Managing Director's proposal set forth in EBAP/85/267 (11/4/85) requesting extended sick leave for a staff member.

Adopted November 8, 1985

APPROVED: June 23, 1986

LEO VAN HOUTVEN
Secretary