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OFFICE MEMORANDUM

TO: FILES

DATE: August 11, 1980

FROM: Caio Koch-Weser

SUBJECT: CHINA--Mr. Husain's Meeting with Vice Premier Gu Mu, Beijing, July 24, 1980

PRESENT: Messrs. Gu Mu, Wu Bo (Minister of Finance), Xie Beiyi (Vice Chariman of State Capital Construction Commission), Gan Ziyu (Vice Chairman of State Planning Commission), Li Peng (Vice Minister of Finance), Wang Liansheng, Chen Hui, Mrs. He Liliang (Deputy Director, International Department, Ministry of Foreign Affairs), Messrs. Husain, Jaycox, Kirmani, Lim and Koch-Weser

In introducing the meeting, Vice Premier Gu Mu pointed to the rapid development of China's relationship with the Bank in recent months and expressed his appreciation for Mr. McNamara's and Mr. Husain's support. Mr. Husain said that Mr. McNamara had expressed his satisfaction at the speed at which the change of representation of China in the Bank had been effected. In response to a question by the Vice Premier, he said that Mr. McNamara had announced his retirement as of mid-1981 and that he had mentioned China's change of representation as one of the major achievements of his tenure at the Bank.

Mr. Gu Mu said that, in meeting Mr. Husain on the eve of his departure, he wanted to express his appreciation of the Bank mission's work; he was ready to discuss remaining issues. Mr. Husain thanked the Vice Premier for the assistance his mission had received from the Chinese Government; he was overwhelmed by this excellent cooperation and the honor the Government had accorded to the mission in sharing important information with the Bank.

Mr. Husain said that the purpose of his mission was (i) to develop greater mutual acquaintance and to foster the dialogue between China and the Bank; (ii) to improve the Bank's understanding of the Chinese economy--the major issues and Government plans and priorities; (iii) to lay the foundation for future cooperation by agreeing on a small number of projects on which work could start immediately; and (iv) to agree on the organization of future cooperation and on a work program for the next 12 months. In concluding his mission, he was very satisfied on all these scores--although he realized that some important work remained to be done over the next week while Mr. Kirmani and his associates would still be in China.

With regard to developing mutual acquaintance, he was very satisfied with the extensive discussions which the mission had held with the various commissions and ministries of the State Council. As a result, the Bank was now much better informed about the programs, the management and organization and the planning process of these agencies; no foreign officials--he believed--had been given such ample access in the past. He would like to assure the Vice Premier that the Bank would properly handle the information obtained; the Bank's only purpose was to help the Chinese Government in its heroic task of development and modernization. He was deeply impressed with the competence and commitment of the officials he had met. The Bank staff was also fully committed to development; this devotion on both sides could enrich the future relationship.

As to the mission's objective of improving the Bank's understanding of the Chinese economy, he and his associates were impressed by the analysis of past economic trends, particularly with regard to the 10 years of Cultural Revolution, given by the officials of the various agencies. He now had a better understanding of the economic issues to be faced and the Government's programs for future modernization of China's economy. He believed that the Government was undertaking a very important task in trying to achieve a better balance between sectors, introduce greater efficiency, improve consumption standards, decentralize the economy and rely more on market forces. In April, the Vice Premier had told Mr. McNamara that the Government aimed at restructuring the economy by giving emphasis to agriculture, light industry, energy, transportation and education. The mission believed that these were the right priorities and that they provided an adequate and broad framework for Bank cooperation with China. The Bank's work program in member countries always took place in the framework of the country's development plans and financial needs; the Bank would further deepen its understanding of these issues through the economic mission whose terms of reference had been discussed with the Ministry of Finance, the State Planning Commission and other agencies, and which would visit China in the autumn. The purpose of Bank economic missions to member countries was threefold: (i) to enable the Bank to formulate its economic cooperation strategy for the country concerned, (ii) to provide a basis on which the Bank's Board could make its decisions on individual lending operations, and (iii) to enable a continued dialogue with government on important development issues. He was fully confident that the same spirit of mutual confidence and cooperation encountered on this mission would prevail also during the forthcoming economic mission.

In order not to wait for the results of the economic mission before embarking on initial work on lending operations, the mission had agreed with the respective Government commissions and ministries on a number of projects as candidates for early financing. He was grateful for the work done since April by the Ministry of Finance and the State Capital Construction Committee on selecting projects; the Construction Commission had handed the mission a list of 19 projects, mainly in energy, and transport and communications. In subsequent discussions with the Ministries of Education and Agriculture, certain additional project ideas emerged. He hoped that during the next 10 days Mr. Kirmani's team and their Chinese counterparts would be able to develop a thorough understanding of each other's methods of work. He would expect Mr. Kirmani to leave with an agreement on, say, five projects on which the Bank could start work immediately. These projects did not all have to be capital intensive; the Bank was very flexible in its methods of financing. Hopefully, these initial projects would cover the following four sectors: education, energy, transport and communications, and agriculture. It was entirely possible that an education project--with emphasis on improving the capacity of higher institutes of technical education--would be the first project to be financed by the Bank. However, these first five projects were only the beginning; before long, the Bank and the Chinese Government would be working on a rolling five-year lending program and he would like to suggest that, as soon as the work of the economic mission was concluded, his associates would begin work on such a lending program, reaching agreement with the Government on priorities and strategies. As the Bank filled its project pipeline and the program matured, he would expect that China and the Bank would work at any time on some 20-25 projects. In sum, the Bank

would in the near future work simultaneously on analyzing the Chinese economy and on the first five projects, and, as the economic work matured, the Bank would begin a broad dialogue with the Government on a five-year pipeline of projects.

Mr. Kirmani, who was one of the most experienced and best-known hydraulic engineers in the world, had reviewed the technical work carried out in some of the ministries. His initial view was that the quality of this work was very high. However, in the case of many member countries, governments benefitted from the expertise of consultants, either hired under Bank projects or brought in as part of Bank missions. He hoped that selectively and carefully this form of assistance could also be associated with the Bank's work on China. His mission had consulted with UNDP whose experience in working with the different ministries had been extremely good; the mission was told that UNDP had a small fund which was available for pre-investment work on projects to be financed by the Bank.

Mr. Husain said that he was aware that the Chinese Government was concerned about the composition of World Bank assistance to China in terms of IDA vs. IBRD resources; this matter had also been raised with Mr. McNamara in April. He was confident that China would look at its relationship with the Bank from a long-term perspective. Both the Vice Premier (Gu Mu) and Mr. Deng Xiaoping had mentioned to Mr. McNamara that China did not want to disturb the Bank's and China's relationship with other poor countries. Thus, one of the most delicate tasks for any World Bank President and Board would be to find ways of accommodating China with minimum disturbance of others. Few people would doubt that by the mid-80s or a few years later the Bank should become the largest single group providing development assistance to China. In his view, it was entirely possible that by the beginning of the seventh five-year plan China would be the single largest borrower of the Bank; but, in the process of getting to that point, certain compromises would be necessary because of the historic evolution of the Bank's relationship with its other member countries. A number of African and Asian countries had come to depend heavily on soft funds from the Bank. Thus, it was likely that, at least in the earlier years of the Bank's cooperation with China, the major part of Bank financing would be from IBRD; however, as new IDA agreements were negotiated, China's needs would of course have to be taken into account.

As to China's representation in the Bank's Board, Mr. Husain said that the process of increasing China's quota in the Fund and its subscription in the Bank was well in hand. On this matter, and on the matter of creating an additional seat, the Bank and the Fund were moving in parallel. In both institutions, recommendations would be submitted to the Boards by the second week of August. The resolutions would then be submitted to the Governors and it was expected that the Governors' votes on both issues would be obtained well before the Annual Meeting.

With regard to future channels of communication between China and the Bank, he understood that on general issues the Bank would work through the Ministry of Finance and on project matters with the State Capital Construction Commission and the Import and Export Commission. He would hope that the Bank would have direct access to the technical ministries on technical project issues. Further, it had been agreed that the economic mission would work with a broad range of institutions and hopefully in particular with the State Planning Commission and the Statistical Bureau.

Mr. Husain said that he would like to conclude by emphasizing the importance of China's appointing a high-level and suitable person to the position of China's Executive Director on the Bank Board. This would improve communications between the Bank and China--but this was only one aspect; the Fund and Bank were the leading international financial institutions and China's Executive Directors on their Boards would be the country's "eyes and ears" and would carry a great weight in international deliberations.

Vice Premier Gu Mu thanked Mr. Husain for his friendly and comprehensible presentation. He was satisfied with the understandings reached between his Government and the Bank; Mr. Husain's presentation had covered all issues. He was aware that the institutional framework of his Government needed simplification and that there were too many agencies; the existence of such a large number of agencies had complicated the work of the Bank mission because so many institutions had to be visited. Mr. Husain replied that his mission's task had not been complicated at all; in no other developing country had he encountered such good organization in government. Mr. Gu Mu said that the large number of ministries had one advantage, namely, that information on China's economy gathered from, say, ten different agencies helped in obtaining a more objective picture.

The Vice Premier said that, due to the fact that his Government still lacked experience in terms of working with the Bank, only very large projects, covering energy, and communications and transport, had been presented to Mr. Husain's mission initially. Education, agriculture and light industry had been omitted. China's efforts in developing energy, and communications and transport had not been as successful as expected; the Government was worried about this lack of progress and had therefore considered these sectors to be priority candidates for World Bank assistance. The fact that projects in these sectors took a long time to be completed and were very costly was another reason for seeking World Bank funds for their financing. In light of the discussions held by the Bank mission and after listening to Mr. Husain's explanations, he could accept Mr. Husain's ideas in this respect; i.e., it was entirely possible to include education, agriculture and light industry among the first group of projects to be presented to the Bank. It was in conformity with the spirit of China's adjustment program. He remembered that during his last visit Mr. Husain had enquired about the greatest difficulty confronted by China in carrying out its development program. He (Gu Mu) had replied that it was the lack of skilled personnel. Thus, it was important to develop human resources and to obtain Bank assistance for these programs.

The approach suggested by Mr. Husain had yet another advantage: China's education projects were at an advanced stage of preparation; therefore, there was not much further preparatory work required; whereas, for example, in the case of heavy industry, preparation of projects would require considerable time. He concluded that the approach suggested by Mr. Husain was more practical than the approach followed by the early project list presented to the Bank delegation. This morning Mr. Xie Beiyi had proposed six projects to the Bank; he hoped that Mr. Kirmani would be able to agree on these projects as a first step in the cooperation between China and the Bank. As to the longer term, the emphasis of Bank assistance should perhaps be on energy, and transport and communications, in order to help the Government carry out its next five-year plan.

As to future Bank missions, he would like to assure Mr. Husain that they were welcome and would receive the same cooperation which Mr. Husain's delegation had received.

The Vice Premier said that he had intended to ask Mr. Husain about the Bank's projections for a five-year Bank lending program, particularly with regard to the approximate volume of lending that China could expect to receive. China was a planned economy and the Government had to take into account the rough amounts to be obtained from the Bank in preparing its sixth and seventh five-year plans. However, Mr. Husain had already laid out a rough framework which coincided with what Mr. McNamara had indicated earlier in the year; i.e., by the mid-80s or by the time of the seventh five-year plan, China would become the Bank's single largest borrower. Mr. Husain interjected that he had said that China "should" become the single largest borrower. Mr. Gu Mu said that Mr. Husain's point on the project pipeline--namely, that eventually China and the Bank would at any time work on some 20-25 projects--gave him an indication of the volume of future lending. He remembered that Mr. McNamara had said that he wanted to return to China in 10 years' time because by then China would certainly have become the Bank's single largest borrower. This was the goal to work for. China was a country with a population of one billion, abundant resources and firm development policies. Its development would depend primarily on its own efforts, but it would not be insignificant for mankind as a whole if, through its assistance, the Bank could help in accelerating the country's economic development. China would take all possible steps to facilitate cooperation with the Bank.

Mr. Gu Mu said that he fully understood Mr. Husain's point on the delicate nature of the problem of finding the necessary financing for China; but he was confident that the Bank would find ways both to accommodate China and to continue its support of other developing countries. He understood that in the beginning China and the Bank might have to move more slowly but that by the mid-80s they would still reach the goal which both sides had in mind.

Referring to the time required to carry out future lending operations, the Vice Premier mentioned that during initial negotiations the Japanese had also pointed out that it usually took 14-24 months to arrive at a decision on a given project. The Chinese Government had then suggested ways of rationalizing this process. These efforts turned out to be successful and only eight months passed between initial negotiations and the signing of the final agreement. He hoped that the Bank and China could set a record in cooperating with high efficiency. Judging by the results of the cooperation of the last 12 days, he was confident that his Government's expectations could be met.

With regard to China's subscription increase in the Bank and the creation of an additional seat on the Bank Board, he was confident that these issues would be resolved soon with the help of China's friends in the Bank. His Government was presently trying to find a highly qualified person to represent China as Executive Director; he had promised the Finance Minister that he would personally do his best in helping in this process.

As to channels of communication, he agreed with the arrangements as outlined by Mr. Husain.

In sum, he was very satisfied with the results of Mr. Husain's mission and he hoped that the Bank and China would proceed jointly in the spirit of today's talks in order to master the difficult steps ahead. He hoped that Mr. McNamara would not wait for 10 years before he returned; rather, he should return in five years' time in order to see the results of the cooperation. As he had mentioned to Mr. McNamara, neither one of the two might then be in their present positions, but they could drink together and review the results.

With reference to Mr. Gu Mu's statement on the initial list of projects presented to the Bank, Mr. Husain emphasized that the 19 projects were good projects and that, in due course, the Bank would hope to be able to finance most of them. With regard to the five projects for early financing, this morning Messrs. Kirmani and Jaycox had extensive discussions with the Capital Construction Commission; he hoped that Mr. Kirmani would reach agreement before he left. As to the Vice Premier's desire to shorten the project fruition period, he could assure him that the Bank shared his aim; both sides should try to do their best. With respect to amounts of lending to China, he hoped that he would be able to be more specific when he returned to China next spring; this matter had not yet been considered by the Bank's Board. The State Planning Commission and the State Capital Construction Commission had indicated appropriate amounts which the Government expected to obtain; all he could say was that these amounts did not appear unrealistic. Mr. Gu Mu replied (laughingly) that he was satisfied with that answer. Finally, Mr. Husain said that the Bank would try to get its best people to work on China; to work on China would not only reflect a professional commitment but also a personal commitment of Bank staff. This was the spirit in which he and his associates approached their work.

Mr. Gu Mu said that he was glad to hear that the Bank would put its best people to work on China. He and his associates in Government shared the strong personal commitment to do their best in advancing China's development; but they needed help where they lacked experience. He concluded by saying that there was now a rule in China that officials could hold office only for three terms; therefore, in five years' time he and Mr. McNamara would celebrate while the young people, such as the head of the Bank's China Division, would have to do the work.

cc: Mr. Husain
Mr. Hasan
Mr. Jaycox
Mr. Kirmani
Mr. Lim
Mr. Kimura

CKW:ml

International Bank for Reconstruction and Development

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SecM80-614

FROM: Vice President and Secretary

August 6, 1980

MISSION TO CHINA

Statement by Mr. S. S. Husain

As requested at the meeting of the Executive Directors held on July 29, 1980, attached hereto is a copy of the shortened version of the oral statement made by Mr. Husain at that meeting.

Distribution:

Executive Directors and Alternates
President
President's Council
Vice Presidents, IFC

IBRD DIRECTORS' EXECUTIVE SESSION - JULY 29, 1980

[Mr. HUSAIN'S STATEMENT ON MISSION TO CHINA]

Excerpts from Verbatim Transcripts

Mr. Husain: Thank you, Mr. Chairman.

Soon after the Board approved the change of representation of China in the Bank, we had arranged with the Chinese authorities the Bank's first operational mission to China, which was led by me and included senior officials of the East Asia and Pacific Regional Office.

The purpose of the mission was five-fold. First, it was to develop and further the mutual acquaintance of the senior officials of the East Asia and Pacific Region and authorities in China.

Second, it was to evaluate the overall environment within which the relations between the Bank and China will be conducted.

Third, it was to make an assessment of the institutions in China concerned with economic development and formulation and implementation of projects.

Fourth, it was to initiate a dialogue with the Chinese authorities on a work program -- particularly on a work program for economic and sector work in China.

And lastly, it was to identify a small number of projects which could be suitable for financing by the Bank.

I will report on each of these issues.

The discussions between us and the Chinese authorities were far-reaching. We met two Vice Premiers, Mr. Zhao Ziyang, who is now in charge of most administrative matters of the Government, and Mr. Gu Mu, who is in charge of capital construction, i.e., the investment program as well as all operations concerning foreign borrowing.

Mr. Zhao Ziyang emphasized that his meeting us was to indicate his and the Government's broad support for China's policy towards the World Bank. The meetings with Chinese officials were very frank, and there was a complete sharing of information.

As to the environment, there are major and basic changes taking place in China, in terms of their impact on policies, institutions and the overall philosophy of the Government. They are perhaps the most far-reaching changes that have taken place in China since the Revolution of 1949.

These changes are the results of many issues but basically they stem from two factors: First, the evaluation by the Chinese of the results of ten years of the Cultural Revolution and the impact of that on the economy; but beyond that there is a reassessment of the entire development experience of China over the last 30 years. At this point, there is great disappointment in Government and among officials in policy-making positions with this development record.

Second, China's assessment of its international position and its relationship with the countries of the world.

The weaknesses which the Chinese see in their economic system at this point are many. According to the Chinese, the economic system — which has basically remained unchanged since the liberation and the ensuing transformation of the economy in the 1950s — has perhaps reached its logical limits; the weaknesses and shortcomings that they see are about three or four.

One is — in a country as large and as diverse as China — the excessive control and excessive day-to-day management of productive units, apart from agriculture, by the central state government and the provincial governments.

Second, a substantial — almost total isolation of the productive apparatus from the structure of demand and the absence of any meaningful prices which could govern the rationality of the decisions.

