

# COUNTRY OPERATIONAL STRATEGY

## Chapter I

### RECENT PERFORMANCE AND DEVELOPMENTS

#### A Introduction

1. With a population of 1.2 billion people and a land area of 9.6 million square kilometers, the People's Republic of China (PRC) is the largest country in the world in population and the third largest in area. The sheer size of the country and its rapidly transforming economy are major developmental challenges. The PRC has successfully pursued a strategy of reforming and modernizing its economy for 18 years. In general, the reform measures were first introduced on an experimental basis in some localities and were adopted on a national scale only when they had proved successful at the local level. This pragmatic approach to reform helped to transform the economy from a predominantly centrally planned system to one in which markets play an increasingly important role in allocating the factors of production and in increasing economic efficiency. (The reforms in the different sectors of the economy are discussed in Appendix 1).

2. The structure of the economy has been transformed by the rapid growth. With real output increasing by 9 percent a year, the size of the PRC economy has nearly quadrupled since 1980.<sup>1</sup> The gains in productivity have resulted in substantial improvements in real incomes and living standards and notable progress has been made in reducing poverty. Many of the distortions and rigidities of the former centrally planned system have been eliminated or reduced, and economic agents have increasingly been allowed to make their own decisions based on market signals. A vibrant non-State sector, which now accounts for more than half of industrial output and two-thirds of GDP, has emerged to compete with the State sector. The economy has also become more open and integrated with the rest of the world through trade and investment. During the 1980s, the incomes of about 170 million people were raised above the poverty line.

3. Prior to the beginning of the reform program, the inefficiencies in resource utilization were reflected in the high incremental capital output ratio (ICOR) of 7.7 during 1975-1977. The gains in productivity and improvements in efficiency as a result of the reform program have gradually reduced the ICOR to 3.8 during 1992-1995. Similarly, total factor productivity (TFP) has increased for all sectors. Agricultural productivity gains were particularly rapid during the first half of the reform period, but have slowed down since 1984. The growth in TFP in agriculture averaged 9.5 percent per annum during the 1980-1984 before stabilizing at 2.8 percent per annum during 1984-1994. In contrast, industrial reforms came later, and growth in TFP in this sector accelerated after 1984. The growth in TFP in the industrial sector averaged 2.6 percent per annum during 1980-1984 before increasing to 4.6 percent per annum during 1984-1994. Within the industrial sector, the growth in TFP in the non-State sector (including owner operated businesses, joint ventures, collectively owned enterprises and township and village enterprises) was higher than that of the State sector. While the growth in TFP in the non-State sector increased from 3.5 percent per annum during the 1980-1984 to 6.2 percent per annum during the 1984-1994, the corresponding growth rates for the State sector were 1.8 percent during

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<sup>1</sup> In terms of size, the GDP of the PRC was the tenth largest in the world in 1993.

1980-1984 and 3.0 percent during 1984-1994. This difference reflects the inherent problems of the State-owned enterprise (SOE) sector.

4. The improvement in the quality of life of the population since the reform process began is reflected by the Engel Index, the ratio of expenditures on food to total expenditures on consumption. Between 1980 and 1984, the ratio fluctuated between 56.5 and 59.5 percent. Between 1985 and 1989, the ratio decreased to an average of 52.5 percent reflecting the diminishing proportion of income being spent on the basic necessities such as food and clothing. The ratio fell below the 50 percent level during the 1990-1994, when it averaged 49.9 percent, reflecting the higher levels of income and the increasingly modern consumer lifestyle of the population. As a result of the reforms, the consumers' range of choices among better quality products and services improved significantly. Between 1985 and 1994, the possession per 100 persons of color TV sets increased at an average annual rate of 19.6 percent; of washing machines, 6.8 percent; and of refrigerators, 28.3 percent.

5. Notwithstanding these achievements, important challenges remain to be addressed because of the partial nature of the reforms. Among the most important is the need to strengthen the institutions and instruments for macroeconomic management. Because of the incomplete nature of the reforms in this area, the economy has been prone to "stop-go" cycles of macroeconomic instability. The continued poor performance of SOEs is another legacy of partial reforms. This has constrained the implementation of financial reforms and hindered the development of the financial system. The weak legal and regulatory framework has impeded the development of competitive markets and the clear delineation of the rights and obligations of market participants. The obstacles posed by these problems for maintaining sustainable growth have become increasingly evident with each macroeconomic cycle.

6. A new phase of economic reforms began in 1994, aimed at addressing the problems left by partial reforms and establishing by the year 2000 a "socialist market economy," in which market forces rather than administrative controls will play the primary role in resource allocation. Public ownership, however, will remain dominant in the economy. Mass privatization of State assets is not envisioned. The emphasis is on improving economic efficiency rather than transferring most of the ownership from the public to the private sector. The Government's strategy calls for fundamental changes in a broad range of important areas. A major theme of the strategy is to build the institutional infrastructure necessary for indirect macroeconomic management. This requires reforms in such areas as the exchange and trade system, the central banking and financial system, the tax and fiscal system and the investment system. Addressing these macroeconomic issues is closely related to reforms of SOEs, which is another important focus of the Government's reform agenda. This will require developing a social safety net and pension system so that surplus labor can be reallocated from SOEs in a manner that keeps the associated social costs within acceptable limits. The agenda also includes a comprehensive plan to develop the associated legal and regulatory framework. The reform agenda, if successfully implemented, will lay the foundation for the PRC to exploit the full potential of its economy.

## **B. Macroeconomic Performance**

7. The macroeconomic performance of the PRC has been outstanding since 1991 (see Table 1). The average annual real growth rate of gross domestic product (GDP) for 1991-1995 was 11.7 percent, which was one of the highest growth rates in the world. The major driving force of the high growth was non-State investment, including huge inflows of foreign

direct investment.<sup>1</sup> The trade and current account deficits, which have been a concern in other rapidly growing economies in Asia, has not been a serious problem for the PRC. During 1991-1995, the trade and current accounts remained in balance despite the year-to-year change in their positions.

Table 1: Selected Macroeconomic Indicators (1984-1995)

Indicators	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
	<b>(Annual percent change)</b>											
Real GDP	15.2	13.5	8.8	11.6	11.3	4.1	3.8	9.3	14.2	13.5	11.8	10.2
Real Gross Industrial Output	16.3	21.4	11.7	17.7	20.8	8.5	7.8	14.8	27.5	28.0	28.1	14.5
Real Investment	17.8	26.0	8.3	6.9	13.7	1.8	-0.5	10.4	22.0	34.9	14.4	11.0
Retail Prices	2.8	8.8	6.0	7.3	18.5	17.8	2.1	2.9	5.4	13.2	21.7	14.3
Broad Money	42.4	17.1	29.3	13.2	21	18.4	28	26.4	31.3	23.7	34.4	29.4
Merchandise Exports (percent change in \$)	15.4	5.0	2.6	34.9	18.2	5.3	19.2	17.8	18.6	8.0	30.5	23.0
Merchandise Imports (percent change in \$)	27.6	60.0	-8.7	4.3	27.4	5.3	-13.3	22.3	26.2	29	10.5	14
Trade Balance (in billion of \$)	-1.3	-14.3	-12.0	-3.8	-7.8	-6.6	8.7	8.1	4.4	-12.2	5.4	16.7
	<b>(in percent of GDP)</b>											
Gross Domestic Investment	34.4	37.8	37.7	36.1	36.8	36.0	34.8	34.8	36.2	43.5	42.1	42.5
Gross National Savings	35.0	35.9	36.0	37.7	37.3	37.5	38.7	39.4	40.2	41.4	40.6	38.7
Current Account Balance	0.8	-4.0	-2.6	0.1	-1.0	-1.7	3.9	3.8	1.8	-2.5	0.4	2.4
State Budgetary Balance	-1.5	-0.5	-2.0	-2.2	-2.4	-2.4	-2.2	-2.4	-2.5	-1.9	-1.8	-1.2
State Revenues	26.4	26.6	25.1	22.8	19.9	20.4	19.9	18.2	16.1	15.3	12.7	11.4
State Expenditure	27.9	27.1	27.1	25.0	22.3	22.8	22.1	20.5	18.6	17.4	14.5	12.6

Source: China Statistical Yearbook, 1995 and Staff estimates.

8. During the 1990s, remarkable gains in productivity were realized from the accumulation of new capital and the introduction of new technology. The technical progress has been most significant in the export-oriented manufacturing sector in the coastal cities. The economic growth was accompanied by rapid structural transformation with many of the distortions under the former planning economy being eliminated or reduced. The non-State sector has rapidly become dominant in the PRC economy, and accounted for two-thirds of GDP by 1995.

9. Domestic savings in the PRC have consistently been between 35 and 42 percent of GDP since the reform program began. There has been a slight increase since 1990. Domestic investment has remained between 35 to 44 percent of GDP with year-to-year fluctuations. The high rate of domestic savings has contributed to the high investment rate without aggravating the current account position or requiring excessive reliance on external debt financing. Assuming that the savings rate remains about 36 percent and the ICOR about 4, an economic growth rate of about 9 percent should be sustainable over the medium term.

10. While the GDP growth rate was high in the 1990s, there were significant differences among the sectors of the economy. Agriculture, which is a dominant industry and employs more than half of the labor force in rural areas, grew at 3.8 percent during 1991-1995.<sup>2</sup> Agriculture grew more slowly than the other sectors because of: (i) the unfavorable terms of

<sup>1</sup> In 1994, the PRC attracted \$31.8 billion or 74 percent of the total Foreign Direct Investment (FDI) flows to developing countries. Actual FDI in 1994 and 1995 amounted to \$34.4 billion and \$37.8 billion, respectively.

<sup>2</sup> While agriculture growth in PRC is modest compared with the other sectors of the economy, it is relatively high when compared to other countries in Asia [e.g. Bangladesh (0.9 percent); India (2.5 percent); Indonesia (2.7 percent); Malaysia (2.4 percent); Pakistan (3.4 percent); and Philippines (1.5 percent)].

trade for agricultural production; (ii) natural disasters such as floods and drought; and (iii) the relatively low investment in rural infrastructure. Consequently, the share of the agriculture sector decreased from 28.4 percent of GDP in 1990 to 19.7 percent in 1995. The township and village enterprises (TVEs), engaged in agroprocessing and manufacturing, continue to grow rapidly and have become a major source of employment and income for residents in rural areas. The availability of off-farm employment opportunities generated by the TVEs is an important reason for differences in rural income levels among the different regions of the PRC.

11. Between 1991 and 1995, the industrial sector grew rapidly and achieved significant gains in productivity. The share of the industrial sector in GDP increased from 37 percent in 1990 to 48 percent in 1995. Rapid industrialization also contributed to the declining share of agriculture and other primary industries. Although this trend is common in the other industrializing countries in Asia, it also reflects Government policies to encourage the growth of export-oriented manufacturing. The policies include price regulations that favor manufacturing exportable goods, significant investment in infrastructure in coastal provinces, and price subsidies on food and other consumption goods for urban residents.

12. In centrally planned economies, the services sector is not well developed. This was true in the PRC. However, as the PRC moves toward a market economy, the services sector is growing rapidly because of the growth in real income levels; the growth in retail trade; and the expansion in demand for commercial services such as banking, insurance, and business services. The share of the services sector in GDP, although low compared with market economies at 32 percent,<sup>1</sup> is anticipated to increase in the medium term.

13. Despite the overall good performance of the economy, some macroeconomic concerns remain, including inflationary pressures and a relatively large fiscal deficit of about 5-6 percent of GDP if policy loans channeled through the central bank to the SOE sector are included. There have been repeated bouts of inflationary pressures, the most recent began in 1991. Partly as a result of the Bank's policy advice, in July 1993, the Government introduced the "16-point program", which included tightening credit, and cutting current and capital expenditures to lower inflation. Although the program successfully moderated the growth of aggregate demand, this was not sufficient to contain the increase in money supply. Rapid capital inflows increased foreign reserves and monetary aggregates continued to expand in 1994 and 1995. Inflationary pressures continue to surface from time to time because of the partial nature of the reforms for SOEs and the financial sector and the lack of effective instruments for macroeconomic management. The periodic easing of credit in response to the needs of SOEs and the pressure from the faster growing provinces resulted in the loss of control over money supply growth. Indirect instruments of monetary policy are being put in place gradually and when the process is completed it should result in better control over inflation in the future.

14. Fiscal policy also came under strain during the Eighth Five Year Plan period (1991-1995). The Central Government's influence over public finance weakened as administrative power was devolved to the provinces, and the budget deficit persisted. The ongoing reforms increased the demands on fiscal policy to support the reform process and to help stabilize the economy. During 1991-1995, the overall budget deficit was about 2.0-2.5 percent of GDP, although in nominal terms it has been increasing progressively (see Table 1).

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<sup>1</sup> Share of the services sector in GDP in the other countries in Asia are: Bangladesh (42.3 percent); India (38.8 percent); Indonesia (40.9 percent); and the Philippines (40.4 percent).

15. However, there was also a considerable amount of directed credit which, if included, increased the consolidated budget deficit to about 5 to 6 percent of GDP. The revenue-GDP and expenditure-GDP ratios have been declining since 1978 to less than 20 percent, reflecting the redefinition and reduction of the role of Government, reforms for enterprises and the changing nature of intergovernmental fiscal relationships. The "16-point program" in July 1993 introduced several measures to prevent the further decline of the tax to GDP ratio. These measures included banning unauthorized tax exemptions by local authorities and introducing a broad-based value added tax (VAT).

16. Previously, the fiscal deficits were met by overdrafts by the Ministry of Finance at the central bank. After 1 January 1994, the fiscal deficits ceased to be financed by overdrafts at the central bank and, instead, were financed by bond issues. The majority of the Government bonds are sold to domestic investors. Bond issues have increased sharply since 1991, when the Government abolished the compulsory purchase system in favor of developing the bond market. With outstanding public debt of only 5 percent of GNP and a national savings rate of about 40 percent of GNP, the potential bond market in the PRC is large. However, the rapid rise in debt servicing costs because of inflation indexed interest rates on bond issues raises doubts about the sustainability of the level of bond issues, which totalled about Y 350 billion at the end of 1995. Also, the legal and regulatory frameworks are not yet well established as evidenced by the turmoil in the bond market in Shanghai in February 1995.