Third, a factor whose far-reaching consequences are becoming very serious for China has been the isolation of the country, which has led to a substantial lag in technology — particularly industrial technology. In science, and agricultural research and extension there are substantial lags in China.

And lastly, a factor which explains the great disparity between the rate of investment — running at around 33 percent in the last few years — and the slow growth in the consumption standards of the people, excessive reliance on heavy industry — exacerbated by the autarkic strategy of internal development which has prevailed since the late 1950s, i.e., a pattern of development under which most of the localities have to be self-sufficient in most goods. The initial extreme manifestations were the backyard steel mills and the backyard fertilizer factories.

The remedies that the Chinese are thinking of in the face of what they see as the prolonged stagnation of the Chinese economy are several:

First and foremost, they feel that the quick raising of the consumption standards of the people is a political and economic imperative.

The measures taken to achieve this are directed both at increasing production and at increasing consumption in the near term.

The measures that are addressed to increasing production are, first, relaxing the whole economic structure and the incentive structure of the economy.

As far as the incentive structure of the economy is concerned, there is a plan for industry -- at least for light industry - to decentralize the management base substantially, to sharpen the responsibility of local management, and to improve the level of performance of industry by giving a share of the profit to the enterprise, letting its management decide on the portions to be invested and to be distributed for the welfare of the laborer.

A certain amount of private enterprise is being introduced, particularly in the small service sectors, either in the form of cooperatives or small individual enterprises.

In agriculture, last year there was a significant increase in agricultural prices as an incentive for the improvement of agricultural production. There is also greater freedom now for the communes and the production teams to sell a part of the agricultural surplus in the free market, and amounts above the compulsory quota to be delivered to the state can be sold at prices about 50 percent higher than the quota prices.

Both in industry and in agriculture, there is an attempt to introduce an element of free market, and I will mention later what difficulties the Chinese might face in this.

These are one set of measures; another set of measures is the attempt to import foreign technology and capital; and third, to improve consumption standards, there is a deliberate attempt to reduce the rate of investment, which has been running at about 33 percent of the GNP; the plan is to bring the rate of investment down to about 25 percent of GNP in the next five years.

At the same time, as far as the overall pattern of investment is concerned, there is to be a shift from heavy industry towards sectors and projects of quicker gestation, where the final demand may be more in conformity with the proposed pattern of production: i.e., a shift towards light industries, consumer goods and agriculture.

There are some risks in this economic policy. The first risk stems from the fact that this is an attempt at the reversal of a 30-year old policy. It is difficult to imagine that in a country like China such a major and radical shift could go unchallenged. However, there is the fair chance that the leadership may be able to generate broad support among the population for this program, particularly if they are able to improve quickly the consumption standards of the people.

The second and more immediate risk is the difficulty that the Chinese Government may have in translating these broad objectives into very specific measures of policy. It will take quite some effort and time to develop the appropriate incentive system for changing the direction of investment. What happened about three years ago is an indication of the difficulty that the Chinese Government may face in translating objectives into specific plans. At that point, the Government decided that it wanted to undertake a massive program of investment with the help of foreign funds. China contracted about $27 billion in foreign funds for a variety of projects - steel mills, chemical plants and so on. However, when the Government started examining these projects and programs, they were found to be untenable. They were not untenable individually, but as a whole when added together; therefore, the Government has stopped those programs and has not drawn on the foreign credit facilities to any major extent. A comprehensive re-examination of the ambitious program was initiated.

We should not, however, underestimate the resolve of the Chinese authorities in proceeding with the new policies.

Next, I would like to give a brief view of Chinese economic institutions and management.

The institutions of management suffered very heavily during the Cultural Revolution for nearly ten years. Statistics were not collected. The Statistical Bureau was abolished. The Planning Commission was defunct. Many educated people, many heads of organizations, high-level technical people were sent out to work in farms. The institutions have been rebuilt since 1976, and the indications are that there has been a substantial rehabilitation of the institutions of economic management.

The officials we met, especially the higher managers in organizations and sectors as diverse as education, agriculture, industry, state planning commission, statistical bureau, were a very impressive and committed group. Our group included my Director of Projects and two of his Division Chiefs -- the Division Chiefs in charge of electric power and transport; they have had chance to review with these organizations, particularly in electric power, education, transport and agriculture, their investment programs and projects. They had a chance to visit some projects. We were favorably impressed with the institutions of economic management, particularly the institutions which design and implement projects.

We have worked on many countries and we find these Chinese institutions to be more advanced and more competent than the institutions in many countries.

There are three or four aspects which I might mention under which these organizations seem to us to be particularly competent.

One is the clarity of objectives and their ability to communicate these objectives to the various levels.

Second, as far as projects are concerned, the ability of these organizations to translate broader ideas into specific projects, particularly in areas such as power, ports and education.

Third, the effectiveness of coordination between institutions, particularly at senior levels.

And lastly, the well-developed project implementation machinery of these institutions. Every ministry has an elaborate planning system. Practically all ministries, as well as the central coordinating agencies have organizations for screening and evaluation of projects. Also, the construction force in the various organizations is very well organized.

There is indication of a lag of technology in civil engineering and in other areas, but, once we accept this shortcoming of technology available to China, we must conclude that the implementation of projects is effective.

At the moment the people who are in charge of running these organizations are those who were in charge in the early ´60s and later on were in exile in various parts of the country. What happens when the generation of the Cultural Revolution comes forward, one doesn´t know. Hopefully by then enough training programs and enough programs of reorientation would have been undertaken.

The State Planning Commission is now working on the sixth plan. The Statistical Bureau is engaged in reconstructing statistics. Things are reasonably functional now.

Let me now say what China expects of the Bank. The desire to join the Bank stems from what I mentioned before: an awareness on the part of China that future stages of growth will require very substantial cooperation with the outside world, both in terms of the import of capital as well as the import of technology.

In Mr. McNamara´s discussions on China´s membership in April and in my discussions now with the two Vice Premiers, we made a specific point of stating that China is not just another new member country which can be accommodated without much of a side effect. Clearly, China´s membership of the Bank is a major event and the entire dimensions will have to change.

We have said to the Chinese, first, that IDA VI was negotiated without taking into account the needs of China; and second, that accommodation of China will require major reconsideration by the Bank of the magnitudes within which the Bank operates.

The Chinese hope that in due course the Bank will be a very important source both of capital and technology for Chinese development. They are conscious that China does not want to get its share of Bank resources by disrupting the expectations of other countries and the relationship that exists between the Bank and those countries; but they do hope that the Bank will, within a reasonable period, find a way of adjusting so that China's needs can be taken into account.

The Chinese regard themselves as a poor country. Their own estimate of their per capita income is about $230. Some other outside estimates go as high as $400 in '79 prices.

Whatever the estimate taken within that range, China would under normal criteria be eligible for IDA. The Chinese are aware of this and they made a point of this.

We mentioned to the Chinese that we are not just a financial institution, that we are a development institution, and that we conduct our financial operations within the overall context of economic issues and economic priorities of a country, and that we would like to do the same in China; that before we present any operation to the Board, we would like to have a full view of the Chinese economy, Chinese institutions, their plans for the future, their economic policies, issues such as creditworthiness, issues such as capital requirements, and also that we would like to have a fairly detailed knowledge of the sectors in which our initial operations will be. We had discussions on the scope of this work, and the Chinese agree that this work should proceed. They are ready to receive an economic mission and sector missions on education, energy, and transport in the fall of this year. These are the sectors in which we expect our early operations in China.

The Chinese have presented to us a list of projects which appear to be well prepared; our intention is to select, say, about five projects to begin with, which could be processed for FY82 and FY83. There is a slim possibility that one of the projects might be ready in the very late FY81.

We have not indicated any amounts to the Chinese as to future Bank lending.

In sum, we have the basis for putting together a work program on China, for the early years; we have a basis for initiating project preparation work; and we do hope to submit a budget for our work in China to the Board within this month which hopefully can be discussed in September.

MR. McNAMARA: Thank you very much, Mr. Husain.

OFFICE MEMORANDUM

TO: FILES

DATE: JULY 29, 1980

FROM: Caio Koch-Weser

SUBJECT: Mr. Husain's Meeting with Vice Premier Zhao Ziyang, Beijing, July 16, 1980

1. On July 16, 1980, Mr. Husain met with Vice Premier Zhao Ziyang at the Great Hall of the People. The Vice Premier was accompanied by Messrs. Wu Bo (Minister of Finance), Wang Bingqian (Senior Vice Minister of Finance), Xie Beiyi (Vice Chairman of State Capital Construction Commission), Gan Ziyu (Vice Chairman of State Planning Commission), Li Peng (Vice Minister of Finance), Wang Liansheng, Fei Lizhi and Mrs. He Liliang (Deputy Director, International Department, Ministry of Foreign Affairs). Also present were Messrs. Jaycox, Kirmani, Beach, Carnemark, Lim and Koch-Weser. The meeting lasted for about one hour.

2. In introducing the meeting, the Vice Premier expressed his appreciation for Mr. McNamara's and Mr. Husain's contribution to bringing about the recent Board decision on the change of China's representation in the World Bank Group. Mr. Husain expressed his expectation that China's voting strength would soon be commensurate with its position among Bank member countries; Mr. McNamara was trying to get an early decision by the Bank's Governors on both the requested subscription increase and the additional Board seat for China.

3. Pointing to the fact that the Bank's relationship with China was only three months old, Mr. Husain said that his mission and the Chinese counterparts were already engaged in a detailed discussion of future modes of cooperation. In the last three days, he had been most impressed with the frankness and candor of these discussions; this constituted an important step towards establishing a relationship based on mutual confidence. The Government faced the great task of modernizing China; he hoped the Government and the Bank would be full partners in this endeavor.

4. Mr. Zhao Ziyang said that China was not an insignificant nation but a rather poor country; in its determination to modernize, the country could build on certain advantages such as abundant resources and a diligent population, but also had to face certain difficulties such as a very large population, lack of financial resources and a backward system of economic management. China's friends were right in criticizing the country's slow and inefficient bureaucracy; however, this was not a question of the personal style of Chinese officials but rather stemmed from the present system which had been copied from the Russians in the 1950s. His Government was determined to restructure the system. A beginning had been made two years ago and had yielded quick results. But these had been only preliminary and minor changes; restructuring would take a long period of time to accomplish. The Government was experimenting and applying the results; in other words, restructuring was being carried out in a step-by-step way, deepening and broadening the efforts in the process.

5. The over-all goal of restructuring was to integrate socialism with an open economy, based on commodity economy (or market economy); i.e., centralized economy was to be linked with market economy. Formerly, these two concepts were considered contradictory; but after decades of experience, the Chinese leadership had arrived at the conclusion that this viewpoint was not correct.

6. Two basic aspects were involved in restructuring:

(i) To enable enterprises and other productive units to have more independence vis-a-vis central and local government. Although their means of production were owned collectively, they could decide on their production plans and marketing of goods, and have their own cost accounting, i.e., be economically viable units to a certain degree. A program along these lines had been initiated over a year ago--but a larger area remained yet to be restructured.

(ii) To give full play to market forces in directing the production of enterprises. In the future, the centralized plan would not stipulate what enterprises should produce and sell; rather, the "law of value" would rule, i.e., demand and supply would set prices. Centralized planning would not be dispensed with altogether; but the State Plan would only set guidelines and not rigid economic targets which enterprises had to comply with. Thus, in the future the economic plan would be more flexible and focus more on macro-economic targets.

7. China had to tackle the problems of development and modernization on its own, relying mainly on domestic savings to raise the necessary funds. However, in addition the country would actively seek foreign financing; this was a major policy decision the Government had reached and would adhere to. In view of the fact that China had not used the large amounts of external credit facilities which had been made available, there had been some doubts abroad whether the country needed large amounts. China's policy had not changed. It was true that the Government had not utilized foreign credit over the last two years to the extent envisaged earlier. The main reason was that the country lacked experience as to how to make best use of foreign funds; a way had to be found of making the most effective use of these resources--which after all would have to be repaid. If no efficient use were made of external borrowing, China's creditworthiness would suffer. In sum, as the Government gained experience, it would make increasing use of foreign financing for development.

8. There was still another reason for China not making full use of external credit facilities. In the country's modernization drive, infrastructure--energy, transportation, communications, and urban construction--lagged behind badly. With the exception of coal and petroleum, infrastructure projects took a long time to construct and could not provide resources for repayment directly. Therefore, there was great need for loans on favorable terms from the World Bank and inter-government facilities for financing infrastructure development; such loans would enable the country then to use the commercial credit facilities for other development needs.

9. He concluded that the Government hoped to obtain World Bank financing for developing energy, transportation and communications, education and other sectors. Although China was a large country, its present contribution to mankind was quite insignificant. He hoped that the country's physiognomy would be changed by the year 2,000; China's contribution to mankind would then be greater.

10. Mr. Husain thanked the Vice Premier for his comprehensive account of China's program of restructuring the economy. These policies would have a great bearing on China's economy and its position by the end of the century. He hoped that these measures would liberate the energies of China's people. The Bank was not only a financial agency but also a development institution. The Bank had much to learn about China's economy and development programs, and it would do its best--as early as possible. In that, the Bank would need the fullest cooperation of the Government--the State Planning Commission, State Capital Construction Commission, Statistical Bureau and many ministries. As to China's need for foreign capital, he hoped that in due course China would become one of the largest borrowers of the Bank; however, this might take a little while because the Bank had first to understand better the country's economy and find ways to accommodate this large country in its over-all plans. China and the Bank shared the desire that China's proper place in the Bank be assured with minimum disruption caused to other countries.

11. In concluding the meeting, the Vice Premier expressed his expectation that all departments of the Government would fully cooperate with this and future Bank missions, supplying all necessary information. Towards the end of Mr. Husain's visit, Vice Premier Gu Mu would meet with the Bank delegation and answer remaining questions. He (Zhao Ziyang) had received Mr. Husain at this point in order to welcome him and to manifest the Government's support of the Bank's work. Finally, he asked Mr. Husain to convey his regards to Mr. McNamara and express the Government's appreciation for all he had done for the cooperation between the World Bank and China.

cc: Messrs. McNamara
Stern
Husain
Jaycox
Kirmani
Lim

CKoch-Weser:ml

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara
THROUGH: Mr. Ernest Stern
FROM: S. Shahid Husain

DATE July 27, 1980

CONFIDENTIAL

SUBJECT: CHINA - Mission Report and Recommendation

1. I led a mission [1/] to China from July 14 to 26, with the following purpose:

(a) to promote the mutual acquaintance of the higher level Chinese staff and the principal managers of the East Asia and Pacific Regional office;

(b) to evaluate the overall environment within which relations between China and the World Bank will be conducted;

(c) to make a preliminary assessment of the capacity of Chinese institutions to formulate and implement projects financed by the Bank;

(d) to agree with the Chinese authorities on a work program for FY81, particularly the scope and timing of initial economic and sector work; and

(e) to select projects on which work can begin now for financing in FY82 and FY83.

2. The Chinese authorities received the mission with great warmth and cooperated fully in enabling us to fulfill our objectives. The following is the report.

3. The Environment

China is undergoing the most far-reaching change in its economic philosophy, institutions and policies, and in its political and social premises since the 1949 revolution and the socialist transformation of the 1950s. The range and the depth of the changes in process reflect not only a rejection of the excesses of the Cultural Revolution but also disappointment over China's 30 years of development experience. A new interpretation is being given to Chinese socialism; there will be greater reliance on the market, greater decentralization of economic decision making, greater reliance on economic incentives and imported capital and technology.

1/ Comprising Messrs. Jaycox, Kirmani, Koch-Weser, Ed Lim (Senior Economist, China), Curt Carnemark (Transport Division Chief), Jack Beach (Energy Division Chief).

4. The ten years of the Cultural Revolution have been interpreted in various ways and it will be sometime before the full facts are known. To many it was yet another chapter of the Maoist theme of continuing revolution and perpetual class struggle. The institutions of government, party, industry, agricultural research and intellectual pursuit, which normally are the instruments of orderly change, were identified as instruments of bourgeois revivalism. For ten years a mass movement, sometimes violent and uncontrolled, raged all over China. The targets were institutions and their managers, intellectuals and almost anyone who did not make his living by physical labor alone. The theory gained ground that only mass action and only physical labor were the bases of progress and wisdom. Institutions bred privilege and privilege bred class structure. Hence, institutions must never be allowed to become stable and their continuity should be contested.

5. Another interpretation of the Cultural Revolution is that it was a prolonged struggle for succession to Mao. While in its early years the Cultural Revolution may have had a Maoist ideological origin, as the years progressed, ultra leftists, including Mao's wife, surrounded him and gained control of the movement and key sections of the Government. Party stalwarts such as Liu Shaoqi and Deng Xiaoping were disgraced and even Zhou Enlai, who retained his prestige and authority through the chaos, was often attacked. The "objective" was to wrest the control of China from leaders who had until the early sixties conducted the domestic economy on substantially pragmatic and moderate socialist lines.

6. The most significant aspect of our discussions in Beijing was the frankness with which Chinese officials, including Vice Premier Zhao Ziyang (expected soon to be nominated as Prime Minister), expounded on the country's economic and social shortcomings as well as achievements since liberation. We were told that there had been little increase in per capita consumption during the twenty years since 1957, although there were periodic improvements. The Chinese particularly emphasized the disruption caused by the Cultural Revolution. Agricultural growth slowed down and may have barely kept pace with population growth. While there was continued emphasis on heavy industry, a lot of the capacity created may have been redundant and uneconomic. Worst of all, because of the disruptions caused to the education system, an entire generation of young people were not properly educated. In many places schools and universities were closed. Where they were open, mass action and indiscipline were such that educational pursuits were difficult if not impossible. According to the Ministry of Education, for the first time since 1949 the rate of illiteracy increased and the Cultural Revolution bred a generation of adult illiterates. In terms of high level manpower, China "lost" about one million university graduates and about two million technical school graduates.