17. Except in 1993, the current account remained in surplus during 1991-1995. Initially, imports grew more rapidly than exports, and resulted in a decline in the trade surplus. The trade account fell into deficit in 1993. The turnaround in the current account position in 1994 was due to the significant improvement of the merchandise trade balance. Export growth was stimulated by the unification of the exchange rate, which effectively devalued the Yuan by 33 percent. As a percent of GDP, exports increased from 17.0 percent in 1990 to 26.9 percent in 1995. Imports increased from 13.8 percent of GDP in 1990 to 22.9 percent in 1995. The growth of imports was slower than exports in 1994 and 1995, which reflects the austerity measures introduced to control inflation and the consequent easing of domestic demand. Net foreign direct investment also increased significantly, from \$3.5 billion in 1991 to an estimated \$35 billion in 1994, \$38 billion in 1995 and \$\_\_\_ billion in 1996. The surplus in both the current and the capital accounts resulted in an increase in foreign reserves by an estimated \$45 billion during 1991-1995. At the end of 1996 the international reserves stood at \$105 billion.

18. The external debt and the debt-service ratios reflect the generally prudent management of public finances. The debt-service ratio has remained at the level of about 9 to 12 percent of total export earnings and the debt outstanding has been about 15 to 20 percent of GDP since 1991.<sup>1</sup> The robust external position is expected to continue in the medium term.

### **C. Social and Environmental Developments**

19. The PRC has made commendable progress in improving several key socioeconomic indicators as well as in reducing absolute poverty (see Table 2). Although classified as a low-income country, the PRC has made significant improvements in health, education, and nutrition because of the high growth performance of the economy and the

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<sup>1</sup> The internationally acceptable danger level for the debt-service ratio is 20 percent, while the level for the debt ratio is 45 percent.

relatively equitable income distribution. Most socioeconomic performance indicators improved during 1991-1995. Despite the tighter fiscal conditions, the expenditure for education and health increased from 18.5 percent of total expenditures in 1991 to 22.1 percent in 1994.<sup>1</sup> The increase in education expenditures reflects an increase in the school enrollment rate. The performance of the PRC in these areas is comparable with other middle-income countries.

**Table 2: Selected Socioeconomic Indicators**

Indicator	1985	1990	Latest	Year
Population (millions)	1,051.0	1,133.7	1,202.5	1995
Annual Average Growth Rate (%)	1.4	1.3	1.2	1995
Crude Birth Rate (per 1,000)	21.0	21.1	17.7	1994
Crude Death Rate (per 1,000)	6.8	6.7	6.5	1994
Life Expectancy at Birth (Years)	69.0	68.5	69.0	1993
Female	70.0	70.4	71.0	1993
Male	68.0	66.8	68.0	1993
Infant Mortality Rate (per 1,000 live births)	35.0	-	30.0	1993
School Enrollment Rate (%)				
Elementary	96.0	97.8	98.4	1994
Junior Middle	68.4	74.6	86.6	1994
Senior Middle	41.7	40.6	46.4	1994
Persons Receiving Relief Funds (percent of population)	3.9	2.9	2.6	1994
Real per Capita Income (yuan at 1985 prices)				
Rural	397.6	415.7	489.6	1994
Urban	685.3	837.7	1,167.0	1994

Sources: SSB, China Statistical Yearbook, 1995; UNDP, Human and Development Report; WB, World Development Report.

20. A weakening in the social safety net and the increase in relative poverty, which are transitional by-products of economic reform, have become important policy concerns. Since 1991, the problem of underemployed labor has become increasingly recognized despite the rapid economic growth. There is significant surplus labor in the SOEs (estimated at 23 million) and in the rural areas (estimated at 170 million) and the rigidities in the labor market.

21. Reflecting the widening gap between rural and urban incomes, the Gini coefficient<sup>2</sup> of the PRC rose from 0.38 in 1988 to estimated 0.45 in 1993. The main cause for the widening rural-urban gap has been the relatively faster growth rates of the coastal regions compared with the interior regions, although such trends were also evident within the provinces. While the increase in the Gini coefficient was marginal in rural areas (from 0.32 in 1978 to 0.34 in 1993), it was larger in urban areas (from 0.16 in 1980 to 0.26 in 1993). The increase in relative poverty across the country has become a major policy concern which the Government will

<sup>1</sup> In contrast, Indonesia spent 14.3 percent of total expenditure on health and education, while Malaysia spent 25.1 percent, Philippines 16.3 percent, Republic of Korea 15.4 percent, Singapore 24.5, and Taipei, China 12.8 percent.

<sup>2</sup> The Gini coefficient is an index for measuring inequality in the distribution of income. The index ranges from 0 (the community's income is equally distributed among the population) to 1 (the entire community's income belongs to one individual). Thus an increase in the Gini coefficient reflects an increase in the inequality of income distribution.

address this problem during the Ninth Plan by channeling more investment to the interior provinces and to the rural areas.<sup>1</sup>

22. Gender-based socioeconomic indicators for the PRC compare favorably with selected developing member countries and even with industrialized countries. Over the last five years, the health and education indicators of both men and women have improved, although the indicators for women (except for life expectancy) still lag behind those of men. Recognizing that gender inequalities create inefficiencies that hamper growth, and the social and economic losses when women are denied access to basic education and health care, the PRC introduced compulsory education laws in 1986. This was complemented by policies intended to reduce poverty and to increase overall gender equality. The main decision was to devolve responsibility for primary education to local communities, which were expected to devise appropriate measures for raising primary enrollments, especially for girls, taking into account specific local problems. Measures taken by the Government included awareness campaigns to motivate parents to enroll all children, flexible work schedules, evening classes, sibling care, and special schools for girls. The programs succeeded in raising enrollments among both girls and boys, even in some of the poorest and most remote regions. The laws in the PRC stipulate clearly the equal rights of men and women in politics, economics, culture, education, family, and social life. However, deep-seated cultural factors and social values continue to discriminate against women in indirect ways despite the existence of such laws. The Government has renewed its efforts to eliminate discrimination of women at the workplace or in the home since it hosted the Fourth World Conference on Women in September, 1995 in Beijing.

23. PRC's population increased from 705 million in the Third Population Census in 1964 to 1,143 million in the Fourth Census in 1990. The 62 percent increase in population was a major concern to the Government. The rate of growth has slowed significantly since the early 1970s because of the decline in fertility rates, which fell from 3.8 births per woman in 1975 to 1.8 in 1994. The estimated mid-year population in 1994 was at 1,191.8 million of whom 53 percent are males. The decline in the population growth rate reflects the success of the population control program of the Government. Family planning is widely practiced and supported by the Government. However, more recently, there has been a problem of aborting female fetuses reflecting deep-seated cultural factors. The male/female ratio of newborns increased from 106 males per 100 females in 1970 to 112 males per 100 females in 1994. The Government has responded by enacting laws and regulations that outlaw these practices, such as using ultrasound to determine the sex of fetuses.

24. Improving the environment is also a major policy concern in the PRC. The urban and industrial areas, including such cities as Beijing, Xian, Shenyang, Shanghai and Guangzhou, and some rural areas where TVEs predominate, are heavily polluted. In the past, the pricing of natural resources did not adequately reflect social costs. As a consequence, polluting and energy-intensive technologies proliferated and caused severe air, water and land pollution. The Government's present policies reflect its increased sensitivity towards the environment and its commitment to the protection and rehabilitation of the environment. Investment in environmental improvement projects has increased from 0.67 percent of GNP during the Seventh Five Year Plan period (1986-1990) to about 0.8 percent of the GNP during the Eighth Five Year Plan period (1991-1995). The enforcement of environmental regulations is becoming more stringent. By September 1996 more than 50,000 heavily polluting enterprises had been closed. The Government has adopted the National Environment Action Plan and Agenda 21 program, which

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<sup>1</sup> The Bank is also supporting a study on relative poverty under TA no. 2328-PRC: *Income Distribution Study*, for \$100,000, approved on 9 May 1995.

provide guidelines for environmental improvement efforts to the year 2000. The Government also recognizes that it will take another 30-40 years beyond the turn of the century to reverse the trend in environmental degradation and to improve the country's environment.

#### **D. Labor Market Policies and Practices**

25. Under the employment system that prevailed prior to the economic reform program, the State assigned workers to enterprises which were in turn obliged to provide jobs. The workers were guaranteed lifetime employment and were provided with housing, medical and retirement benefits, and a basic salary that depended on the worker's years of service. Such a system, known as the three irons, namely, the iron rice bowl (guaranteed employment, housing, and other benefits), the iron chair (job security), and the iron wage (wages that are not related to performance), was very rigid and resulted in overstaffing in most enterprises, with virtually no labor mobility. Employment reform in the PRC is therefore focused on breaking the three irons and facilitating the reallocation of labor to more productive uses that is consistent with the needs of a more market-oriented economy.

26. The major employment and labor related problems are: (i) large numbers of new entrants into the labor force; (ii) large scale rural underemployment; (iii) rising urban unemployment; (iv) growing income inequalities between different segments of the population (v) over-employment in SOEs and rural areas; and (vi) the need to develop alternative mechanisms for the provision of pensions and social services to employees. The Government is addressing these problems as part of the transition to a market economy, with the objective of developing an integrated labor force. The improved functioning of the labor market is needed for a more efficient allocation of labor and to facilitate employment restructuring consistent with market forces. The Government is in the process of formulating labor market policies to mitigate the social costs of reform while at the same time facilitating efficient employment adjustment through job-search assistance, retraining, employment creation, and redeployment of people into more productive activities. A framework covering such factors as dispute settlement, worker safety, and protection of workers rights is being developed. While progress has been made, considerably more progress will be required during the remainder of the 1990s. The Bank has been involved in two areas: (i) social security reform; and (ii) worker safety in the context of individual projects.

27. Since the mid-1980s, the Government has issued a number of regulations and guidelines to promote employment reforms and a more market-based operation of the labor market. However, some of these measures have been temporary in character and some have conflicted with others. The Government has recognized these problems and the need for comprehensive labor legislation to create a unified regulatory framework governing the development and operation of the labor market. Since 1993, the focus has been on establishing a permanent legal and regulatory framework for employment promotion, labor safety and dispute settlement.

28. The centerpiece of the legal framework governing labor is the Labor Law which was enacted in 1995. The Ministry of Labor is formulating supporting laws, regulations and rules with the objective of creating an efficient and equitable labor market within the framework of the Labor Law. A total of nine supporting laws are envisaged, of which the Law on Mine Safety has been enacted and the rest are in various stages of preparation and implementation. The Social Contract Law and the Social Insurance Law are expected to be reviewed by the National People's Congress in March 1997. Drafts of the Employment Promotion Law, Labor Safety Law and the Health Law for Labor are being reviewed by the Legal Affairs Bureau of the State

Council. Laws currently being drafted are the Collective Contract Law, the Salary Law and the Law on the Settlement of Labor Disputes. Developing an appropriate legal framework for the settlement of labor disputes is being given priority attention because of the recent escalation in the number of labor disputes in foreign-funded enterprises due to differences in social, judicial and economic systems in the PRC and in the countries of origin of the foreign investors. The Government's objective is to establish the legal framework for all matters pertaining to labor before the end of the century. The Labor Bureaus at the provincial, city and district/county levels are also being provided training by the Ministry of Labor on how to effectively enforce the laws pertaining to employment and labor welfare.

## Chapter II

### DEVELOPMENT ISSUES, KEY POLICY CONCERNS AND OUTLOOK

#### A Development Challenges and Policy Concerns

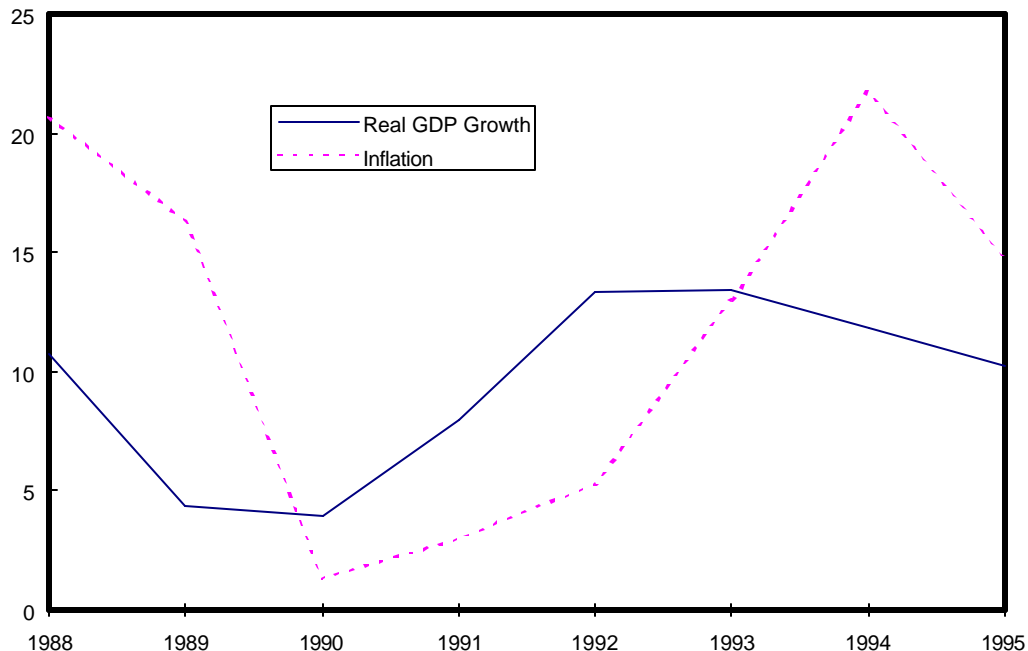
##### 1. Introduction

29. Notwithstanding the impressive economic growth and improvements in welfare achieved by the PRC since 1978, particularly during the first half of 1990s, the Government still faces significant challenges in the medium term. The three major challenges include: (i) creating a stable and efficient macroeconomic environment, which would foster rapid, sustainable, and noninflationary growth; (ii) supporting sustainable growth by reallocating resources towards priority areas such as infrastructure, environmental protection, human resource development, and poverty reduction; and (iii) ensuring broad-based growth and a relatively egalitarian distribution of its benefits between the urban and rural areas and between the provinces on the coast and in the interior.

30. In the absence of well-developed institutions and instruments for efficient macroeconomic management, the high growth rate has put strong pressures on macroeconomic balances, resulting in major cycles of excessive expansion and austerity (see Figure 1). The strong inflationary pressures in 1994, which persisted during the first half of 1995, highlight the need to develop the necessary instruments for better macroeconomic management. Effective macroeconomic management is currently constrained by the incompleteness of reforms in such interrelated areas as the monetary, financial, fiscal, and enterprise sectors.