7. Chinese officials are ready to concede the existence of great regional disparities and substantial poverty in many parts of China. They

confirm what any casual tourist has seen in the cities, the existence of substantial unemployment and underemployment. They say that while they have succeeded in meeting the basic needs of the mass of the people, for many life holds no better promise. The highest organs of the Party and the Government recognize the need for raising the people's consumption standards quickly. These are seen as political as well as economic imperatives.

8. The commitment to improve China's economic performance is one aspect of the environment. Another is the geopolitical aspect. This was very much evident in Deng Xiaoping's exposition to you in April. The Chinese see Russia's strategic moves and advances as a fundamental element in the world scene in this last part of the 20th century. They feel that China's internal problems require a few decades of peace to resolve. They also feel that in the face of a deterioration of their relative strategic position they need to strengthen their domestic economy, achieve domestic consensus on economic and political questions and further their economic and political links with the Third World, the Western countries and Japan.

9. Economic Policy

The elements of policy which follow from the above considerations are as follows. First and foremost, there is a determined effort to restructure and modernize the economy. Chinese leaders, including Vice Premier Zhao Ziyang and Gu Mu, are frank about the inefficiencies of the Chinese economic system which has remained largely unchanged since the late fifties. They feel that these inefficiencies arise from: (a) excessive centralized control and planning; (b) inadequate use of prices as an instrument and insulation of production from demand; (c) isolation from foreign technology; and (d) an excessive concentration on heavy industry. Consequently, steps are being taken to delegate significant production and investment decisions to industrial and agricultural units, to create a free market for some consumer and producer goods and to introduce new monetary incentives for productivity. Many industrial enterprises are being transformed from direct state-managed units to substantially independent entities with full accountability of managers for their performance. A part of profit will be available to the enterprise for reinvestment without reference to the state and a proportion can be distributed as bonuses and welfare expenses for workers. A part of production will be available for sale in the "free market," i.e., to individuals or other producing units at mutually agreed prices. Producing units will be allowed to form joint ventures especially to establish linkages to markets and material supplies without the intermediary of the state. In agriculture, greater freedom is being given to production teams (the lowest collective units, comprising 10-15 families) to determine what they produce and how they distribute the benefits of production among the team members. To stimulate production, prices for compulsory sale of agricultural products to the state have been increased and quotas for these sales are fixed for

five years. Production teams will be able to sell any additional production in the "free market" or to the state at 50% above the quota price.

10. In all sectors of the economy there is evidence of a technological backwardness compared even to some developing countries. Through much of the last 30 years China has tried to pull itself up by its own bootstraps. While the results in many areas have been impressive, the isolation of China, and the destruction caused by the Cultural Revolution have left major gaps in technology, management and higher scientific education. There is evidence of a serious lag in agricultural research. The Chinese admit that many of the technical advances in industry during the last 30 years have bypassed China. Many institutions of higher technical education and research are badly in need of expertise, training and equipment.

11. In the circumstances, the Chinese leadership sees an expansion of financial and technological links with the outside world as an economic and political imperative. Such links are an integral part of their effort to modernize and restructure the economy, to improve consumption standards, and to deepen the technological base of the economy. Foreign technical and financial cooperation is also a complement to the Chinese efforts to broaden their political links in the face of what they consider as a significant strategic advance of their arch adversary, the Soviet bloc.

12. There is clearly great disappointment that economic results, especially in terms of the people's standard of living, of the last 30 years of development are not commensurate with the magnitude of the effort. There is concern that an orderly political process can endure only if the people experience a continuing improvement in the quality of their lives. Now two sets of measures are being taken to bring about a quick improvement in the standard of living. First is the greater emphasis on agriculture and light industry. Second, the Government is planning over the next five years to reduce the rate of investment from 33% to about 25%. During the last year there has been an across-the-board increase in urban and rural incomes, and in the shops the quantity and variety of consumer goods are greater than two years ago.

13. Risks of the New Economic Policy

There are fundamental risks in the course the Chinese are following. First, they are changing a 30-year old course of history and institutions. In China an entire ideology had evolved around mass action and moral and political mobilization for material production. These are being modified. Economic and material incentives for production are now considered to be needed, as are growing personal consumption and rapid improvement in higher education and research. Exclusive consideration on

the basics is no longer commensurate with the economic and geopolitical needs of the country. Foreigners and foreign ideas are expected to contribute to all aspects of national economic life — industry, agriculture, education, science, technology and infrastructure. Can this happen without adverse reaction? Have the ideologues of the last 30 years been converted and purged? We do not know and only time will tell. What we do know is that the Cultural Revolution led to considerable fatigue, suffering and disappointment among the people and accentuated the shortcomings of the system. We also know that the Chinese Communist party is an exceptionally efficient instrument of communication between the leadership and the masses. So, there is a chance that the leadership will carry the masses with it, particularly if there is a continuing and perceptible improvement in their living conditions.

14. A second risk is more serious in the near term. Will the Chinese be able to translate the new economic policies into concrete measures within a reasonable period of time and without generating undue friction and disruption within the system? The thinking on many key issues is still at an early stage. Planners and managers are unclear about how, and with what speed, market forces can be introduced into a rigid and over-managed system. Regions and provinces have hitherto developed on autarkic lines and there are signs of reluctance of local authorities and agencies to follow the new policies. The institutional framework for managing the new strategy — financial institutions, fiscal measures, economic laws and regulations, foreign trade and exchange mechanism — are not yet in place.

15. Finally, over-ambitious plans are another possible problem. The Chinese leadership realize that their initial plans and programs in 1977 and 1978 were over-ambitious and could have created serious distorttions in the economy. In early 1979, a policy of readjustment was introduced, setting more modest targets and aiming at a more balanced process of development. The haste with which the Chinese moved at first to obtain $27 billion worth of foreign credits in 1978 was a case in point. Later, this volume of borrowing and the investments associated with it were questioned and much of the loans remain unused. The Chinese officials are conscious of this risk and it is possible that for a while they will move to the other extreme of being excessively conservative in their plans and targets.

16. While identifying these issues, I do not wish to underestimate the commitment and the resolve of the Chinese to proceed with the change. Perhaps for the first time in modern Chinese history there is open and lively discussion and debate on economic targets and means of reaching these targets. We were highly impressed by the quality of Chinese economic managers and institutions. This issue I will analyze in the next section.

17. Institutions of Economic Management

We had detailed discussions with practically all central institutions of economic management. Although these contacts were brief, we have a fair assessment of the capacity of institutions.

18. Four features of China's development management were particularly striking:

(i) The clarity of overall objectives and policy and the effectiveness with which they are communicated to the grass-roots of the organizational structure;

(ii) The importance attached to detailed planning, particularly of projects and the capacity developed for this;

(iii) Effectiveness of the coordination machinery at the senior policy level — though ministries and agencies remain highly compartmentalized in their programs; and

(iv) The well-organized system of project implementation.

19. In making these observations we are not discounting the shortcomings of the system. However, the mission, which represented a pool of experience in many developing countries, is of the judgment that China's institutional capability to formulate and implement development programs and projects is more advanced than in most developing countries. Having said this, let me mention some of the weaknesses. The economic management apparatus suffered seriously from the disruptions of the Cultural Revolution. Comprehensive planning, already weakened by the reduced scope of statistical work after the Great Leap Forward of 1958/59, virtually ceased to exist during those ten years. Planning was reduced to the maintenance of annual balances in key commodities such as steel, coal and oil. Many planners were sent to work in rural areas. The central authorities lost control of the economy. Statistical work was virtually nonexistent.

20. Planning activities were revived in the early 1970s, but it was only after 1976 that comprehensive planning and statistical institutions were restored. Progress appears to have been rapid and an effective planning apparatus, supported by statistical and research organizations, is now substantially in place. Economic planning is the responsibility of a planning system extending from the State Planning Commission to planning commissions and bureaus at provincial and local levels. The system is supported by a parallel statistical system, now in the process of restoration and reconstruction. Planning is further supported by a number of research institutions, the largest being the Academy of Social Sciences. Its activities have expanded rapidly over the last few years.

21. A number of other commissions attached to the State Council and headed by Vice Premiers are also associated with economic management. Design and implementation of major projects are supervised and coordinated by the State Capital Construction Commission. An export-import and foreign investment commission plans and supervises the management of the balance of payments. A number of specific commissions supervise and coordinate activities in specific areas, such as agriculture and energy.

22. Each ministry and provincial government has its own planning bureau. In the context of the current state of technology in China, these organizations are experienced in the techniques of project formulation, design and implementation. However, in many areas the insulation of China from the outside world and technical progress has led to low level of technology, overdesign of projects and excessive use of resources compared to countries with more advanced technology. The Chinese are aware of this gap and are keen to import technology in important sectors of the economy.

23. We were highly impressed by the commitment and competence of senior members of the economic management team. Many of them have received their training in western countries in the 1930s and 1940s and in Eastern Europe in the 1950s. Below this top level, however, the capability of the Chinese officials is much less clear. This reflects the neglect of higher education and advanced training in China over the past 20 years and the consequence of the Cultural Revolution. Many of the top leaders are in their 60s and 70s and, in the coming years, economic management, as well as other aspects of the economy, may suffer from a shortage of competent personnel among the younger generation.

24. <u>China's View of the World Bank and its Expectations</u>

China's decision to seek representation in the Bank and Fund was one of fundamental economic and political significance. Politically, the Chinese view this act as yet another step in building bridges with the countries of the West and the Third World. Economically, the Chinese leaders view the relationship with the Bank as a major element in mobilizing financial and technical support for their program of modernization and restructuring.

25. I am gratified as well as sobered by the seriousness with which the Chinese regard us. Our meetings with Vice Premier Zhao Ziyang and Gu Mu and senior officials from a wide range of commissions and ministries were remarkable from three points of view. First, the Chinese leaders attached great symbolic significance to this first operational mission of the World Bank. Zhao Ziyang said that, although he was not directly in charge of external economic affairs, he met us precisely to make a show of support for the new relationship between China and the World Bank. He also used the occasion to reaffirm the direction of the new economic policy. An ample account of the meeting was publicized in the Chinese media. Second,

we were given full access to the organizations we had wanted to see, including top-level agencies of the State Council such as the State Planning Commission which had hitherto been closed to foreigners. These meetings were very well prepared with high level participation in all cases. Third, the Chinese officials were frank and candid in discussing the failures and shortcomings of the past and plans for the future. We have been able to build up substantial individual contacts in various organizations.

26. The Chinese authorities attach great importance to an early start of Bank group lending. Soon after arrival, we were presented with a list of 19 projects requiring external financing of about $6.0 billion during 1981-85. We have had detailed discussions with various organizations to see if five projects could be selected for Board presentation in FY82 and the first half of FY83. It is clear that there should be no difficulty in finding well-prepared projects suitable for Bank financing.

27. We went to considerable pains to explain to the Chinese that the Bank was not just a financial institution and that it was a broad based development institution which financed projects only in the context of a broad analysis and view of economic issues and priorities. We explained the need for economic and sector work as well as the fact that we would make heavy demands on them for data and analyses. We discussed in detail the plan for economic and sector work, including specific issues to be reviewed. We further stressed that the ultimate Bank assistance strategy and the pipeline of projects will flow from this work. The Chinese authorities accept this approach and have agreed with our economic and sector work program. They are making preparations for the economic and sector missions in the fall of 1980, including organizing counterpart teams to work with the missions, and have already been given a detailed scope of work and statistical questionnaire. The Chinese officials see this not simply as a basis of decisions within the Bank, but also as an instrument for a dialogue with an objective external agency on their own economic issues.

28. We were pressed by Gu Mu and other senior officials to indicate the size of the future lending program of Bank and IDA. We indicated our inability to do this now. But, clearly, before long, we will have to discuss with them the broad orders of magnitude they and we should keep in view. The Chinese authorities fully regard China as obviously eligible for IDA credits. Time and again they point out that China is a poor country, with major issues of poverty and development and, therefore, should receive an appropriate share of IDA. I have suggested that, as is usual with them, they should take a long view of things. I have repeated that IDA VI has been negotiated without China's needs in view and that it may be difficult to provide any significant amount of IDA for China during the sixth replenishment period. I also suggested that it would be undesirable that China's entry to the World Bank group should cause any major disturbance to the expectations of, and assistance to, other nations, particularly the poorest countries.

While reiterating their needs, the Chinese authorities fully share this point of view.

29. The Chinese expect that our assistance and cooperation should be an important vehicle for the import of technology. We have explained in detail the Bank's project procedures, particularly issues such as international competitive bidding. As Bank policies and procedures are explained to them, Chinese officials are quick to appreciate that they are also useful for China. The Chinese, however, are keen that the three-year Bank project cycle should be shortened and I have suggested that we should both work towards this.

30. In sum, China expects the World Bank group to be a major source of capital, if not the major source of capital,and perhaps also of technical assistance. It understands that the Bank will want to conduct its operations within a broader context of economic and sector work and is willing to co-operate in this. China regards itself as fully eligible for IDA. The Chinese authorities, however, recognize that it may take a little while before China obtains its due share of Bank and IDA resources.

31. The Bank's Response

China is a poor country; estimates of per capita GNP range from $230 to $400. It is committed to far-reaching policies and programs to modernize its economies and to improve its people's standard of living. It has made a decision to seek our assistance in its development effort and can utilize this assistance effectively. The Bank, therefore, has an obligation to find ways to accommodate China's needs within its overall operation.

32. The following issues will have a bearing on how we organize a response to China's developmental needs:

(a) Despite the warmth of the first contact between the Bank and China, we have a long way to go in developing full acquaintance of each other. In a country as large and complex as China, the Bank has substantial work ahead in learning about the various aspects of the Chinese economy and administration;

(b) It is entirely possible that there are differences of view within the Chinese government on opening relations with international financial organizations. An early initiation of Bank group lending will be important in establishing our relevance;

(c) Whatever the Bank's response, it will be small in relation to the Chinese dimensions and particular care should be taken to ensure the effectiveness and efficiency of the Bank's assistance;

(d) Any suitable response to China's needs will be a significant addition to the Bank group's lending and cannot be accommodated within the present plans. The issue of additionality to overall Bank lending will have to be faced squarely;

(e) Whatever China's per capita GNP, it will be well within the range of IDA eligibility. At least a modest amount of IDA lending should be included even in the initial years of lending.

33. With these considerations in view, I would propose that we proceed as follows. We now plan to send an economic mission during the fall. It will particularly focus on the economic system, the current developmental issues and priorities, creditworthiness and capital requirements. It will also cover in some depth the sectors in which we expect to initiate our operations. Simultaneously, we should begin preparation and processing of five projects, three for FY82 and two for the first half of FY83. On the first review of projects proposed by the Chinese, these will probably be in education, electric power, transport and agriculture. Possibly one of the FY82 projects, an education project, could be advanced to the last quarter of FY81. In May 1981, following completion of the economic report, we shall present a CPP for review by the President. Thereafter, a lending program will be reviewed with the Chinese and work will proceed on projects for the second half of FY83 and later years. This is a gradual approach and is commensurate with our capabilities and those of the Chinese.

34. I would suggest the following progression of lending as an initial hypothesis:

	FY82	FY83	FY84	FY85	FY86
	($million)				
Bank	350	650	900	1,250	1,650
IDA	150	350	850	1,250	1,600
Total	500	1,000	1,750	2,500	3,250

This progression of lending would make minimum demands on IDA in the initial years and would make use of the existing creditworthiness of China. As IDA VII is negotiated, China's needs will have to be taken into account.

35. To sum up, I propose that we proceed with:

(a) the economic and sector work scheduled for this fiscal year;

(b) the preparation of five projects with a view to lending in FY82 and FY83, and recognizing that possibly one project could be advanced to FY81;

(c) the preparation of a comprehensive CPP for the President's review in May 1981; and

(d) the preparation and submission to the Executive Directors a supplementary budget, for approval in the first week of September.

cc: Messrs. Ernest Stern
Jaycox
Kirmani
Koch-Weser
Lim

SSHusain:bce

Record Removal Notice

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File Title	Barcode No.
Country Files: China - Correspondence 01	1774657

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April 15, 1980	Minutes	

Correspondents / Participants
Office of the President

Subject / Title
Meeting with Premier Deng Xiaoping, Beijing, April 15, 1980

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April 13, 1980	Minutes	

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Subject / Title
Meeting with Premier Gu Mu, Beijing, April 13, 1980

Exception(s)
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Withdrawn by	Date
Shiri Alon	March 17, 2017

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Briefing note for Mr. McNamara Prepared in March 1980

OPERATIONS STRATEGY

I. Introduction

For the first time in its history, the PRC is making a major effort to become an active member of the world development community. During the early years of the PRC, Chinese development was largely based on the Soviet model and used Soviet technology. But political differences, and evidence that the Soviet model was not suited to Chinese conditions, soon led to a violent rejection of Soviet influence and a decision to pursue development in China in isolation from the rest of the world. For almost two decades since the late 1950s therefore, China has isolated itself from the rest of the development community: virtually no data have been released on the economy; few visitors have been allowed in China and even fewer Chinese travelled abroad; technological exchange was kept to the minimum; and external trade was pursued mainly to relieve temporary domestic supply shortages.

Both in terms of growth and equity, the achievements of this development effort have been considerable and, especially over the past decade, the Chinese experience has gained much attention among developing countries as a possible development model. Features of the Chinese experience in areas such as rural development and human resource development are today emulated by many developing countries.

Ironically, as the Chinese development model - or, more frequently, an idealized version thereof - began to capture the attention of the world development community, evidence was growing within China of only a moderate increase in the people's standard of living, despite rapid growth; of technological backwardness even relative to other developing countries; and of disproportionate growth among different sectors of the economy. Extremist policies pursued intermittently since the mid-1960s further exacerbated economic problems caused by inherent deficiencies of the planning and management system and by the economy's isolation from technological advance in the rest of the world.