**Figure 3: PRC: Real GDP and Inflation**

(Percent)



## 2. Monetary and Financial Sector

31. Despite the far-reaching monetary and financial sector reforms that have been introduced over the last fifteen years, the financial sector is still not sufficiently developed to meet the needs of a market economy. Indirect monetary policy instruments (e.g., open market operations) are not fully developed yet. The transformation of the People's Bank of China (PBC), the central bank, into a full-fledged independent central bank, with powers to control monetary policy through the use of indirect policy instruments, is still underway within the context of the Central Bank law passed in 19\_\_\_. The credit plan continues to be used as the key tool for implementing monetary policy, although the importance of the credit plan is diminishing rapidly. Interest rate policy remains relatively inflexible. The banking sector is neither sufficiently commercialized nor is it fully competitive. The four large State-owned commercial banks, which control nearly 80 percent of the total assets of the financial sector, have a large percentage of their portfolios tied up in nonperforming loans to lossmaking SOEs. Despite the creation of the three "policy banks" for directed lending, the four State banks still provide directed credit for certain purposes. The regulatory and supervisory framework for banks and nonbank financial institutions (NBFIs) remains weak. Capital markets also remain underdeveloped and not sufficiently regulated and supervised. Necessary future financial sector reforms include: (i) deregulating interest rates, removing central bank subsidies, and eliminating directed credit from commercial banks; (ii) deepening the financial market by developing indirect instruments of macroeconomic management (e.g., open market operations) to dampen the "stop-go" cycles experienced during the last 15 years, strengthening monetary control procedures, and developing money, interbank, treasury, and trade bills markets; (iii) modernizing the payments system and developing longer term Yuan denominated financial instruments; (iv) promoting the commercialization of banks and competition among domestic and international financial institutions; (v) improving the legal and regulatory framework for banks, nonbank financial institutions, and capital markets; (vi) capitalizing, restructuring, and liquidating financial institutions as required; and (vii) making better use of modern technology to improve efficiency in the financial sector.

32. The Government's objective is to transform Shanghai into an international financial center to compete with London, New York, Tokyo, Hong Kong, and Singapore. Achieving this objective will require Shanghai to play a leading role in the reform and modernization of the financial sector in the PRC. Efforts to develop the financial sector in Shanghai will need to be implemented by parallel efforts to develop the related human resources, improve the environment, and develop the required supporting physical infrastructure.

## 3. Public Finance

33. The major fiscal reforms that have been implemented in the 1990s include: restructuring intergovernmental fiscal relations to increase the Central Government's share in tax revenues and greater fiscal equalization across provinces; overhauling the tax system to simplify the tax structure, increase tax buoyancy, and reduce reliance on discretionary taxes; and rationalizing government expenditures. However, the incomplete nature of the fiscal reforms is currently holding back improvements in macroeconomic management. Increasing the Central Government's share of total revenue is required to strengthen macroeconomic controls. The fiscal reforms will also help increase economic efficiency, enhance the social impact of public expenditures, and facilitate the reform of SOEs by transferring the primary responsibility for providing social services to the Government. Fiscal reforms at the subprovincial level are particularly important to improve the financing of health and education expenditures. The wide-

ranging fiscal reforms introduced in 1994 have affected the roles, revenues, and expenditures of local governments. However, despite the recent reforms in central-provincial fiscal relations, provincial public finance has not been reformed to take account of the new realities. This means that many local governments do not have sufficient funds to meet the basic social service needs of their communities.

#### **4. State-Owned Enterprises**

34. Reforms in State-owned enterprises are critical to the overall reform process, particularly with respect to the completion of the reforms in the fiscal and financial sectors. The PRC has over 100,000 medium and large-scale SOEs, about a third of which incur losses in 1996, but continue to be financially supported by the State. A sizable share of the loan portfolios of the four large State banks are tied up in nonperforming (mainly working capital) loans to SOEs. Because of this problem of "directed credit" for loss-making SOEs, the reform of the banking system is linked closely with progress on reforms of SOEs. Restructuring SOEs into shareholding companies fully responsible for their own financial operations, using more market-based labor practices, and improving managerial and financial accountability will be crucial in establishing a more efficient SOE sector. Some progress in the reform of enterprises has been made. The prices for industrial inputs and outputs, which the SOEs produce, have been largely liberalized. The SOEs have been subjected to competition from TVEs and imports, which has helped increase efficiency. The managerial autonomy of SOEs has been increased and a significant proportion of the SOEs have become subject to the hard budget constraint, which makes them responsible for their own profits and losses. Direct budgetary support for the SOEs was eliminated as of January 1994 and credit is now being provided based on commercial considerations except for the SOEs deemed to be of strategic importance for which directed credit is now channeled through the three newly created policy banks. The social obligations of urban-based SOEs are gradually being removed with the introduction of individual home ownership schemes, unemployment insurance, medical insurance, and wage reforms. Finally, asset mergers and formal bankruptcy procedures are increasingly being applied to failing enterprises.<sup>1</sup> However, because of the social cost of unemployment, the Government has adopted a cautious approach in restructuring inefficient SOEs and in allowing them to go bankrupt. Because the SOEs have traditionally performed the role of "employer of last resort" and the main providers of social security and other welfare benefits to workers, the potential for social dislocation by reforming and restructuring the SOEs is enormous. An estimated 27 million workers would be made redundant if SOE reforms were to be implemented immediately without considering the social costs of these reforms.<sup>2</sup> The reforms of the SOEs must be accompanied by an acceleration of efforts to establish a social security system, develop housing markets, and expand the tertiary sector to absorb the surplus labor. The problem is complicated by the existence of about Y400 billion (\$47.6 billion) of interenterprise debt, which creates the potential for a series of associated collapses if "directed credit" is denied to a few large enterprises.

#### **5. Infrastructure Development**

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<sup>1</sup> The courts in the PRC closed over 100 SOEs under bankruptcy procedures in 1995 and another 400 SOEs were merged with others to rationalize their capital structures and to improve their management.

<sup>2</sup> For a more detailed analysis of the issues involved in this context see the "Study on Social Welfare and Labor Adjustment for Enterprise Reform" prepared under TA 1923-PRC.

35. Bottlenecks in the energy, transport, communications and water supply sectors, pose another major obstacle to sustainable growth. Large investments, in the order of \$500 billion to the end of the decade, are required to overcome these infrastructure bottlenecks. Such requirements are too large to be financed from traditional sources (e.g. domestic sources and multilateral and bilateral agencies). An increasing portion of the additional funding for infrastructure will have to come from direct cost recovery and the private sector, both domestic and foreign. New methods of financing infrastructure will need to be explored and developed. A transparent environment also will need to be created for joint public and private sector investment in infrastructure, including foreign direct investment (FDI).

36. A large part of the demand for infrastructure reflects the sharp acceleration in the rate of urbanization as a result of the transition process. When the “floating population”<sup>1</sup> is included, the urban population has grown at an annual rate of 5 percent since market reforms began. This trend in migration is expected to continue and the urban population will more than double before the year 2010. Financing the increased demand for urban services and infrastructure poses a major challenge for municipal governments.

37. Financial sector reforms will need to be expedited to develop alternative mechanisms for financing investments in infrastructure which require long-term local cost financing - such as bonds, long term bank loans and the mobilization of pension and insurance funds - to complement equity investment and the development of domestic mutual funds. This will help to create an efficient and competitive banking and nonbank financial sector and well-developed capital markets; and promote domestic resource mobilization and efficient financial intermediation.