Thus, since the early 1970s, China's attitude towards foreign technology, external trade and alternative approaches to development organization began to change. Its policy since 1976 has been especially unambiguous. The import of foreign science, technology and equipment will be an important component of China's future development effort. To finance its vastly increased import program, exports will be developed and, if necessary, foreign borrowing will be pursued. To increase the efficiency of the economic system, planning and management will be reformed based on lessons learned from China's own experience, as well as the experience of Eastern European, Western and other developing countries.

II. Objectives of Bank Operations

It is clearly in the context of this fundamental change in development strategy that China is seeking to establish relations with the IMF and the Bank Group. The objective of initial Bank operations in China must therefore be to (a) facilitate China's re-entry into the world development community; (b) assist Chinese officials in selecting and absorbing available technology from the wide range of Bank member countries; (c) provide technical assistance in investment planning and management in key infrastructure sectors; and (d) assist China to gain access to concessionary development capital, including the Bank Group's own resources.

To facilitate China's re-entry into the world development community, the Bank and the Fund can assist the Chinese authorities in increasing their understanding of the international economic and monetary systems, and in seeking ways to exploit the country's comparative advantage in an international context. China can also benefit from the Bank's development experience in its wide range of member countries. The Bank's initial economic and sector work in China, on the other hand, should aim at an understanding of China's economic system and development priorities, both to support the initiation of lending operations and to broaden the Bank's own understanding of development issues. This exchange of development experience should be the first step towards a dialogue with China on the country's development issues.

Most Chinese officials and managers have had little or no experience in importing and absorbing foreign technology and equipment. Their lack of knowledge and experience has, in the last few years, reportedly resulted in the purchase of obsolete equipment and technology inappropriate to Chinese conditions; disputes have arisen with foreign suppliers because of incorrect or ambiguous technical specifications. The Bank can assist Chinese officials not only in overcoming these problems, but also in widening their knowledge of available technological options.

In the initial stage of Bank operation, there will probably be little possibility of the Bank offering advice on general development issues. China, however, is faced with difficult planning and management problems in key infrastructure sectors. In transport, for instance, inappropriate investment planning, and lack of inter-modal coordination have apparently caused serious bottlenecks in the system. In power, obsolete equipment, inadequate fuel sources, and a lack of coordination between investments in generation and transmission have combined to make the inadequate supply of electric power a key constraint to industrial development. The Bank has had broad experience over many years in these sectors, and a major component of Bank operations should be technical assistance in planning and management, in the economic analysis of infrastructural investment, and in institution building in these sectors.

A final objective of Bank operations in China should be, to the extent that Bank resources and the competing claims of other countries permit, to transfer its own resources on concessionary terms and to assist China in obtaining development capital fromother sources. Although China's national savings rate - at probably over 30% of GNP - is among the highest in developing countries, the country, in its effort to modernize the economy, will face in the coming years large and probably growing balance of payments current account deficits. Concessionary assistance will be needed to cover these deficits and keep external debt servicing within a reasonable limit. (See briefs on "Creditworthiness" and "IDA Eligibility.") The amount of resources the Bank Group can provide will inevitably be small compared to the country's needs, but the Bank can play an important role, through its economic reporting, policy dialogue and co-financing, in helping China to gain access to other sources of concessionary development capital. Participation by the Bank and the Fund in China's development may also improve China's access to commercial capital, although at present China has offers for more commercial capital than the country can reasonably service. In fact, China has already

obtained commitments of Exim Bank-type credits amounting to some $16 billion, with interest rates between 7.25% and 7.50%. The Government has been reluctant to draw on these credits and will obviously be looking for softer terms from the Bank Group.

III. Alternative Approaches to Lending Operations

The vast size of China and the complexity of its development problems offer a challenge as well as enormous opportunities for the Bank Group. Indeed, quite apart from the uniqueness of its size, the current development problems of China are different from those of most Bank member countries. In areas such as rural development, small-scale industries, health, primary education and family planning, which usually represent the most intractable problems in developing countries, Chinese achievements have been very impressive. On the other hand, development of the Chinese economy is now seriously constrained by bottlenecks in sectors such as power, mining and transport where Bank assistance has recently become less important for most countries. In China, although a large industrial base has been created, industries suffer from backward technology, inefficient use of energy and raw materials, and weak management. Thus, although the country's development strategy calls for renewed emphasis on the agricultural sector, foreign capital and technology are most urgently needed for large-scale industry and traditional infrastructure.

Concentration of Project Lending in Infrastructure and Large-scale Industry

A quick build-up of Bank lending operations can be achieved by concentrating initial efforts on project lending in power, transport, communications and large-scale industries. Projects large enough to permit a reasonable contribution of resources should be available. China's current Ten-Year Plan (1976-85) centers on 120 large-scale projects, including 10 iron and steel complexes, 9 nonferrous metal complexes, 8 coal mines, 10 oil and gas fields, 30 power stations, 6 new trunk railways and 5 key harbors. Available information on some of these projects and China's investment program in infrastructure and industry is summarized in Annex A to give an idea of the types and scale of projects involved.

It is likely that, once the membership issue has been resolved, the Chinese authorities will seek Bank Group financing for some of these projects. In the first development assistance credit offered to China from any source since 1960, the Japanese government in December 1979 agreed to finance the construction of a new wharf and extension of the coal terminal in Qinhuangdao port, and extension of the deep water wharf in Shijiusuo port (both in northern China); a new electrified double railway line from Beijing to Quinhuangdao to facilitate the export of coal; a 300-km railway line between Yanzhou and Shijiusuo port (also for coal shipments); a railway line parallel to an existing line in the South; and a flood control, navigation and hydro-power project in central China, with a generating capacity of 1.5 million kilowatts. The concentration of Bank operations in similar projects, at least until its understanding of more complex sectors improves, would be consistent with the Bank's comparative advantage and with the country's development needs.

Sector Lending in Infrastructure and Industry

Project lending that involves the technical appraisal of specific investment proposals is not, however, an efficient way to use Bank manpower and resources in a country of China's size. Although project lending could provide a vehicle for Bank assistance in project preparations, economic analysis, and international procurement, the impact of such assistance would be much broader through sector lending. Moreover, assistance to the Chinese authorities seems necessary for strengthening their capability to plan and manage sector investment programs, for developing techniques of project appraisal and for improving technical and financial management. This assistance can be best provided through sector lending. A government priority in the coming years is to modernize the mining and manufacturing industries. Since technical appraisal of individual plants and mines by Bank staff would be impossible, an alternative for Bank assistance would be, for interim, an industrial sector modernization loan aimed at developing investment appraisal criteria for government agencies in these sectors, as well as at improving the agencies' procedures for selecting and procuring foreign technology and equipment. Sector lending in industry and infrastructure would thus maximize the development impact of Bank manpower and financial resources which, at least in the early years of our relations with China, must be very limited relative to the country's needs, if the Bank's ongoing operations in other countries are not to be disrupted.

There are, however, higher risks in sector lending. The Bank's understanding of sectoral problems and the sector's management capability will be very limited during its initial operations in a sector. It may take time to understand how the sector is organized. In the early stages of Bank relations with China, the Government may be sensitive about the in-depth sector review needed to prepare for sector lending (although in sectors such as power, transport and communications, such a review is necessary even for project lending, to ensure that the proposed investment is economically and technically justified).

Lending in Other Sectors

Concentration of the Bank's initial efforts in industry and infrastructure is justified in view of the Bank's comparative advantage and the need to rapidly build up the Bank's program in the country, in order to demonstrate its willingness and ability to assist the Government's development effort. This may, however, impede the development of a broad-based relationship between the Bank and China, and it will be important, from the outset, to attempt to identify projects in other areas, even though these projects may take longer to prepare.

Agriculture is the Government's priority sector. Some massive investment projects are under consideration, such as the project to divert water from the Yangtze River to irrigate water shortage areas of North China, but feasibility studies will still take many years to complete. Possible areas for Bank project lending in the near future include construction of secondary systems in existing irrigation works, the development of groundwater

irrigation, and agricultural research, which has now been given a renewed emphasis after its disastrous neglect during the Cultural Revolution (1966-76). The Bank for Agriculture was recently reinstated and may be a possible vehicle for Bank assistance to agriculture.

The integrated development of agriculture, industry and social services in the rural sector has been one of the most impressive achievements of the Chinese development experience. An important feature of the Chinese rural development strategy has been self-reliance, but a consequence of this policy has been growing regional inequality and persistent poverty in some resource-poor areas. The Government has recently decided to allocate more central government resources to these areas and may seek external assistance for this purpose.

Despite commendable progress in many areas of education, the development of higher-level manpower has been relatively neglected, especially since the mid-1960s. The Government is now attempting to compensate for past neglect by sending a large number of Chinese students and technicians abroad for training. At the same time, technical education facilities will have to be rapidly expanded if the technical manpower requirement of the modernization program is to be met. The Bank could make an important contribution to this effort, through technical assistance and the provision of funds for training facilities and equipment, and for training abroad.

Since media reports on the Chinese investment program have mainly been limited to large industrial and infrastructure projects, it is difficult, at this point, to speculate on possible Bank projects in these other sectors. A review of the Government's investment program in those sectors should therefore be a major objective of the Bank's economic and sector work.

Program Lending

There is no justification for program lending in the early stages of the Bank's relationship with China. Indeed, a premature attempt to initiate a policy dialogue on broad economic issues may prove to be counter-productive.

IV. Lending Strategy

A first step in formulating an operational strategy in China should obviously be to seek the Chinese authorities' view on the role of the Bank in China and the type of assistance they wish to have. This should be done at the earliest opportunity. Given the centralized nature of the Chinese Government, this view should be sought from the highest government authorities.

The Chinese authorities have reportedly been studying the issue of Bank-Fund membership for some time, and some staff of the Bank of China, in particular, probably have a reasonable understanding of the Bank and Fund. Nonetheless, it will be important in our initial dialogue with the Chinese

authorities to emphasize the wide range of possibilities for cooperation between the Bank and China, and to explain the broad program of assistance that the Bank Group could provide to the Government.

Initial operations of the Bank Group should be concentrated in the infrastructure and industrial sectors where the needs for foreign capital and technology are most urgently needed. The Chinese authorities will probably seek assistance mainly for the large projects contained in China's current Ten-Year Plan (1976-85). Because of serious structural imbalances and inefficiencies in the economy, the Government has begun a process of "readjustment, restructuring, consolidation and improvement" during the three-year period 1979-81, and the bulk of the program for the construction of new capacity and modernization of existing capacity will have to de delayed until the mid-and later 1980's. Thus the Bank Group can play an important role in the implementation of the Ten-Year Plan.

While the availability of large-scale, high priority projects permits a rapid build-up of the Bank's operations, selective sector lending should be attempted as soon as possible. The concept and advantages of sector lending should be explained to the Chinese authorities at the earliest opportunity, and, where appropriate, sector work should aim towards this type of lending. On the basis of the limited information available, sector lending at an early date might be possible in railways (reportedly one of the best managed sectors in China), industrial modernization and technical upgrading (where technical appraisal of individual projects would require extensive staff-time), and electric power. In all sectors, the Bank should try to move to sector lending as soon as possible.

China's creditworthiness and eligibility for IDA borrowing are reviewed in separate briefs. Their conclusion is that, by virtually all criteria currently applied by the Bank Group in determining Bank/IDA borrowing, China seems eligible to be the Group's largest borrower. The Bank Group should aim to achieve annual operations in China of about $3,000 million by the mid-1980s. Creditworthiness, poverty and performance considerations would argue for a blend of IBRD and IDA funds.

Possible FY82-83 Lending Program

Assuming that, before the end of 1980, the membership issue is resolved and agreement reached to begin operations, the Bank Group should plan to complete its first operation by FY82. For the IDA-6 period of FY81-83, an appropriate lending target would be $2,000 million, comprising, six operations. . A reasonable blend will be $1,000 million of IDA and $500 million of Bank funds.

The program might comprise 6 operations of $250 million each. Since an objective is to build up a much larger program in the future, the 6 operations should preferably be in different sectors and might comprise project or sector lending in:

Power
Railways
Ports
Industrial modernization
Agriculture/irrigation
Technical education

Organizational Implications

Even though the membership issue will probably not be resolved until the 1980 Annual Meeting, work will need to be initiated even earlier in order to complete the first operations by FY82. To plan and organize this work, a small office, attached either to the East Asia and Pacific RVP or Program Director's office, should be established as soon as feasible. By the beginning of FY81, the office should have a minimum staff of three general/sector economists and one operational officer. The main tasks of this office during FY80 will be to review the operational and budgetary implications of China's membership in the Bank Group, and to organize and initiate an economic and sector work program to support the proposed operations.

V. Economic and Sector Work Program

In planning an economic and sector work program for China, it should be noted that extensive literature exists on the Chinese economy and considerable research is in progress in many academic and government research institutions. The aim of the Bank's economic work should not be to duplicate work already done or in progress, but to gain institutional knowledge, partly through studies already completed, and to undertake work necessary to support the Bank's operations. The following is a proposed work program beginning in May 1980.

May - September 1980

The first objective of the economic and work program should be to absorb the considerable knowledge that already exists of the Chinese economy. This can be achieved through a series of desk studies on the following topics:

(a) Economic and planning systems and direction of reforms currently being considered

(b) Emerging development issues and the Government's development program

(c) Infrastructure, especially bottlenecks in power and transport

(d) Industry - problems of growth and modernization

(e) Agriculture and rural development

(f) Manpower development, especially technical education

(g) Balance of payments prospects, external capital requirements and creditworthiness.

Although these desk studies should be managed by Bank staff, a large consultant's input will be necessary to draw on all existing knowledge outside China.

October - December 1980

An economic mission with basically the same terms of reference as for desk studies described above. The purpose will be to further the work of the desk study through field visits and discussions with Government officials. The mission will include specialists in all major sectors and several visits by small teams may be preferable to one visit by a large team.

The mission should aim to produce an introductory but comprehensive economic report on China by early 1981.

January - April 1981

Project identification missions to follow up on sector work undertaken as part of economic missions.

April - June 1981

CPP on China to be prepared on the basis of the findings of the economic and project identification missions.

Manpower Implications

Manpower for work during the remainder of FY80 will need to be allocated from other assignments, although a budgetary allocation of $10,000-20,000 will facilitate the initiation of desk studies by consultants. Manpower required in FY81 to achieve the above program is estimated as follows:

	Man-weeks
Desk studies of selected sectors and issues (staff and consultants)	150
Oct/Dec 1980 economic mission (total of 20 persons, probably divided into three visits, 15 man-weeks per person including preparation and report writing)	300
Jan-April 1981, follow-up sector/project identification missions in sectors agreed with Government to be focus of initial operations	150
April-June 1981, CPP preparation and other follow-up economic work	100
	700 man-weeks

MAJOR PROJECTS IN CHINA'S TEN-YEAR PLAN (1976-85)

The Ten-Year Plan centers on 120 large-scale projects including 10 iron and steel complexes, 9 nonferrous metals complexes, 8 coal mines, 10 oil and gas fields, 30 power stations, 6 new trunk railways, and 5 key harbors. The original plan called for expansion or completion of these projects by 1985. As a result of the recent economic reassessment, many of the projects will probably be stretched out into the late 1980s or the 1990s. So far about half of the 120 projects have been identified in the Chinese press, and are summarized in the following sections.

Electric Power

To achieve the industrial targets of the ten-year plan, China will probably need to add at least 4,000 MW of power generating capacity a year between now and 1985. Of the 30 major power stations planned to be built by 1985, 10 were to be hydroelectric. One major plant - the Gongzui hydropower station in Sichuan Province - has been completed. This 750 MW plant is the biggest power station in southwest China.

Construction has begun on several large hydropower projects: the station with a planned capacity of 2,700 MW on the middle reaches of the Changjiang (Yangtze) River, the largest construction project in China; the 1,600 MW Longyangxia station on the upper reaches of the Huanghe (Yellow) River; and the 900 MW Baishan power station on the Songhua River in the northeast. China has discussed with foreign firms, including those from the United States, Canada, France, Norway, Sweden and Japan, the possibility of participating in the Changjiang and Huanghe projects. Other hydropower projects under construction include the 800 MW Ankang station on the upper reaches of the Han River, the 630 MW Wujiangdu station in Guizhou Province, the 400 MW Dahua station in the Guangxi Zhuang Autonomous Region, and the 255 MW Xierhe station in Yunnan Province. Recently, construction also has started on the Dongjiang station in Yunnan Province and the Wanan station in Jiangxi Province.

Also under construction are several thermal power plants, most to be coal-fired. To reduce the pressure on rail transport, China has adopted the policy of building some new thermal plants close to coal mines. Construction of two mine-mouth power stations is underway on the outskirts of the coal mining city of Datong in Shanxi Province. The Shentou Thermal Power Plant with a generating capacity of 300 MW is near completion, while construction of the 1,200 MW Datong No. 2 Power Plant has just begun. Construction has also started on the Shiliquan Plant at the new Yanzhou coal base in Shandong Province, and plans are being made for building three large power plants in the vicinity of the Huolinhe Coal Mine in western Jilin Province.

China appears to have decided to start developing its nuclear power industry. Discussions were held with the French regarding the possibility of buying two 900 MW nuclear power plants.

Coal

The PRC plans to produce over 1 billion tons of coal by 1987, or more than 400 million tons above the present level. China hopes that the production increments will come partly from increased mechanization of existing large mines and partly from the eight coal bases to be established under the current plan.

The new capacity created by the eight bases will amount to about 100 million tons. At five of these bases - Datong in Shanxi Province, Kailuan in Hebei, Xuzhou in Jianqsu, Lianghuai in Anhui, and Liupanshui in the Wumeng mountain areas in Guizhou - new mines will be constructed in existing large coal fields. The other three bases will be new. Under construction are the Yanzhou coal base in southwestern Shandong and the Huolinhe Coal Mine, an open-pit mining complex of 20 million tons capacity in western Jilin. The latter, designed by West German firms, will be completely outfitted with imported equipment. Another 20 million-ton open-pit mine is planned for Yiminhe in Heilongjiang.

Oil

China is still searching for 10 new oilfields. While primary attention is being directed toward offshore deposits in the Bohai Gulf, the Yellow Sea, and the South China Sea, exploration of onshore deposits is underway in Nei Monggal, Jiangsu, Guizhou, Guangxi, Shaanxi, Shanxi, Ningxia and Xinjiang. The prospect for southern Xinjiang appears especially promising. Among the new oilfields, the Renqui oilfield on the central Hebei plain is reportedly developing into a major center.

Negotiations are continuing with foreign firms for the joint development of offshore petroleum resources and of the South Xinjiang oilfield. Last March, British Petroleum announced that it had contracted with Chinese Petroleum Corporation (CPC) to undertake a seismic survey in the southern part of the Yellow Sea. The CPC also has signed letters of intent and contracts with a number of American oil companies for exploration in the South China Sea.

Petrochemicals

China is building several petrochemical complexes including those in Jilin, Sichuan, Tianjin, Shanghai, Guangzhou, and Anqing. The city of Cangzhou in Hebei, near the Renqui oilfield, is rapidly becoming another petrochemical center. Under construction also are several oil refineries, including those with a capacity of 2.5 million tons each in Shijiazhuang, Hebei, and Zhenhai, Zhejiang.

Two large synthetic fiber complexes containing plants imported from West Germany and Japan are under construction in Shanghai and Nanjing with a combined capacity of 800,000 tons a year. In addition, two Japanese polyester fiber plants with an annual capacity of 60,000 and 81,000 tons, respectively,

are nearing completion in Beijing and Tianjin and a 66,000 ton French plant at Liaoyang in Liaoning Province is scheduled to begin operations next year. By 1985, chemical fiber production in China will probably match the current level of Japan.

Steel

As part of its Ten-Year Plan China announced the ambitious goal of producing 60 million tons of steel annually by 1985 (compared to 32 million tons in 1978). It has now become apparent that some Chinese leaders are skeptical about the steel plan, and that the 1985 target has been reduced to 40-50 million tons. The reduced target will still require a substantial expansion of the steel industry.

The original plan called for the creation of two or three new steel complexes. Construction has begun for the Baoshan complex near Shanghai, which will eventually be capable of producing 6 million tons of crude steel. Major plants for the complex are to be imported from Japan and possibly elsewhere. Although plant contracts signed with Nippon Steel last December have been suspended, construction work for the complex is continuing. Plans for a 10 million ton integrated steelworks in eastern Hebei, however, will probably be delayed indefinitely.

Nonferrous Metals

China is grossly deficient in nonferrous metals production, and has become more reliant on imports to meet industrial growth requirements. Yet the country is endowed with large deposits of such minerals. The establishment of nine nonferrous metals complexes should enable China to become self-sufficient in certain of these metals. Further, Chinese planners envisage nonferrous metals as a major source of export income for China, and are interested in making compensation trade arrangements with foreign firms for the development of China's nonferrous metals production.

At least two nonferrous metals complexes will be situated in Guangxi Zhuang Autonomous Region: an aluminum ore mine in Pingguo county and a tin mine in the northwestern part of the region. The first phase of a mining and ore-dressing project for the tin mine has been completed, and construction of the second phase is underway. Guangxi is also the site for a US$116 million copper smelting plant purchased from Japan. The plant is to be built before 1982 with an annual capacity of 90,000 tons of refined copper.

In Xingjiang's Qaidam Basin, the development of the Xitieshan Lead and Zinc Mining Complex will be facilitated by the recent extension of the Qinghai-Xizang (Tibet) Railway to that area. Another lead and zinc mining complex will be established in Western Yunnan Province. The area has proven resources of over 14 million tons of lead and zinc as well as some quantities of certain rare minerals. A major copper mine will be built in Dexing County in northeast Jiangsi Province, which has one of the biggest copper deposits in the world. So far, the proven reserves amount to over 8 million tons.

Telecommunications and Electronics

China plans to develop a wide range of telecommunications and electronic production systems and products, including a domestic communication satellite system. An informal agreement has been signed with the United States that will permit the PRC to purchase both satellites and ground relay systems. Last spring, China reached an agreement, with a West German firm for the delivery and future manufacture in China of between 10 and 20 television satellites. Technical assistance is expected to come from France and Japan as well. In the area of electronics production, China recently has purchased color television tube plants from Japan.

Transport

Chinese planners have emphasized the importance of transport to their modernization program. Considerable attention has been directed to the expansion of rail networks. Major railways recently completed include the 894-km line from Xingfan in Hubei Province to Chongqing in Sichuan Province, the 885-km line from Zhicheng in Hubei to Liuzhou in Guangxi Zhuan Autonomous Region, the 870-km line from Beijing to Tongliao in Jilin Province, and the 400-km line from Taiyuan in Shanxi Province to Jiaozuo in Henan Province. Two important trunk lines are under construction in the western part of the country: the 476-km line running through the potentially oil-based industrial center of Qaidam Basin in southern Xingjiang and a 830-km section of the projected Qinghai-Xizang Railway. Construction has started on a railway from Anhui Province to Jiangxi Province.

In addition, a number of existing railways are to be electrified using the alternating current system. The electrification of the railways between Beijing and Tianjin (137 km) and between Beijing and Zhengzhou in Henan Province (695 km) will be carried out with Japanese technical assistance.

China's rapid maritime development in recent years has been shown in part by the expansion of port facilities. A number of main ports, especially Xingang, Qinhuangdao, Lianyungang, Shanghai, and Huangpu, will undergo major expansion and modernization. Discussions are continuing with foreign firms, especially those from the Netherlands, concerning development projects at Qinhuangdao, a dredging operation in the mouth of the Changjiang River near Shanghai, and construction of a deep-sea harbor north of Shanghai near Lianyungang, although this latter project may be deferred under the readjustment process.

Source: U.S. Department of Commerce, China's Economy and Foreign Trade

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Briefing Material for
Mr. McNamara
Prepared in March, 1980

PEOPLE'S REPUBLIC OF CHINA

Basic Economic and Social Data - 1978

Population: 958 million (excluding Taiwan)
Cultivated area: 105 million ha
Cultivated area per capita: 0.11 ha

Birth Rate	Death Rate	Population Growth Rate
per thousand		
18.3	6.3	12.1

Literacy rate: 65-75% of adults
% of age group in primary school: 94%

Daily per capita caloric supply: 2,200

Gross National Product: $240-290 billion *
GNP per capita: $250-300 *

	US$ billion	%
GNP *	260	100
Gross domestic investment *	86	33
Gross national savings *	86	33
Current account balance	negligible	-

	Annual Growth Rate of GNP Per Capita (constant prices)			
	1950-57	1957-70	1970-76	1976-78
GNP *	8-10	4-5	3-4	9
Population	2.2	2.0	1.8	1.3
GNP per capita *	6-8	2-3	1.2-2.2	7-8

Government Finance	Billion yuan	% of GNP
Revenue	112.1	28
Expenditure	111.1	28
of which,		
Capital construction	45.2	11
Support of industry	16.8	4
Support of agriculture	7.7	2
Health, education	11.3	3
Defense	16.8	4
Administration & others	13.3	3

Balance of Payments	US$ billion
Exports	10.0
Imports	11.1
Net services	1.2
Current Account Balance	-

Exchange Rate
1978: $0.60 per yuan
1.66 yuan per $
1979: $0.65 per yuan
1.54 yuan per $
Jan. 1980: $0.67 per yuan
1.50 yuan per $

International Reserves: $2-3 billion *

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* Tentative estimates

ECONOMIC BRIEF /1

DEVELOPMENT PERFORMANCE AND ISSUES

A. Human Resource Development and Employment

Human Resource Development

1. When the People's Republic of China (PRC) was established in 1949, the Chinese population was estimated to be about 540 million. During the next 30 years of the PRC, the population grew by slightly less than 2% a year. The significance of this figure cannot be fully realized unless it is also noted that this growth added more than 400 million people - equivalent to the entire population of India in the 1950s - to the Chinese population. The population of China (including Taiwan) is estimated by the Government to have surpassed one billion in January 1980. The performance of Chinese development reviewed in this Brief must be understood in the context of this vast population, whose annual increment alone is equivalent to the population of most other countries./2

2. It is to the credit of the Chinese leaders that they attempted to deal seriously with the human dimension of the development problem before this issue received attention from most other world leaders. In fact, the development of human resources is one of the most impressive achievements of the Chinese development experience. The result of the Chinese strategy for human development is a near universal availability of low level services. For instance, enrollment in primary schools is virtually universal. Most provinces also have a cooperative health program for 80-100% of their rural villages, so that the people receive a minimum level of health care within the village and have a referral system to a higher level of services.

3. The provision of these services has produced impressive results. The level of human resource development is distinctly higher than that achieved by most countries with the same level of income and is comparable to the achievement of middle-income developing countries with incomes several times higher. Today, life expectancy at birth in China is close to that in developed countries. The crude death rate is half that of middle-income countries and is reported to be even less than that of the industrial countries. Over 90% of the children of school age attend school, compared to 73% in low-income countries. The adult literacy rate is over 70%, nearly double that of poor countries (see Table 1 below). The overall level of human resource development in China is equivalent to that in countries with many times its current per capita income.

/1 This brief was prepared on the basis of a desk study using information available outside China. Because much of this information is conjectural, conclusions presented in this brief must remain tentative.

/2 Annex A contains a review of the country's population problem and current government population policy by one of China's Vice Premiers.

Table 1: INDICATORS OF HUMAN RESOURCE DEVELOPMENT: AN INTERNATIONAL COMPARISON /a

	Crude birth rate	Crude death rate	Population per physician	Daily per capita calorie supply	% of age group in primary school	Adult literacy rate (%)
China	18	6	939	2,200	94	65-75
Low-income countries	40	15	10,300	2,036	73	36
India	35	14	3,140	1,976	79	36
Pakistan	45	15	3,780	2,146	50	21
Indonesia	37	16	16,430	2,126	82	62
Sri Lanka	26	6	6,230	2,019	77	n.a.
Middle-income countries	35	11	4,470	2,557	92	69
Thailand	32	8	8,460	2,382	83	82
Philippines	35	9	3,150	1,971	105	87
Korea (R.O.)	21	8	1,680	2,630	109	91
Industrialized countries	14	9	630	3,342	102	99

/a All statistics are for latest available year, all in the late 1970s. Data for all countries except China are from the World Development Report, 1979.

4. China's emphasis on improving its human resources is illustrated by the data in Table 2 below. In the 30 years following 1949, the number of students attending primary school increased sixfold, implying a rate of growth of 6% p.a. There was an even more extraordinary increase in the number of children attending middle school.

Table 2: SCHOOL ENROLLMENT AND SIZE OF TEACHING STAFF, 1949 and 1979

	1949	1979
School enrollments (million)		
Primary	24	146
Middle	1	65
Number of Teachers (thousands)		
Primary	836	6,220
Middle	83	3,280

5. One consequence of this emphasis on human resource development is the remarkable progress made in reducing population growth. Improvements in social services, coupled with an active family planning program, have reduced the population growth rate from 2% in 1970 to the current rate of 1.2%. Over the past year, even stronger incentives have been introduced in an effort to reduce the growth rate to 0.5% by 1985.

6. The relatively high level of human resource development in China was not achieved through a high level of financial commitment: the proportion of the Gross National Product committed to social services is not more than the average committed in other poor countries. It is the outcome principally of innovative technology (example: barefoot doctors), full utilization of local resources with low opportunity costs (example: use of old people as school teachers), and a close integration of human resource development with economic, social and political progress.

7. But some problems still remain - in particular, the continued inequality in access to higher level services. For instance, universal upper secondary education has been achieved in the major cities and universal lower secondary education in other cities, but the national enrollment rate remains at less than half the age group. Following the current adjustment of secondary education, the enrollment ratio is unlikely to be much higher than one quarter among the rural population of secondary school age. Differences in tertiary enrollments are likely to be even greater, with the number of students from rural areas limited by the number of rural children in secondary schools, as well as by the lower quality of rural secondary schools. Similarly, the availability of fully trained medical doctors and hospital beds is undoubtedly greater in urban than in rural areas.

8. During the decade of the Cultural Revolution (1966-76), major efforts were made to expand education in rural areas, especially secondary education, by reducing the length of schooling and by shortening courses and simplifying materials. The duration of higher education was reduced and admission requirements relaxed; responsibility for student admission was taken away from university officials and given to factory and commune managers and local party cadres who would nominate students from their units. Examination results were no longer the main criterion for school and university admission, and testing played a much less important role in education. Students and teachers were required to participate more in manual labor, and at least two years' work experience was required for entrance into higher education institutions. Educational administration was decentralized to the lowest level possible to increase responsiveness to local needs, and the role of the central government was substantially curtailed.

9. However, the available records reveal that the reforms of the Cultural Revolution solved few of the educational problems China faced in the mid-1960s and introduced many new ones. Despite the intense effort to universalize primary education during this period, retention rates in rural schools remain relatively low. This is especially true for girls. Although the enrollment ratio for rural children reached 94% in 1978, only somewhat over 60% of children entering the first grade in 1973 finished the final year of primary school in 1978. The reasons for this are common to all developing countries: the need for boys to begin earning income and for girls to help with household chores, and parents' perception of the irrelevance of education, especially for girls. Secondary school enrollment expanded from 14 million in 1965 to 58 million the year after the Revolution officially ended in 1976, but this appears to have been achieved at the cost of substantial lowering of quality.

10. The most serious impact of the reforms undertaken during the Cultural Revolution may be in higher level manpower. During that period, specialized institutions, particularly at the secondary level, were abolished because they were thought to be symbols of a two-class system of education. As a result, technical schools, agricultural secondary schools and other specialized secondary schools were closed, and the concept of "school in the factory and farm, and farm and factory in the school," which had been a hallmark of Chinese education, was largely abandoned. Higher education institutions were closed for many years; after they reopened, enrollments were sharply curtailed and basic research in science and technology prohibited. The Chinese authorities now consider this hiatus in scientific and technical manpower development, and the general lowering of quality, as a wasted decade in education, resulting in a lost generation of high-level manpower.

Employment, Migration and Urbanization

11. Estimates of the population and the labor force are given in Table 3. Although the enormous increase in the size of the population over

the past three decades was accompanied by substantial growth and structural change in the economy, the vast majority of the Chinese people today live where they, or their parents, lived 30 years ago. The absence of new cultivable areas precluded any significant migration of farmers seeking new land. The centers of many rural communities have, over the past 30 years, become the locus of nonagricultural activities, but they have remained integrated within the rural economy and society, with a large proportion of the workers continuing to live in their villages; thus they apparently remain, by Chinese definition, part of the rural sector. Migration into urban areas has, on the other hand, been severely restricted by the Government since the early 1960s. In fact, large numbers of urban educated youths have been sent to work in rural communes since the late 1960s. Thus compulsory emigration and a low rate of population growth have maintained the urban population at about 110 million since the early 1960s.

Table 3: RURAL-URBAN POPULATION AND LABOR FORCE, 1957-78

	1957	1978	Average annual growth rate (%)
	- (million) -		
Population	647	958	1.9
Rural	555	848	2.0
Urban	92	110	0.9
Population-Labor Force Ratio			
Rural	2.2	2.2	
Urban	3.3	2.0	
Labor Force	280	440	2.2
Rural	252	385	2.0
Urban	28	55	3.3

Employment

12. Employment estimates by sector, based on the limited available information, are given in Table 4 below. These figures show that, despite the significant growth of nonagricultural employment in rural areas, the annual growth rate of farm workers over the past two decades was 1.6%. This compares, for instance, to about 1% a year between 1950 and 1970 in South Asia. Thus, farm work has continued to absorb the bulk of the new labor force over the past two decades to a greater extent than in countries with similar natural resource conditions.

Table 4: EMPLOYMENT BY SECTOR, 1957-78
(millions)

	1957	1978
Nonagricultural	42	123
State-owned units		(75)
Urban collectives		(20)
Commune and brigade enterprises		(28)
Urban Unemployed	8	negligible
Farm Workers	230	317
Total	280	440

13. Table 5 summarizes the number of workers in different occupational groups in China and their relative income levels. Although some of the estimates were conjectural, the figures give a rough indication of the structure of employment and income among major population groups. It is apparent that by far the largest, and poorest, group comprises members of the rural communes. In 1978, the total population of this group was about 760 million people, whose per capita income averaged only 105-115 yuan, or about $60 at the official exchange rate.

Table 5: OCCUPATIONAL GROUPS AND THEIR AVERAGE INCOME, 1978

	Number of workers (millions)	Average worker's income	Per capita income of worker's families (yuan per year)
Urban Occupational Groups			
Employees of state enterprises and organizations	35	662	331
Workers in urban collectives	20	488	244
Unemployed - negligible, except for educated youths who have left their job assignment in rural communes and are now living off parents' incomes; number may be as high as 5 million.			
Rural Occupational Groups			
Employees of state enterprises and organizations (state farms; state-owned local industries, schools, hospitals, etc.)	40	628	314
Workers in commune and brigade enterprises	28	Wages generally paid to production teams, so that income is the same as for farm workers, or possibly slightly higher	
Farm workers	317	230-250	105-115

B. Institutions of Development

Introduction

14. China's economic progress over the last three decades has depended heavily on the mobilization of the labor force through organization and institutional changes. These changes are often introduced by the Communist Party. The number of personnel at the Party's disposal now exceeds 30 million, and they provide the Party with the political power and the administrative leverage, for instance, to mobilize agricultural labor for production and the construction of rural capital projects, and to maintain a monitoring and verification system, which ensures the implementation of government-sponsored health, education and demographic programs.

15. The Chinese have repeatedly proclaimed that development depends on effective leadership and the dynamic interplay between the Party cadres and the masses. Thus at the interface between the state organization and the populace, control is not an administrative process but a political one. The Chinese also have a firm belief in the efficacy of mass campaigns. These are launched after extensive political and administrative preparation by special cadres and are used to motivate the populace to undertake projects requiring very large inputs of labor.