38. Efforts to promote FDI and to create a more favorable environment for private investment in infrastructure will require: (i) creating transparent policy, legal, and regulatory frameworks for private domestic and foreign investment in infrastructure, including an appropriate framework for BOT/BOO type projects and joint ventures; (ii) developing capital markets as a source of long-term yuan-denominated equity and debt funding; (iii) using international capital funds to provide equity and/or debt financing for infrastructure and industrial restructuring; and (iv) maintaining a stable macroeconomic policy environment to reduce risks faced by foreign and domestic investors.

## 6. Agricultural Development

39. The Ninth Five Year Plan (NFYP) identified agricultural development as PRC’s top priority. The Government’s medium term sectoral objectives are to: (i) increase the food production to meet the increase in demand from the growth in population and income; and (ii) increase rural incomes and employment opportunities to check the widening rural-urban income disparities. Given the arable land constraints (0.1 hectare per capita) in the PRC, the sectoral development strategy focuses on increasing productivity, developing underutilized and unutilized lands, and using an integrated approach to agricultural farming. The strategy also seeks to increase the value added for agricultural produce and to create off-farm employment opportunities.

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<sup>1</sup> Transitory population from the countryside who do not have urban residency rights and who move regularly from the countryside to urban centers for employment purposes. Although the urban residency permit system has been decreasing in importance and is not strictly applied to these transitory workers, they do not normally set up permanent dwellings in the urban centers because they cannot have access to public utilities and social services. The “floating population” in the PRC is estimated to be between 70 and 100 million.

40. Consistent with these policies and strategies, the key elements of the agricultural development plan under NFYP include: (i) the protection of arable land from desertification and urban/industrial encroachment; (ii) an improvement in agricultural production technology; (iii) improved support services and delivery of inputs; (iv) the enhancement of farm infrastructure including irrigation and drainage facilities; (v) an improvement in postharvest handling, storage, and distribution facilities; (vi) the integration of crop production with forestry, livestock, and aquaculture, whenever feasible; (vii) the provision of production incentives to farmers by deepening agricultural reforms; and (viii) the creation of off-farm employment opportunities through the development of rural agroprocessing industries. The NFYP envisages a substantial increase in investment in agriculture during the plan period, which is expected to be met through an increase in the appropriations from the Government's budgetary resources supplemented by external funding.

## **7. Environmental Concerns**

41. The spread of environmental problems is a constraint to sustainable growth. A better environment is essential for improving the quality of life of the population, attracting foreign investment, and achieving sustainable growth and development. The long-standing problems of population pressure and limited resource base have been exacerbated by the emergence of environmental problems associated with rapid economic growth and the legacy of inappropriate environmental and pricing policies. Major environmental concerns include: (i) urban air pollution caused by such factors as the use of obsolete industrial production and power generation technology and the country's dependence on coal as a primary energy source; (ii) water and land pollution caused by a lack of wastewater treatment and inappropriate industrial toxic and hazardous solid waste disposal and urban refuse; (iii) a relative shortage of water resources in the northern part of the PRC and serious water shortages in many cities; (iv) soil erosion caused by deforestation and overgrazing; and (v) a low forest coverage rate, depletion of natural forests and degeneration of grasslands. These problems reflect the inappropriate pricing of resources, a weak policy and regulatory system, and the past use of outmoded and polluting technologies and production techniques.

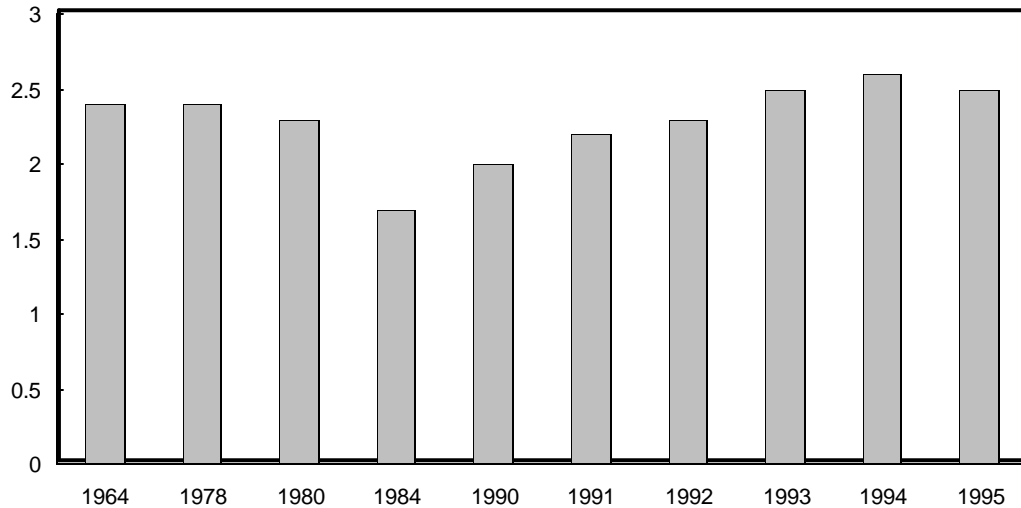
42. Massive investments, stricter legislative and enforcement frameworks, and market based incentives are required to encourage environmentally friendly behavior to address these problems. Improving environmental protection measures is an integral part of the medium-term development strategy in the PRC. The financing plans must cover both "economic" and "environmental" investments.

## **8. Regional Disparities in Growth and Poverty**

43. Despite the PRC's impressive economic performance, growth has not been shared equally among the regions. The regions on the coast have grown faster than the regions in the interior. Interior regions have been disadvantaged by their relatively poorer access to investment funds, and inadequate infrastructure and market linkages. These interior areas are also disadvantaged by relatively slower implementation of economic reforms compared with the regions on the coast, weaker institutional capacity, and limited financial resources available to local governments because transfers from the Central Government were reduced as the fiscal system became more decentralized. While such inequalities existed before the reforms, regional differences have increased since the mid-1980s. The disparities between average per capita urban and rural incomes have also widened in real terms because urban wages are rising more rapidly (see Figure 2). Market-based reforms, coupled with more liberal policies towards the

movement of labor from one region to another, have increased the migration from rural to urban areas and raised urban unemployment. The rise in urban unemployment has coincided with the dismantling of social safety mechanisms that had been established on a collective basis. While urban poverty is increasing, poverty in the PRC is still largely a rural phenomenon.

Figure 4: Ratio of Urban and Rural Per Capita Incomes



44. While rapid economic growth has made a major contribution to the reduction of poverty, there are still about 65 million people in PRC living below the poverty line.<sup>1</sup> The poor are largely concentrated in the remote mountainous rural areas in the inland provinces. Promoting rapid, efficient economic growth in the poor inland provinces is a major challenge and requires: (i) developing infrastructure in the less developed inland regions and creating better incentives for investment and growth in these areas; (ii) developing an effective system of intergovernmental fiscal transfers to support the development of poorer regions; (iii) tackling the problem of massive underemployment in rural areas and growing unemployment in urban areas as a result of the new entrants into the labor market and the reforms in the SOE and agricultural sectors; (iv) increasing agricultural production; (v) providing better social services in poorer regions where health and education need improvements; and (vi) formulating innovative and targeted responses to address absolute poverty in rural areas.

## B. Government's Medium-Term Development Strategy and Objectives - The Ninth Five Year Plan (1996-2000)

### 1. Introduction

<sup>1</sup> The World Bank in a recent study entitled "Poverty Reduction and the World Bank", reestimated the extent of poverty in various countries using the criteria of \$1 a day per person. Based on this criteria, the PRC's estimated population living below the poverty line was over 370 million.