Rural Institutions and Management

16. Although the rural organization of China since the completion of institutional reform in the 1950s has come to be associated mainly with the communes, the traditional peasant family, averaging 4-5 persons and including two full-time workers, remains the most important economic and social institution in the rural economy. It is the basic consumption unit and an important production unit. In fact, the development process and government policy have combined to strengthen rather than weaken the role of the family. Restrictions against migration have held rural families together, more so than in most developing countries. Government policy explicitly required children to be responsible for aged parents in rural areas.

17. Incomes are distributed to heads of families according to the labor contributed by family members. Labor contributions are measured by work points. The calculation of work points varies considerably within the country and may be based simply on the number of days worked, or more complex measures of work output (e.g., kilograms of grains harvested, area planted, quantity of earth removed, etc.), which reflect the quality as well as the quantity of labor input. In addition, about 5-7% of all farmland is distributed to families for private farming activities which, together with other sideline activities, normally account for 20-30% of family income.

18. Above the family is a multi-level management organization within which the division of responsibility for economic and social activities

among institutions is determined, in principle, by three criteria: complexity of management required, optimum scale of activity, and the need for a close link between production efforts and rewards. The average size and responsibility of each management level is shown in Table 6. The production team, for instance, is responsible for, and bears the consequences of, all major decisions on agricultural production. It collectively owns the land farmed (averaging 20 ha) and all major farm animals and implements. Apart from relatively small contributions to the brigade and commune for collective investment and social welfare (generally 5-7% for investment and 2% for social welfare), the team retains all its net income. The production team in principle functions within the rural commune much like the "profit center" of a large organization.

Table 6: RURAL INSTITUTIONS

Institution	Average number of people in unit /a	Responsibility
Family	4-5	Private plots, distribution of consumption among individuals
Production team	150 (30-35 families)	Management of agricultural production, ownership of land, income distribution among families
Production brigade	1,000 (7 teams)	Primary schools, cooperative health services, machinery repairs
People's commune	15,000 (about 15 brigades)	Secondary schools, health clinics, small-scale industries, marketing, services, civil administration

/a Figures are national averages, but large regional variations exist.

19. The communes and brigades, on the other hand, are responsible for activities requiring large-scale operations or management and technical skills not available to the production team. Rural industry, for example, is mainly the responsibility of the commune, while the brigade is responsible for handicrafts and the repair of farm machinery. The brigade's main responsibility is the delivery of social services to the rural population: it staffs and manages the cooperative health service, which provides the lowest level of health care available, and runs the primary schools. The commune is

responsible for providing the next level of social services, through commune health clinics and secondary schools. It is also responsible for procuring farm products and marketing inputs and consumer goods, and for all aspects of civil administration in the areas it controls. The importance of the commune lies mainly in its dual role as the lowest level of the state apparatus and as the highest level of the agricultural collective organization. The commune therefore serves as the crucial link between the Government and the rural population; it is responsible for collecting taxes and procuring farm products for the state while, in the opposite direction, it delivers public and social services, extends agricultural technology, and disseminates political information.

20. Rural institutions in China have retained close links with the past. Indeed, rural China today is essentially a modern socialist system grafted onto the traditional socioeconomic system; the role and functions of today's rural institutions probably reflect centuries of evolution more than changes introduced since the revolution. The commune, for instance, corresponds to the traditional marketing area ("Xiang") where a group of villages would be served by a market town. The market town has now become the commune's headquarters, but its function as the marketing, credit, industrial and service center for the surrounding villages remains and has been much strengthened. Large villages have become production brigades, with teams organized from the neighborhood of each village, while small villages have become production teams and form brigades when organized with neighboring villages. While terms like commune, brigade and team have modern, socialist connotations, it is important to realize that the production team, for instance, typically consists of some 30 families whose ancestors have lived in the same villages for decades, and whose members are either near or distant cousins and usually bear the same surname.

Organization of the Urban Economy

21. The Chinese experience in managing income in urban areas has been far less complex than in rural areas. A major reason for this is, of course, the much smaller scale of the problem, since the urban population has been well under 15% of the total population throughout the past three decades. In addition, the urban population has enjoyed the "urban bias" normally associated with the development process and, specifically, has benefited from the disproportionate allocation of investment resources to urban-based activities. Nonetheless, the management of the urban economy is one of the most impressive achievements of the PRC. Chinese cities today are characterized by an absence of poverty and a remarkable stability of living conditions that visitors sometimes mistakenly regard as typical of conditions throughout China.

22. The bulk of urban economic activities today are organized as state enterprises owned and managed by the Government. The largest and most important enterprises are managed by the central government, but most enterprises are controlled by provincial and municipal governments. Other urban activities, particularly handicrafts, small-scale industry and services, are organized as cooperatives collectively owned and managed by the workers.

Reflecting the Government's control of both internal and external trade, as well as prudent and conservative fiscal and monetary policy, overall inflation since the early 1950s has been below 1% a year, though there were significant price movements for some consumer items.

23. Property ceased to be a major source of urban household income after the late 1950s, though some urban handicraft collectives own their own equipment and tools, and some housing is still privately owned. Income disparity among urban households is, therefore, attributable mainly to wage differentials among workers in state organizations (about two thirds of the urban work force) and to differences in the pay of cooperative workers. Significant wage differentials do exist, with the most senior government officials earning 5,000-6,000 yuan a year, while some service workers earn considerably less than 500 yuan a year.

24. The Government's price and rationing policy, however, effectively reduces real income inequality much below that implied by the wage differentials. At one extreme, a rationing system ensures a minimum supply of basic necessities at low prices to all urban populations. The number of rationed items in Chinese cities is very large, in the hundreds at times, and includes basic items such as grains, vegetable oil, meat, sugar and cloth. Prices for these basic items are at low levels that have remained largely unchanged since the late 1950s. At the other extreme, prices for consumer goods such as bicycles, sewing machines and radios, which remain in short supply, are relatively high and effectively reduce the purchasing power of high-income workers. Housing, which is very scarce and generally of low quality, is allocated mainly according to need and rents are low. Thus, the consumption patterns of urban workers vary less than their income differences imply.

25. On the average, per capita income of the urban population is two to three times that of farm families. Probably of even greater importance than relative income levels are the security and quality of life in urban areas. The medical, educational and welfare needs of state industrial workers are more likely to be met - and with a better quality of service - than are the needs of peasants. Medical care is provided free to state employees and at 50% of cost to their dependents, while health care in rural areas is provided through a cooperative system financed by annual contributions of members. Although urban housing is usually cramped, with kitchen and bathroom facilities typically shared between two or more families, rents are well below cost and amount to no more than 4% or 5% of the employee's basic monthly wage. Peasants own their own houses and receive no assistance from the Government for construction or maintenance. In the urban state sector, men are normally eligible for retirement at 55 or 60 and women 5 years earlier. The pension, paid by the state, is 60% or 70% of salary after 10 years of work, 85% after 20-30 years. Sick leave is paid at 60-100% of wages for six months, depending on the enterprise and duration of work, and at somewhat lower percentages thereafter. No retirement schemes exist in rural areas except in a very limited number of higher income communes. In all these and many other respects, the urban worker's life is materially secure to a degree unmatched in the countryside, and rural-urban disparity remains a central development issue in China today.

C. Achievements and Pattern of Economic Growth

Growth Performance

26. In terms of economic growth, the performance of the Chinese economy has been quite impressive. For a long time after 1957, when the Chinese Government ceased publication of economic statistics, much of the evaluation of China's growth performance was based on guesswork using incomplete information. Although the available information is still far from adequate for any definitive analysis of the economy's performance since the late 1950s, information available by the end of 1979 can confirm the substantial growth of the economy since 1949.

27. Growth of national income and income per capita derived from official data are given in Table 7. Whether the data are in current or constant prices is not known, but given the low rate of inflation in the country, the figures indicate an aggregate growth rate of about 5% since 1955 (when rehabilitation had been largely completed) and a per capita income growth of 3%. National income, as defined by the Chinese, excludes most service sectors, so that if services had not grown as fast as material production, the growth rate in terms of the conventional GNP concept would be somewhat lower. Though this is possible, the change in the growth rate is unlikely to be major; the growth rate of GNP by conventional measures would probably be roughly 4-5% and GNP per capita, 2-3% over the 30 years of the PRC.

28. In comparison with other low-income developing countries, which averaged a GNP per capita growth rate of 1.1% in the period 1950-75 - India for instance averaged 1.5% - China seems to have done very well in overall terms and appreciably better in terms of per capita growth. Nevertheless, its per capita income in 1978 remained quite low by international standards. Based on official estimates of gross values of agricultural and industrial output in 1978 and a rough guess about the size of the service sector, GNP in current prices would be around 400 billion yuan, or 420 yuan per capita. At the official exchange rate, this would be equivalent to a per capita income of about $260./1

/1 The 1979 Bank Atlas quotes a CIA estimate of $460 for China's per capita income in 1978. This includes an adjustment for purchasing power and is now generally accepted as much too high. Most recent estimates by Western and Japanese scholars are in the $250-300 range. The IMF Background Paper on the PRC (March 6, 1980) contains an Appendix reviewing China's GNP, which concludes that per capita income, at the official exchange rate, was $266 in 1978.

Table 7: GROWTH RATE OF NATIONAL INCOME, 1950-78 /a

	1950-55	1955-70	1970-76	1976-78
	(Average annual growth rate over period, in %)			
National income	12.9	6.2	4.5	10.1
Population	2.2	2.0	1.8	1.3
National income per capita	10.5	4.2	2.4	8.7

/a National income is according to socialist concept and excludes passenger transport and most services. Because the price basis of the estimates is not known, the growth rates are calculated for illustrative purposes only (see qualification in text above).

29. A noteworthy feature of China's development is that economic growth was financed virtually entirely by national savings. During the 1950s, the PRC received substantial financial and technical assistance from the Soviet Union. In addition to technical aid in the form of blueprints and information, technicians and training the Soviet Union provided a total of $1.4 billion in loans, of which $430 million were for economic development. In 1960, however, following the break of relations with the Soviet Union, Soviet technicians were withdrawn abruptly and outstanding loans repaid in the following few years under an accelerated repayment schedule. Since 1960, therefore, the PRC has been a net exporter of capital, first to repay the Soviet loans and later to maintain a sizable foreign assistance program of its own. During the 1970s, for instance, the PRC's foreign aid program amounted to $300-400 million a year.

Investment Rate and Pattern

30. The bulk of incremental income arising from the substantial growth of output was not used to raise the level of consumption. A prominent feature of Chinese development policy over the past three decades has been a relentless drive to raise the rate of investment (Table 8). From about 20% in the mid-1950s, the rate was raised to close to 30% over most of the following two decades; since foreign capital inflows in the 1950s became outflows in the 1970s, the increase in the rate of national savings was probably somewhat higher.

Table 8: INDICATORS OF INVESTMENT RATE AND PATTERN, 1953-78

	1953-57	1958-62	1963-65	1966-70	1970-78	1978
Rate of accumulation /a	24%	31%	n.a.	n.a.	33%	36%
(Estimated rate of investment by conventional measures)	(20%)	(27%)	n.a.	n.a.	(30%)	(33%)
Share of agriculture in total investment	4%	n.a.	n.a.	----- 10% -----		11%
Share of industry in total investment	n.a.	n.a.	n.a.	----- 60% -----		60%
Ratio of investment in heavy industry relative to light industry	8:1	11:1	13:1	14:1	8-11:1	10:1

/a Socialist concept of the rate of investment, which is somewhat higher than the ratio of investment over GNP according to the conventional definition. Investment estimate in China, however, does not include farmland construction by commune labor. Figures in brackets are conjectural estimates of the ratio of investment over GNP according to the usual definition of both terms.

31. The major proportion of investment was allocated to industry and, within this sector, to heavy industry. Moreover, heavy industry was not developed to serve agriculture or consumer goods industries; instead heavy industry was producing mainly for other heavy industry. For instance, in 1978, 29% of steel products were used for machine building, only 16% for agriculture and the maintenance of agricultural machinery, and only 12% for light industrial goods. In the consumption of electric power, the shares for agriculture, light industry and heavy industry were 12%, 13% and 54%, respectively.

32. The emphasis on heavy industry and the availability of local resources to support capital accumulation in the agricultural sector held down the share of agriculture in state investment. In the First Five-Year Plan, 2.9% of basic construction investment was in agriculture, increasing to 10% between 1962 and 1967. This level was maintained until 1978 when agriculture's share was raised to 11%. During this entire period, a vast amount of investment was carried out in the agricultural sector using the labor power and the savings of the communes. The labor was used to augment the supply of land by expanding the irrigation system, terracing and other schemes, as well as to improve its quality.

33. Table 9 shows the growth of major output since the early 1950s and the level of output per capita in 1978. The pattern of growth in the 30 years of the PRC was clearly dominated by intermediate and producer goods. The per capita supply of basic consumer goods in 1978 remains very limited.

Table 9: OUTPUT GROWTH OF SELECTED PRODUCTS, 1952-78

	1952	1957	1978	Growth rates, 1952-78	Output per capita, 1978	
	(million tons, unless otherwise indicated)			-- % --	China ------- kg	India -------
Food grains (processed)	129	153	244	2.5	255	204
Oilseeds	3.7	n.a.	4.6	0.8	4.8	14.8
Cotton	1.3	1.6	2.2	2.0	2.3	2.2
Hogs (mil. heads)	90	115	301	4.8	0.3 head	n.a.
Processed sugar	0.5	0.9	2.3	6.0	2.4	9.2
Cotton cloth (bil. linear m)	3.8	5.0	11.0	4.2	11.5 lin.m	13.4
Bicycles (mil. units)	0.1	0.8	8.5	18.6	0.01 unit	0.006
Crude steel	1	5	32	14.3	33.4	12.4
Pig iron	1.9	n.a.	34.8	11.8	36.3	14.8
Coal	66.5	n.a.	617.8	8.9	644.9	163.7
Electric power (bil. kwh)	7	19	257	14.9	268 kwh	160
Chemical fertilizers (100% effect.)	0.04	0.4	8.7	23.0	9.1	4.6
Crude oil	0.4	2	104	24.0	108.6	18.0
Cement	3	7	65	12.6	67.8	29.5

34. The orientation of the development strategy towards industry is visible in the changing structure of GDP. A little under half of the national product originated in the traditional sector in 1952. This was down to a quarter in 1974, while the share of industry and transport grew from 27% to 52% over the 22-year period (see Table 10).

Table 10: INDUSTRIAL ORIGIN OF GDP

	1952	1957	1965	1970	1974
			(%)		
Agriculture	45	42	32	29	25
Industry and transport	27	32	42	47	52
Construction	4	6	7	6	5
Services	24	20	19	18	18

Constraints to Agricultural Development

35. The relatively slow growth of agriculture is to a large extent attributable to severe physical constraints. Centuries of economic development and population growth had, by the early twentieth century, exhausted opportunities for growth through expansion of the cultivated area. When the PRC Government took over in 1949, the total cultivated area, at slightly less than 100 million ha, was probably smaller than it was in the 1930s because of disruptions caused by protracted warfare. Most of the land previously cultivated was returned to agriculture by 1957, but since then, the new area developed for agriculture has been more than offset by alienation of existing cultivated areas for industrial and other uses, which has resulted in a 5-7% reduction in the cultivated area (see Table 12, p. 18). As indicated by the international comparison presented in Table 11, China is clearly an extreme example of a "land-shortage" economy.

Table 11: CULTIVATED AREA PER CAPITA IN THE MID-1970s: AN INTERNATIONAL COMPARISON

	Cultivated area per capita of	
	Total population	Rural population
	ha	
China	0.11	0.12
India	0.27	0.34
Bangladesh	0.11	0.12
Egypt	0.07	0.15
Pakistan	0.25	0.34
Thailand	0.33	0.38
Indonesia - Java only	0.06	0.08

36. A well-organized, literate and growing population living off a fixed land area will obviously develop a highly productive and land-intensive technology. By the twentieth century, both in terms of available technology and resource use, agricultural productivity per hectare in China, based on a sophisticated system of water control, had already reached a high level. Further growth of output therefore had to be based mainly on the technological transformation of production, which in turn required a growing supply of modern inputs. Although agriculture received a relatively small proportion of investment resources, substantial efforts were made in other areas. Since the early 1960s, resources have been allocated to agriculture through recurrent assistance to disadvantaged communes, development and extension of agricultural technology, allocation of foreign exchange to import grains (less to increase the supply than to allow farmers to retain more of their output) and fertilizer plants, and efforts to encourage and mobilize rural communities to help themselves.

37. The growth of agricultural production was rapid and sustained between 1950 and 1958, but a sharp decline followed in 1959-60 due to extremely poor weather, adverse general economic conditions (caused in part by the withdrawal of Soviet financial assistance and technicians), and mismanagement of agricultural activities during the first attempts to organize rural communes. The damage to agricultural production was so severe during this period that grain output did not recover to the peak reached in 1958 until the mid-1960s. Output growth was much steadier from 1962 onwards, but was marked nonetheless by interruptions caused by the violent beginning of the Cultural Revolution in 1966-69, and by serious mismanagement during 1974-76 when ultra-leftist policies predominated and internal political conditions were unstable. Thus output growth during the 1960s and 1970s as a whole was only moderately above population growth; grain output per capita in 1977, for instance, was about the same as in 1957, although this is a considerable achievement in the face of rapidly falling cultivated area per capita (Table 12).

Table 12: INDICATORS OF AGRICULTURAL DEVELOPMENT, 1950-78

	Population (millions)	Cultivated area (mln ha)	Food grain production (mln tons of paddy equv.)	Per capita: Cultivated area (mln ha)	Per capita: Food grain production -- (kg) --
1950	552	100	130	0.18	236
1952	575	108	164	0.19	285
1957	647	112	195	0.17	301
1967	773	107	230	0.14	298
1977	947	105	283	0.11	299
1978	958	105	305	0.11	318
Annual Growth Rate: (%)					
1950-78	2.0	0.2	3.1	-1.7	1.1
1950-57	2.3	1.6	6.0	-0.7	4.5
1957-78	1.9	-0.3	2.2	-2.1	0.2

/a Food grains include rice, wheat, course grains, soybeans and tubers (converted at 1/5 natural weight).

38. The technical transformation of agriculture over the past three decades was characterized by two distinct phases. Before the mid-1960s, increases in output were achieved through rehabilitation and by widespread application of an essentially traditional technology. Agricultural development was characterized by the increasingly intensive use of local labor and materials, both with a low opportunity cost. Efforts were made to expand multiple cropping and to consolidate fragmented plots of land. The main source of fertilizer was farmyard manure, which was available locally at a low opportunity cost but needed large inputs of labor for collection, preparation and application. By the mid-1960s, however, not only was the supply of labor and local materials nearly exhausted, but their marginal product was clearly falling rapidly. Development in the late 1960s and 1970s has therefore been characterized by an increasing supply of modern inputs such as chemical fertilizers and pesticides, expanding development and use of improved seed varieties, improved water management, and continued growth of multiple-cropping. Yields per hectare of the major crop, rice, rose from about 2.1 tons in 1950 to around 2.5 tons in the mid-1950s, and then to about 3.5 tons in recent years. This level is high by international standards, though still significantly lower than the 4.7 tons achieved in Taiwan or 6.0 tons in Japan and the Republic of Korea. Yields per hectare of wheat and coarse grains remain relatively low by international standards but nonetheless rose in the two decades following the mid-1950s, from about 1.0 tons to 1.2 tons (Table 13).

Table 13: INDICATORS OF THE TECHNICAL TRANSFORMATION OF AGRICULTURE, 1949-77

	Yield per ha			Multiple cropping index	Irrigated area		Supply of fertilizer		Stock of tractors
	Paddy	Wheat	Coarse grains	Sown/ cultivated area	mln ha	as % of cul. area	mln tons of nutrients	Percentage from organic sources	1,000 of standard 15 hp units
	------- tons -------								
1950	2.1	0.6	0.9	n.a.	17	17	n.a.	n.a.	n.a.
1952	2.4	n.a.	0.9	1.31	21	19	n.a.	n.a.	3
1957	2.7	0.9	1.0	1.41	35	31	11.9	96	25
1967	2.9	1.0	n.a.	1.46	39	36	15.2	84	178
1977	3.5	1.3	1.2-1.4	1.58	48	46	26.0	66	1,300

Rural Industrialization

39. As it became more difficult to maintain agricultural growth, development in rural China from the early 1960s was increasingly characterized by diversification into industrial activities. From probably a very small amount in 1960, these activities have grown to a total output value of 39 billion yuan in 1977, or about 25% of the total rural sector output in that year. Since net income as a proportion of output is much smaller in industry than agriculture, the share of industrial activities in total rural income is perhaps only 10-15%, but it is nonetheless a significant and growing share. In some areas, especially in communes surrounding major cities or industrial centers, nonagricultural activities have already become the dominant activity of the communes.

40. The importance of small-scale industries (mostly, but not entirely, rural) to the total industrial sector of China is indicated by the figures presented in Table 14. These statistics indicate how small-scale industries are integrated into the sector as a whole; these industries are clearly not limited to the processing of agricultural products and handicrafts - they are very much a part of the country's industrialization effort.

Table 14: CONTRIBUTION OF SMALL-SCALE INDUSTRY TO TOTAL INDUSTRIAL OUTPUT

Industry	Share of total output (%)	
Fertilizer		
Nitrogenous	60	(1974)
Phosphorous	80	(1974)
Cement	57	(1975)
Iron ore	28	(1974)
Pig iron	28	(1974)
Crude steel	13	(1974)
Agricultural machinery	67	(1966)
Hydroelectric generating capacity	34	(1975)
Coal	28	(1974)

Note: These figures tend to exaggerate small-scale industry's share of output value, since the quality of its output is usually lower than that of large-scale industries.

41. Rural industries can easily adapt to local resource availability and relative factor costs, and they are therefore characterized by intensive use of local materials with low opportunity cost. Most workers in these enterprises continue to live in their villages; thus industrialization is achieved without the social problems and infrastructure investment costs normally associated with rapid urbanization. Rural industrialization, especially in the context of the commune organization, represents an integrated development of the rural sector that avoids the sometimes polarizing effect of the industrialization process. In particular, the heavy engineering content of rural industrialization in China is an important means of training rural workers and of transmitting technological change to the rural sector.

42. The development of rural industries has not been without problems, however. Discussions of agricultural production in the Chinese press over the past year have often cited instances of commune managers requisitioning agricultural workers for industrial enterprises, sometimes without pay, and thus adversely affecting agricultural production. The diseconomy of scale of some of these enterprises is now apparent, especially when they compete with larger, more efficient units for raw materials and energy supply. The lack of standardization of output from these enterprises is now also causing difficulties.

Industrial Development

43. Although balanced development, under the slogan "walking on two legs," has been a central objective of the Chinese development strategy since 1960, the central role of industrial growth in the development of the economy has been a consistent feature of Chinese development. As already mentioned, the Chinese commitment to industrialization is reflected in the allocation of investment resources. During 1953 to 1957, for instance, industry and transport were allocated 77% of all state investment in capital construction. Although agriculture was to have been the priority sector since 1960, available data show that between 1966 and 1978, heavy industry was allocated more than 55% of total investment in capital construction, light industry 5%, and agriculture only a little more than 10%.

44. The result of this concentration of investment in industry is rapid industrial growth, marked nonetheless by sharp fluctuations (Table 15). Between 1949 and 1952, all branches of industry grew rapidly as plants were rehabilitated and expanded. Rapid growth continued during the 1950s, with producer goods industries growing much faster than consumer goods industries. In 1961, however, output fell sharply as a consequence of the withdrawal of Soviet financial assistance and technicians and the general mismanagement of the economy which led to a severe agricultural crisis. As in agriculture, therefore, the first half of the 1960s was a period of consolidation and adjustment, and only in 1965 did industrial output recover to the 1960 level. Output fell again in 1967 and 1968 as a result of the turmoil of the Cultural Revolution, which led to work stoppages, shortages of raw materials and disruption of transportation. Recovery was very sharp in 1969, however, and by 1970, output was some 40% above the 1966 level.

Table 15: GROWTH OF INDUSTRIAL OUTPUT

	1949-52	1952-60	1960-65	1965-70	1970-75	1952-75
	----- (average annual growth rate over period, in %) ----					
Total industrial output	34	18	2	10	9	11
Producer goods	41	25	-2	10	10	12
Consumer goods	29	8	10	8	6	8

45. In the 1970s, serious constraints to industrial growth emerged (see production index, Table 16). During the early 1960s, investment had been limited primarily to the completion of projects started in the late 1950s, and although a broader expansion program started in the mid-1960s, capacity

became a constraint to further expansion of output in the early 1970s. Moreover, imbalances between subsectors and between the different stages of processing began to emerge due to lack of planning. Shortages of coal, iron ore and other basic raw materials, in particular, began to impede output growth in both producer and consumer goods industries. Political turmoil during the mid-1970s, caused by the struggle for succession, further exacerbated the problem of maintaining growth. Thus although a relatively high growth rate was achieved, the investment cost per unit expansion of output rose significantly, and underutilized capacity was built up in many industries.

Table 16: INDEX OF INDUSTRIAL PRODUCTION /a

	1957	1965	1970	1975	1978
Industrial production index (1957=100)	100.0	199.0	316.0	502.0	646.0
Producer goods index (1957=100)	100.0	211.0	350.0	602.0	-
Machinery index (1957=100)	100.0	257.0	586.0	1,156.0	-
Machine tools (thousand units)	28.3	45.0	70.0	90.0	183.0
Trucks (thousand units)	7.5	30.0	70.0	133.0	181.0
Locomotives (units)	167.0	50.0	435.0	530.0	52.0
Freight cars (thousand units)	7.3	6.6	12.0	18.5	16.9
Merchant ships (thousand metric tons)	46.4	50.6	121.5	313.6	865.0
Other producer goods index (1957=100)	100.0	200.0	294.0	472.0	-
Electric power (billion kwh)	19.3	42.0	-	-	256.6
Coal (million metric tons)	130.7	232.2	327.4	479.6	618.0
Crude oil (million metric tons)	1.5	11.0	17.8	24.0	104.0
Crude steel (million metric tons)	5.4	12.2	17.8	24.0	31.8
Cement (million metric tons)	6.9	16.3	26.6	47.1	65.2
Timber (million metric tons)	27.9	27.2	29.9	36.2	51.6
Paper (million metric tons)	1.2	3.6	5.0	6.9	4.4
Consumer goods index (1957=100)	100.0	183.0	272.0	368.0	-

/a Data for 1957 and 1978 are official estimates, while data for intervening years are USCIA estimates not necessarily consistent with the official estimate.

State Budget

46. Reflecting the Government's close involvement in all aspects of the economy, state budgetary revenues as well as expenditures account for close to 30% of GDP. As in most socialist countries, the state budget includes revenue and expenditures of the central and all lower level governments; also, budgetary revenue comes mainly from profits of state enterprises and industrial and commercial taxes. Chinese fiscal policy has been consistently conservative. In most years, small overall budgetary surpluses are generated (Table 17). Thus broad aggregates of both revenue and expenditure closely reflect the level of economic activity in the country, especially industrial activity.

Table 17: CONSOLIDATED STATE BUDGET

	1977	1978	1979	1978	
	Actual		Budget	As % of total revenue/expend.	As % of GDP
	-- (billion yuan) ---			---------- (%) ----------	
State Revenue	87.5	112.1	112.0	100.0	28
Industrial and commercial taxes, etc.	40.1	45.1	n.a.	40.2	11
Income from state enterprises	32.6	44.0	n.a.	39.3	11
Other	14.8	23.0	n.a.	20.5	6
State Expenditure	84.3	111.1	112.0	100.0	28
Capital Construction	30.1	45.2	39.0	40.7	11
Agriculture		(4.8)	(5.5)	(4.3)	(1)
Light industry		(2.4)	(2.3)	(2.2)	(1)
Heavy industry		(33.9)	(30.7)	(30.5)	(8)
Support of Existing Enterprises	13.7	16.8	26.5	15.1	4
Support of Agriculture	5.1	7.7	7.1	6.9	2
Health, Education & Culture	9.0	11.3	12.1	10.2	3
National Defense	14.9	16.8	20.2	15.1	4
Administration & Other	11.5	13.3	7.1	12.0	3

D. External Trade

47. External trade plays a relatively unimportant role in China's economic development. During the period of substantial capital inflows from the USSR in the mid-1950s, total trade amounted to 8-10% of GDP; this share dropped during the 1960s and early 1970s and only rose to about 8% in 1977/78. Although a country of China's size would be expected to have a small foreign trade sector, this also reflects China's policy of self-reliance, which has governed its development since the end of the 1950s when the break of relations with the USSR and trade restrictions imposed by Western countries isolated China both politically and economically. Since the early 1960s and the 1970s, therefore, external trade has been used mainly to relieve domestic shortages and, sometimes, to promote political objectives. Historical trends of external trade and the composition of trade in recent years are given in Tables 18 and 19 respectively.

Table 18: TRENDS IN INTERNATIONAL TRADE, 1953-77
($ billions)

	1953-57	1958-60	1961-65	1966-70	1971-75	1976-77
Exports, f.o.b.	1.3	2.0	1.7	2.0	4.9	7.6
Imports, c.i.f.	1.4	2.0	1.4	2.0	5.0	6.6
Trade balance	-0.1	-	0.3	-	-0.1	1.0

48. Since the mid-1970s, the Government has become aware that the country's inability to use the economy's comparative advantage and its isolation from the mainstream of technological developments in the rest of the world were major causes of the structural imbalances in the economy, the inefficiency of resource use and the backwardness of production techniques. The policy on external trade then began to change and the volume of trade expanded. Since 1976, the decision was apparently also made to allow borrowing from abroad as a means of financing imports required for the country's modernization program.

49. Thus China's policy on foreign trade and borrowing has changed fundamentally over the past few years. For this reason, future trends are likely to differ substantially from past trends, and projections will be subject to a high degree of uncertainty.

Table 19: COMPOSITION OF TRADE
(% of total imports/exports)

	1977	1978
End-Use of Imports		
Food	17	15
Grain	10	
Others	7	
Industrial Supplies	65	59
Iron and steel	22	
Chemicals	12	
Textile fibers	7	
Others	24	
Capital Goods	18	25
Transport equipment	9	
Nonelectrical machinery	6	
Others	3	
Composition of Exports		
Agricultural	36	33
Minerals	13	12
Crude oil	10	
Coal and minerals	3	
Manufacturing	51	55
Textiles	16	
Clothing & footwear	8	
Chemicals	5	
Metal products	4	
Others	18	

50. Some tentative conclusions are possible, however. In the short and medium term, the country's import demands are likely to grow very rapidly. Since the economy has been effectively isolated from the rest of the world for three decades, the transition to a level of imports appropriate for the size of the economy implies a rapid growth of imports for some years. Moreover, the amount of "pent-up" demand is very large, especially to replace obsolete equipment and plants with the more efficient equipment available from abroad. Technological backwardness is widespread in the Chinese economy,

and economic considerations argue for as rapid a replacement of obsolete equipment as the country can manage. Thus imports of capital equipment and industrial plants are likely to grow as rapidly as the availability of foreign exchange permits. In addition, China is likely to continue its large imports of industrial supplies, especially finished steel. Import demand for chemical products, including fertilizer, and nonferrous metals will probably remain strong. Grain imports are expected to reach 10-13 million tons annually through 1985, double the average level of 1971-77.

51. Paying for this great expansion of imports will require a substantial increase in China's export earnings. A major drive is now under way to expand production of export goods and to improve their quality and competitiveness in Western markets.

52. Crude oil is reported to be a major foreign exchange earner. The recent Sino-Japanese trade agreement calls for annual shipments of crude oil to Japan to reach 15 million tons by 1982, with expectations of this amount doubling by 1985. If this happens, and if another 30 million tons can be marketed to other countries by 1985, crude oil exports could be earning some $10 billion annually. However, it is doubtful that China can achieve 60 million tons of crude oil exports annually by 1985. The size of the exportable surplus of crude will depend partly on domestic energy requirements, and partly on the success China has in offshore oil development. Domestic demand for oil is growing fast because of the modernization drive. Negotiations with foreign companies on joint development of offshore petroleum resources are progressing more slowly than originally expected by the Chinese, although a number of exploration contracts have now been signed on tracts for development and production.

53. The country's nonferrous minerals could be another major source of export income in the longer term. In recent years, China has spent considerable amounts of foreign exchange to import nonferrous metals, because obsolete domestic mines and plants could not meet demand. The country is, however, believed to have large reserves of antimony, manganese, mercury, molybdenum, tin, and tungsten, and deposits of aluminous ores, copper, lead, and zinc are also considered extensive. To develop an export surplus, China not only has to build up its technical capability to develop and construct new mines, but also to establish the necessary infrastructure, such as railroads, to carry their products to the port. In view of the shortage of capital and technical manpower in China, the development of the nonferrous metals industry will have to rely heavily on foreign capital and technology.

54. China's large import requirements, but limited export capabilities, will likely cause imports to rise more rapidly than exports through the 1980s. To reduce the deficit, the Government has now begun a major effort to expand hard currency earnings from remittances by overseas Chinese, from a return on investments in Hong Kong, from shipping operations, and from tourism. China's merchant marine has been growing faster than that of any other country in the last several years. The share of China's foreign trade handled by its own merchant fleet now stands at 70% - the highest percentage for any merchant

fleet in the world. Tourism is also a major source of foreign exchange earnings. In 1978, over 100,000 foreign tourists went to China, double the number in 1977. In addition, over 400,000 overseas Chinese visited the country, bringing the total number of tourists to more than 560,000, 59% more than in 1977. However, China's hotel facilities are insufficient to accommodate the increased influx of tourists. The tourist industry also suffers from a lack of experience in planning and management.

55. In an effort to attract additional foreign exchange, China is setting up other international ventures. Overseas investment companies have been established in Guangdong and Fujian provinces to encourage overseas Chinese to invest with foreign currencies. Two construction companies have been organized to contract for construction work in other countries. One company will engage in various types of construction work, including surveying, designing, building, and installing, or will simply provide the work force, while the other company will undertake highway and bridge construction. Thus China is following the successful model of other Asian countries in trying to convert labor services into foreign exchange earnings.

56. As the PRC pursues its modernization program, it is making significant changes in foreign trade practices. In contrast to previous years, China has agreed to use customer-provided designs, raw materials, and equipment in manufacturing commodities for export, and it has agreed to use customers' trademarks on commodities. The Chinese authorities are also experimenting with more flexible approaches, including arrangements under which the Chinese will process imported materials or assemble foreign components according to the specifications of contracting firms and re-export. Another approach is the "buy-back" compensatory trade arrangement. Under this arrangement, the Chinese provide the factory shell and raw labor, and foreign firms supply raw materials, training, designs, know-how, equipment and possibly some supervisory personnel in exchange for part or all of the finished products.

57. Official balance of payments data are not available, but conjectural estimates based on available information are presented in Table 20 below to illustrate the rough magnitude of China's balance of payments over the past few years.

Table 20: BALANCE OF PAYMENTS, 1975-79
($ billions)

	1975	1976	1977	1978	1979 (prelim.)
Exports	7.2	7.3	7.5	10.0	13.3
Imports	6.9	5.4	7.2	11.1	15.1
Trade Balance	0.3	1.8	0.4	-1.2	-1.8
Net services and transfers	0.2	0.3	0.7	1.2	n.a.
Current Account Balance	0.5	2.1	1.1	-	n.a.
Net capital flows	0.7	-0.4	0.1	0.2	n.a.
Foreign aid	-0.3	-0.3	-0.3	-0.2	n.a.
Overall Balance	0.9	1.4	0.9	-	n.a.

58. External trade in China is a government monopoly operated by the Ministry of Foreign Trade. Policy, however, is the responsibility of the State Council's Office of Finance and Trade. The actual conduct of trade is handled by 12 foreign trade corporations organized by commodity groups.