45. The Government's most recent and comprehensive response to these challenges has been the NFYP (1996-2000) approved by the National People's Congress in March 1996. The Government's strategic thrusts and development priorities during the next five years as reflected in the NFYP have been taken into account in formulating the Bank's new operational strategy for the PRC. The NFYP states that the Government will continue to adopt market-oriented reforms aimed at transforming the PRC into a "socialist market economy" by the year 2000. Achieving balanced, efficient and sustainable growth, coupled with a reduction in poverty, will constitute the core of the country's medium-term development strategy. The strategy will deepen reforms, open PRC wider to the outside world, promote economic development, and maintain social stability. The Government has placed priority on achieving an appropriate balance among reform, development, and social stability.

46. By the end of 1995, the Government's original target of quadrupling the GNP in 1980 was achieved five years ahead of schedule. The major long-term economic target will be to double the 1995 GNP between the Years 2000 and 2010, to improve living standards and further to achieve industrialized country status. The nine major principles (together with the strategies embodied in each of these) for the longer term economic and social development of the PRC over the next 15 years, as stated in the NFYP, include:

- (i) maintaining sustained economic growth;
- (ii) achieving productivity and efficiency gains in the implementation of development projects;
- (iii) improving education, and making greater use of modern science and technology;
- (iv) modernizing the agriculture sector;
- (v) reforming and upgrading the technology in SOEs;
- (vi) developing appropriate laws, regulations, and policies to support a market economy;
- (vii) using appropriate market mechanisms to develop the full potential of all sectors of the economy;
- (viii) narrowing regional economic disparities; and
- (ix) ensuring an equitable distribution of the gains from growth;

47. The broad principles guiding the NFYP and the resulting strategies provide an appropriate response to the major development challenges in the PRC. A key element of the medium-term strategy is to achieve macroeconomic stability to facilitate the continuation of economic reforms by adopting policies that will dampen the "stop-go" cycles of expansion and contraction. This requires institution-building at the macroeconomic level including putting in place legal and regulatory frameworks suited to a market economy. Another important element is the commitment to an equitable distribution of income.

## **2. Monetary and Financial Sector**

48. Monetary and financial reforms over the medium term will focus on the deepening of the reform process announced in November 1993 by: (i) completing the transformation of PBC into a true central bank with powers to shape monetary policy and manage the economy through the use of indirect monetary policy instruments, including interest rates, reserve ratios, and open market operations; (ii) promoting the commercialization of the banking sector, with a focus on transforming the State banks into competitive, autonomous and accountable commercial entities, and shifting the responsibility for policy lending to the three policy banks established in 1994; (iii) establishing a modern payments system and developing a national interbank money market to enable PBC to conduct open market operations, to

encourage banks to reduce their reliance on PBC for refinancing and to improve their fund management; (iv) developing capital markets to provide enterprises and investors in infrastructure with an alternative source of long-term financing and to improve domestic resource mobilization by providing households with the opportunity to invest their longer term savings in high-yielding assets; and (v) creating an appropriate legal, regulatory and institutional framework to facilitate the diversification of the financial sector and to encourage the growth of domestic and foreign banks and nonbank financial institutions. The PRC also made the yuan convertible under the current account in 1996, a few years ahead of its self-imposed deadline of the year 2000.

### **3. Fiscal Policy**

49. The Government's fiscal reform program over the medium term will involve further efforts to implement the "tax sharing" system. This will be done by readjusting revenue capacity among the Central Government, provincial, and local governments, and rationalizing the distribution of tax categories into Central, provincial, local, and shared taxes. The NFYP also emphasizes: (i) strengthening revenue collection efforts to raise the share of Central Government revenue in GDP; (ii) controlling and rationalizing government expenditures, including the need to set up a more rationalized grants system; (iii) limiting public debt; (iv) developing standardized regulations and an effective legislative framework; and (v) setting up a fiscal supervision system. The NFYP states that the PRC will have a balanced budget by the year 2001, which will involve a Y13 billion a year reduction in the current level of the budget deficit.

### **4. Enterprise Reform**

50. The Government aims to improve the efficiency of SOEs through reforms in the administrative management, financial management and regulation of the enterprises. The NFYP states that SOEs should declare bankruptcy if their liabilities exceed their assets, if long-term losses are incurred, and if the enterprise cannot compete effectively in the market. The Government recognizes that changes in organizational arrangements will require reforms related to: (i) the legal framework within which SOEs operate; (ii) the systems and regulations governing relations between the Government and SOEs; and (iii) diversification of ownership. Improving the policy environment to increase SOE efficiency will involve financial sector reforms (especially banking reforms, so that directed credit from State commercial banks can be phased out), trade reforms (so that SOEs can be subject to greater competition); social security reforms (so that social obligations such as health, education and housing can be separated from SOEs and retrenchment of the overstaffed SOEs can be facilitated while minimizing the costs of social dislocation); and competition policy (especially in terms of factor mobility and exit policy). The largely completed price reforms and the introduction for profit retention, corporate income tax and financing capital investments by loans have played an important role in improving the efficiency of SOEs by establishing market prices for most inputs and outputs to which the SOEs must respond.

### **5. Infrastructure Development**

51. The Government's policies with regard to infrastructure development focuses on alleviating bottlenecks. Financing PRC's massive infrastructure needs will require appropriate instruments and incentives to channel a larger share of domestic savings, and to attract foreign capital into the sector. The NFYP stresses that efforts will need to be made to: (i) develop domestic capital markets; (ii) promote foreign capital investment through joint ventures, BOO/BOT projects, and international funds such as the Asian Infrastructure Fund and the Asian

Infrastructure Mezzanine Capital Fund; (iii) implement further price reforms and appropriate user fees to increase cost recovery from users, increase the retained earnings of infrastructure companies and create the environment to attract private investment; and (iv) strengthen the ability of local governments to raise their contribution to infrastructure financing. Besides increasing investment, market forces will be used to improve efficiency in the provision and operation of infrastructure by adjusting prices, introducing competition, and commercializing management.

52. In the road subsector, the policies focus on: (i) constructing expressways, to develop a highway trunk system by the year 2020 linking all cities with a population of more than 500,000; (ii) developing secondary roads, particularly those which will assist in creating the environment to reduce poverty and promote rural development; and (iii) building roads that will promote regional cooperation with neighboring countries in the southwest, northeast and northwest. About 70,000 kilometers of the projected 80,000 kms of new roads to be built during the NFYP will be secondary roads that link rural areas with regional growth centers. The total investment required in the road sector during the NFYP is between \$52 and \$85 billion, of which between \$4.8 billion and \$9.7 billion will be financed from foreign sources.

53. Development of the ports subsector is linked closely to the expansion of domestic and foreign trade. Key priorities include: (i) container port development (hardware expansion, software development and development of management skills); (ii) developing coal facilities in the ports in the southern part of the PRC; and (iii) roll-on-roll-off (RoRo) terminal facilities. Efforts will also be made to improve the management, efficiency, and financial performance of ports. During the NFYP, the inland waterways will also be developed further. Total investment required in the ports and inland waterways sector is estimated at \$\_\_\_ billion during the NFYP, of which the Central Government will finance about half.