59. Until recently, the People's Bank of China had overall responsibility for international financial matters, while the Bank of China, under the supervision of the People's Bank, was responsible for day-to-day foreign exchange dealings. Since 1978, however, reflecting the increased importance given to external trade and finance, a reorganization of the foreign trade sector was initiated by the Government to improve the efficiency of conducting international business. As part of this reorganization, the Bank of China was placed directly under the State Council in 1979, thus apparently giving it similar ministerial status to the People's Bank. The Bank of China is now responsible for the unified management of China's foreign exchange business, including commercial and noncommercial exchange, foreign capital transactions, and trade-related credit and loans. A new organization, the General Bureau of Foreign Exchange Control, was also created in April 1979 to be responsible for planning and management of foreign exchange receipts and expenditures. (A list of officials of the Bank of China is attached as Annex F.)

E. Recent Direction of Development Policy

60. Since the death of Mao in 1976, a fundamental re-examination of China's development policy and priorities has been under way. After an extensive assessment of the country's economic situation, the third plenary session of the eleventh Central Committee meeting of the Chinese Communist Party in December 1978 called for a reordering of planning priorities. Basic guidelines for economic readjustment were issued and a picture of the new economic program is gradually emerging. The new program places renewed emphasis on the order of priorities - agriculture, light industry, and heavy industry - which has been the official policy since the early 1960s but was not always followed. The new policy calls for reducing the share of state investment in heavy industry and increases for both light industry and agriculture. In addition, shifts will occur in the order of investment priorities within each sector. As a result, some marginal plants will be closed and a large number of construction projects halted.

61. The fundamental role of agriculture in China's economic development was reaffirmed at the Party plenum. In addition to larger state investment, the new approach toward agricultural development seems to stress incentives, technology, and efficient resource use. This is indicated in the documents adopted by the Party plenum, "Some Questions Concerning the Acceleration of Agricultural Development" (attached as Annex D).

62. Incentive measures center on granting greater decision-making authority to production units and on distributing income among individual peasants according to the amount and quality of the work performed. Additional measures include: (a) the continued maintenance of private plots, sideline production and village fairs; (b) raising procurement prices for agricultural products and lowering prices of industrial goods needed for agricultural production; (c) stabilizing and lowering grain procurement targets; and (d) reducing taxes. Taxes to be paid by commune- and brigade-run enterprises have recently been reduced and grain-deficient production units exempted from taxation.

63. To promote technical progress, more attention will be given to agricultural science and education, improved farming techniques, and advanced methods of management. The policy of agricultural mechanization has shifted away from the previous "all around" approach, under which all production units were expected to progress towards mechanization, to a "selective" approach with emphasis on large farms.

64. In the past, grain was given top priority in agricultural planning, even for areas where resources could be better used for other agricultural pursuits. The Government now appears to be moving towards an approach for simultaneous development of grain, industrial crops, forestry, animal husbandry, fishery, and sideline activities. While grain is probably still considered a "key link," agricultural activities are to be arranged "comprehensively" according to "local and resource conditions as well as traditional experiences" to ensure more efficient use of existing resources.

65. A major objective of current policy is to improve management of state enterprises. To this end, selected enterprises were given in 1979 much greater authority to manage their affairs. This authority includes the right to retain 5% of their profits, and 20% of their profits after state quotas are fulfilled; negotiate directly with foreign companies, and retain a share of their foreign exchange earnings; promote workers according to the principle of "more pay for more work," and control their own welfare and bonus funds, which normally involve around 5% of a factory's total wage bill; draw up their own production plans, and sell above-quota output directly to other factories; receive bank loans, to avoid the red tape involved in requisitioning funds and to increase the role of the People's Bank of China and Construction Bank in monitoring factory budgets.

66. Light industry has long been neglected in investment allocations even though, compared to heavy industry, these investments generally require shorter pay-off periods, yield higher rates of return, provide more diversified sources of export earnings, and create greater employment opportunities. The new policy calls for imports of technology and equipment to update light industry, and compensation trade arrangements will finance the bulk of these imports.

67. The textile industry is emphasized under the new policy. Other sectors in light industry that are being favored include export processing projects and tourist facilities. Investment funds will be channelled to localities designated as "export processing areas" to develop necessary infrastructure and new plants, and to tourist centers for the construction of hotels and related facilities.

68. Although the new policy calls for an increase in the share of state investment in both agriculture and light industry, most investible resources will continue to be devoted to heavy industry. High priority will continue to be given to coal, oil, electric power, transport, communications, and building materials, since the slow progress of these sectors has acted as a brake on industrial growth. The steel industry has less priority, and the over ambitious production target of 60 million tons of crude steel by 1985 has been curtailed.

69. Possibly the most critical bottleneck in Chinese industrial development in recent years has been the shortage of electric power. At the present time, 20-30% of China's industrial capacity remains idle because of power shortages. To assure rapid industrial expansion in the 1980s, electric power will have to grow more rapidly than industry as a whole. In 1978, the power industry was allocated the largest share of state investment within heavy industry and will continue to receive top priority in the immediate years ahead.

70. While investment in the power industry in the past has not been large enough to allow sufficient growth in generating capacity, the present shortage of electric power is reportedly also due to an inadequate supply of both coal and oil. Coal production, though increasing in recent years,

will have to grow much faster to alleviate the current power shortage and to keep pace with the high growth projected for the power industry. The task faced by the petroleum industry is even more difficult, since the production of crude oil, seen as a major foreign exchange earner for China, will have to be large enough not only to meet domestic energy requirements but also to provide an exportable surplus.

71. Transport and communications are two other lagging sectors where larger amounts of resources will be allocated under the new program. Within the transport sector, greater attention will be paid to railways, port development, and the merchant marine. Substantial expansion in these areas will be needed to support planned growth for the economy and foreign trade.

72. The Government was also faced with some serious problems arising from overexpansion and poor planning of the capital construction program. A large number of capital construction projects were planned in the first half of 1978, and more in the second half. These projects and those carried over from the previous years brought the total number of projects undertaken by state enterprises at the beginning of 1979 to several tens of thousands, including more than 1,000 of medium and large size. Because too many projects were undertaken at the same time, serious constraints were placed on the supply of capital funds, equipment, building materials, and technical staff. Completion of all ongoing projects, for example, would require up to 100 billion yuan of additional investment over the next several years. Moreover, many of the 1,000 larger projects under construction last year did not have guaranteed sources of fuel, power, and raw materials, were incomplete in design, or were based on the technology of the 1940s or 1950s. As a result of the current reassessment of the development program, many of these projects are being reviewed and many will probably be postponed.

73. While the need to allow income differentials to grow as part of the development process has been accepted, the Government has given increased attention to the persistence of poverty in the country. A special committee of the State Council is being set up "to make plans and organize forces to assist poverty areas materially and technically and to help them lift themselves out of poverty by developing production." Another major development objective will be to reduce the population growth rate from the current estimated 1.2% to 0.5% by 1985. To this end, a number of economic incentives for one-child families and penalties for multiple-children families were announced in 1979 (see Annex A).

F. Development Issues and Prospects

74. As part of the Government's new economic policy, over the past few years, a much larger volume of data than hitherto has been released and frank analysis of the country's development experience by the Chinese themselves has become available. It has become increasingly apparent that despite many innovative policies and imaginative programs, China has struggled with much the same development problems as other developing countries. Clearly the Chinese experience over the past 30 years offers no quick and easy answer for other developing countries, or, indeed, for the Chinese themselves. Although the current Chinese leadership has in the last few years demonstrated a growing willingness and ability to deal with the development problems the country faces, many major issues remain unresolved.

Planning and Management Problems

75. The planning system suffered seriously from the dismantling, during the Great Leap Forward (1959-61), of the national statistical system, which has only recently been restored; from the rejection of economic considerations; and from the purging of most professional planners and economists during most of the Cultural Revolution (1966-76). Management in general was also seriously weakened by the replacement of professional managers by political cadres and committees. As a consequence, available resources were used inefficiently. Capacity utilization in many industries has been very low because of inadequate raw materials and power. Moreover, the industrial sector faces serious labor management and productivity problems. Especially since 1974, a disgruntled industrial work force has increasingly resorted to slowdowns, absenteeism and strikes to protest eroding living standards. The Government has moved to increase real wages and also to expand the supply of consumer goods and foodstuffs. But the reduction in exports and investment such a policy entails could lead to a lower growth rate and the persistence of bottlenecks and imbalances.

76. In China, capital formation has been sustained at nearly 30% of GDP for close to two decades, a heavy industrial sector has been established with very little foreign technical assistance, and the industrial growth rate over the past 20 years has averaged 10% p.a. In comparison with other developing countries, this performance is not unimpressive. Nonetheless, the industrial sector in China today remains backward by international standards. Foreign specialists have estimated, for instance, that while modern plants exist, average technology in electronics, machine tools, iron and steel, aircraft and textile industries is some 10-20 years behind Western standards. Available information also indicates highly inefficient use of resources. For instance, average nationwide conversion efficiency of primary energy in China in 1978 was only 28%, compared to 51% in the United States and 57% in Japan. Electricity consumption per ton of steel produced in China was 1,100 kilowatt-hours in 1977, more than double the average in industrialized countries. Thus modernization rather than expansion of industries will be the main objective of industrial development in the 1980s.

77. The Government's modernization program can be implemented only if the economy continues to generate a volume of investible resources comparable to that in the recent past, as well as assimilating advanced technologies. But above all, the Government must improve the quality and depth of its planning and its efficiency in managing complex production activities. The past experience of China and other centrally planned economies suggests that the key to efficient centralized management is not easily found. Even countries whose statistical apparatus is far more advanced than that the Chinese are establishing have encountered serious organizational problems in formulating and implementing plans. Some of the planned economies have attempted to introduce schemes for injecting flexibility into the economic system by combining a measure of market guidance with centralized control.

78. Many issues of planning and management remain unresolved. How the desire to maintain centralized planning will be balanced against the need to decentralize some decision making is still unclear. The role of the market is also only slowly being defined. The Government has recently begun to stress once again the importance of avoiding "bureaucratism" and elitist attitudes among government officials and party cadres, as these were major factors leading to the Cultural Revolution. How these concerns will be reflected in policies and procedures remains uncertain, however.

The Rural Sector: Some Issues

79. The commune system has proved to be an effective institutional means of mobilizing rural resources in China, but from the outset problems have been evident that no amount of experimentation has been able to solve completely.

(a) A method of linking rewards to the quality and quantity of work effort would, in theory, increase motivation as well as output. In practice, monitoring costs and the friction generated by differences in work points earned have defeated efforts to institute a more rational mode of remuneration than one that assigns work points according to the number of days worked.

(b) The distribution of discretionary authority across the three basic tiers of the commune system has also caused tension. Production teams feel that they should be allowed to determine their product mix and level of output. They are also anxious to minimize interference in their affairs by brigade or commune level management. The latter feel compelled to enforce grain targets laid down by the center and to mobilize labor for capital construction projects. This issue remains unresolved, and promises of greater autonomy for the team have to be weighed against the call for more extensive planning and detailed management.

(c) The volume of land-augmenting and infrastructural investment over the past three decades was possible largely because the commune administration could deploy the unit's labor force to such projects, usually without compensation from the state. This arrangement is now being resisted. Workers are reluctant to work on commune or county-sponsored projects without pay; they are forcing the state to modify its methods of mobilizing labor and to increase its outlay for rural capital construction projects, which were previously financed from commune resources.

(d) Differences in resource endowment between brigades, and variations even between teams belonging to the same brigade, generate strong pressure from the poorer units for incomes to be shared at the brigade and even the commune level, rather than at the team level. A way of resolving this issue has not yet been found.

80. Many technical difficulties must also be overcome if agricultural growth is to be accelerated. The water shortage problem in North China, for instance, needs to be overcome if the intensity of agricultural production is to be increased. Analysis of input-output relations indicates that Chinese agriculture may be experiencing rapidly diminishing returns, and accelerated technical transformation may be necessary just to maintain growth. The decade-long hiatus of basic agricultural research will have serious implications for the intensification of production, and the Government will have to make a major effort to revive research in China and to adapt technology available from abroad to Chinese agricultural conditions.

Income Distribution and Poverty

81. As a consequence of the country's emphasis on raising the rate of investment and building a heavy industrial sector, the standard of living of the Chinese people has risen only moderately over the past three decades and absolute poverty has persisted. By the mid-1950s, average income per capita had recovered from the depressed level of 1949 but was probably not higher than the previous peak attained in the 1930s. Because income was much more equally distributed, however, the majority of the population enjoyed a substantially higher level of consumption. Redistribution through land reforms combined with rapid growth in the 1950s, for instance, almost tripled the income of the poorest 20% of the rural population and almost doubled that of the poorest 40%. In the next 20 years, output per capita rose by perhaps 60-80% but private consumption rose by much less. The available evidence shows that only in 1977 and 1978, following major policy changes to improve rural income, did per capita consumption of the rural population rise significantly above the mid-1950s level. Urban wages have apparently declined since the late 1950s, but income per capita has risen significantly because more women are working and families have fewer children.

82. Institutional reforms of the 1950s not only removed much of the existing disparity in income but also moderated some of the tendencies towards greater inequality generated by the development process. Income disparity within a rural community, for instance, has been much reduced. The threat for the peasant population of starvation or destitution following a bad crop or an illness in the family is also much less than in the past or in most low-income countries. But significant income differences remain between communities and regions, mainly because of differences in agricultural productivity. During the 1960s and 1970s further attempts at income redistribution were made, but these efforts apparently had an adverse effect on production, impoverishing some of the better-off peasants without benefiting the poor.

83. The pattern of income distribution thus appears to have remained largely unchanged since the late 1950s, though the gap between rural and urban income has widened somewhat. This is not an unimpressive achievement, since widening income disparity in the course of rapid growth and structural change is a common feature of economic development. However, the average level of rural consumption per capita remains low by international standards. The Government has estimated that the consumption of about one fourth of the rural population, around 200 million people, is below a level that would be defined as absolute poverty in most countries, and that more than 100 million people continue to have inadequate food consumption.

84. To an unprecedented degree, the existence of abject poverty in China is today being frankly discussed by the current leadership as well as in the Chinese media; this clearly reflects major disappointment over development achievements in the past, especially since the late 1950s. Moreover, questions are being raised about the implications of highly equal distribution within a community for incentive and motivation. While the present income distribution avoids the demoralizing effect of abject poverty in an environment of conspicuous consumption, narrow income differentials within a commmunity may hamper people's motivation to achieve income growth. On the other hand, it is also recognized that the principle of self-reliance, which has governed Chinese development policy since the 1950s, implies growing regional disparity, and that increased central government effort will be necessary if incomes in some of the impoverished regions are to be raised.

Issues of Education and Manpower Development

85. Although China has made impressive progress in making education available for most of the population, the proportion enrolled in higher education institutions (0.09%) is much smaller than in most developing countries. Although this low ratio reflects in part the Government's ability to resist private demand for higher education, the Government must consider whether this rate of high level manpower development is adequate for the country's development effort. The "lost generation" of high level manpower, as a result of radical educational policies during the Cultural Revolution, as well as the relative neglect of higher education throughout

the past 30 years, may have a far-reaching affect on the country's modernization effort.

86. The current policy response to the consequences of the Cultural Revolution is a return to the multi-track system of the early 1960s. The low quality, egalitarian system of the Cultural Revolution is now being replaced by one of the most quality-oriented hierarchical systems in the world. A nationwide key-point system, under which better students are being enrolled in key-point schools which receive a disproportionate share of funds and equipment and better qualified teachers, has been re-established, involving 89 (out of amost 600) tertiary institutions, as well as primary and secondary schools in every province, district, rural county and city. Selection of students for key-point schools and universities is now based mainly on examinations in academic subjects, although an affirmative action program exists for minority races.

87. A return to the multi-track heirarchical education system will likely re-create the social tension that existed before the Cultural Revolution. Education authorities readily acknowledge that the heavy reliance on examinations in selection will benefit children of the urban population, of intellectual bureaucrats and of party cadres, at the expense of children of the poor and the peasants. The issue of unequal access to education has clearly not been resolved in China today, but a necessary compromise has been accepted in the country's effort to modernize its economy.

88. Another unresolved issue in education results from the frustration of educated urban youths over the past decade, which is now emerging as a serious social and employment problem. Like all developing countries, China has a large number of educated youths, convinced of their own superiority, but who in fact possess skills of limited value to the economy and whose dissatisfaction is thus unavoidable. During the decade after 1968, some 17 million urban school graduates were sent into the countryside. Assimilation of these youths into the rural society has evidently been difficult. Urban youths often took jobs at the commune's enterprises to which educated peasant youths were aspiring. If they worked in the production team, they typically had to be given more income than they were worth to assure them of a minimum level of consumption, and consequently the other workers' incomes were reduced.

89. The policy of sending urban youths into the countryside will apparently continue, since the number of school graduates seeking job assignments is already growing beyond acceptable limits. This problem can only be resolved through the development process, specifically, through the current effort to expand employment opportunities in cooperative service enterprises and through the reorientation of industrial development toward consumer goods, and probably more labor-intensive, industries. In the meantime, difficult social problems will be caused by the large number of urban youths either remaining, but not integrated, into rural societies, or who have returned to the cities without official sanction.

Balance of Payments Management

90. Since the Government has decided to modernize the industrial sector through the import of foreign technology, the foreign exchange cost of its modernization program will be enormous. Careful management of the country's balance of payments and external debt will therefore be crucial in the short and medium term. Although China's outstanding debt is now very small, the country does not yet have the same access to development capital, especially on concessionary terms, as other low-income developing countries. Its ability to absorb external capital and technology is also unknown, and at least in the near and medium terms, inadequate infrastructure, and the lack of technical manpower and foreign exchange, may impede the country's effort to modernize its economy using foreign technology. For the longer term, exports will have to be developed to support a much more outward looking development strategy.