54. In the railways subsector, the policies under the NFYP will focus on investment in new track and rolling stock as well as expansion of capacities in more than half of the 498 sections of the national railway network where bottlenecks have emerged. One of the priorities is to increase the speed of passenger and cargo trains to add to capacity and to reduce capital requirements. The development of local railways will be emphasized to improve the network. The Government has planned capital investment of between \$5 and \$8 billion per annum in the sector during the NFYP.

55. In the telecommunications subsector, the Government aims to link the entire country via public telephone networks by the turn of the century. Specific targets include: (i) constructing 23 optical fibre cable lines to create an optical fibre cable network supported by satellites and digital microwave links that will increase the number of long distance lines to 2.4 million or 3.5 times higher than in 1994; (ii) upgrading/modernizing the optical fibre cable lines constructed during the Eighth FYP; (iii) expanding the capacity of telephone exchanges to reach 140 million lines by the year 2000 and improving the telephone intensity to 30-40 percent in urban areas and providing each village in rural areas with at least one telephone connection by the year 2010 in line with the Government's aim to increase total telephone capacity to 400 million lines and national telephone density to 25 percent; (iv) accelerating the development of cellular phones and radio pagers; (v) developing basic services to support and expand the network; and (vi) developing new services (e.g., on-line data retrieval, information retrieval and processing, e-mail, voice-mail, electronic data exchanges, faxes) to broaden and modernize the network. Total investment required in the sector during the NFYP is estimated at about \$49 billion of which 70 percent will be funded by domestic sources and the rest from international sources.

56. Priorities in the power sector will focus on the twin objectives of increasing energy production and improving energy conservation. The Government's plans in the sector will include (i) increasing generating capacity at a rate of 15-20 GW per year; (ii) improving energy efficiency to meet half of the increased energy demand; (iii) improving energy transmission; (iv) promoting the integration of the network; and (v) reducing the adverse environmental impact of the energy sector. The estimated total investment required in the power sector during the NFYP is about \$100 billion, of which about 20 percent will be sought from external sources while the Central and local governments will each contribute about \$40 billion.

57. The PRC has developed medium term objectives for urban water supply. The following objectives adopted during the Eighth Five-Year Plan (1991-1995) will be continued in the NFYP: (i) raise the urban coverage of water supply from 89 percent of the population in 1990 to 95 percent in the year 2000; (ii) increase the water supply for domestic, public and commercial uses from an average of 170 liters per capita per day (lpcd) in 1990 to 200 lpcd in 2000; and (iii) recycle 65 percent of industrial wastewater by the year 2000. In recognition of the problems in the urban water supply sector, the Government issued guidelines in 1992 that will lead to the rational development of the sector. These guidelines emphasize: (i) proper planning for, and the inclusion of, water supply projects in national, provincial, regional and local economic development plans; (ii) mobilization of financial resources from users and from various Government sources for the construction of new facilities; (iii) full cost recovery from industrial and commercial users and recovery of operation and maintenance costs from residential users by the year 2000; (iv) prevention of excessive groundwater extraction; (v) conservation of water resources; (vi) the use of loans and credits to finance urban water supply; and (vii) the application of new technology where appropriate. Against the background of rapidly increasing water demand, the limited water resources have become a constraint for economic development, particularly in the northern and coastal areas. Government policies and programs, while protecting water resources, seek to increase water supply and ensure better water quality by: (i) implementing water conservation through introducing water saving technologies and an adequate payment system for water use; (ii) improving water management, including the construction of projects for flood prevention, water storage and diversion, and introducing rational planning for water use and distribution; and (iii) improving the monitoring of water quality and pollution discharges. Major efforts will be made to address environmental problems in the water sector by increasing the amount of industrial and municipal wastewater treatment.

## **6. Environmental Initiatives**

58. During the NFYP, the Government will continue to improve its capacity to manage the environment and to conduct environmental impact assessments (EIA). This will be done through strengthening the management information systems (MIS) of provincial and local environmental protection bureaus (EPBs) and promoting EIA training. The network of local and provincial environmental protection bureaus will enforce environmental laws, regulations, and standards to improve environmental protection and management under the leadership of the National Environmental Protection Agency (NEPA). Energy generation (because of heavy dependence on coal and limited investment in appropriate environmental technology) and industry (because of the obsolete production processes, the use of outdated technologies, and the reliance on coal) are the two major sectors contributing to air pollution, particularly in urban areas on the east coast. The Government's environmental policy will focus on both demand- and supply-side measures directed at reducing the high energy intensity in the PRC through

energy conservation and upgrading industrial technology to reduce emissions. Demand-side management will focus on end-use efficiency and appropriate pricing policies in the energy sector to create market-based incentives to encourage energy conservation and to reduce pollution. Supply-side policies for pollution control will include efficiency improvements through rehabilitation, retrofitting and reducing conversion losses. Because coal-fired energy production is a major source of pollution, special attention will be accorded to promoting the use of clean coal technologies. The Government's aim is to half the increases in degradation of the environment by the turn of the century by improving the environment in 52 major cities where pollution is most severe, preventing further degradation of natural ecosystems, and integrating the environmental protection program into national economic and social development planning. To meet the national objective of environmental improvement, environmental expenditures are expected to be equivalent to 1.5 percent of GDP per year during the NFYP.

59. Substantial emphasis is given by the Government to water pollution abatement projects, particularly through central wastewater collection and treatment facilities and industrial pollution control. The Government has given priority on cleaning the seven major river systems (Huai, Songhuajiang, Liao, Hai-Luan, Huang, Zhujiang, and Changjiang or Yangtze) and three lakes (Chao, Dianchi, and Tai).

60. The Government will continue to address environmental issues in urban areas by upgrading the technology in plants, providing tax and fiscal incentives for enterprises to reduce pollution, improving toxic, and hazardous and solid waste management, creating more environmentally friendly land use policies, improving water supply and sewerage/drainage systems, and increasing the use of cleaner forms of energy (e.g. hydropower, natural gas, methane coal gasification and district heating from cogeneration). By the year 2000 all pollution sources should meet national or local standards. Those that do not will be forced to close or to carry out remediation measures.

## **7. Regional Development and Anti-Poverty Initiatives**

61. A key thrust of the NFYP is to promote growth in the poorer inland provinces by: (i) formulating an equitable fiscal transfer system (from the richer coastal regions to the poorer interior and/or remote regions); (ii) promoting investment, both domestic and foreign, in the interior regions; (iii) expediting the implementation of the economic reform program in the interior regions; (iv) accelerating infrastructure investment in the provinces in the interior; and (v) taking measures to alleviate poverty which tends to be concentrated in the interior regions and in rural areas. The NFYP identifies seven transprovincial economic regions to be set up in the next five years to coordinate development and narrow differences among provinces. The Government also recognizes the importance of allowing coastal areas to continue with their rapid pace of development. The economic linkages between the rapidly growing coastal areas and the less developed regions in the interior will be strengthened. This will require investments in transport and communications infrastructure to facilitate increased business relationships between entities located in the two areas.

62. Poverty reduction will be pursued through the continued implementation of the "Eight-Seven Poverty Eradication Plan" introduced in July 1993.<sup>1</sup> The program aims to raise

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<sup>1</sup> The objective of the Eight-Seven Program is to lift 80 million rural poor out of absolute poverty over a seven year period (from 1994-2000) through targeted interventions. The program is designed to raise the agricultural output of the absolute poor located in remote, resource poor upland regions, deserts, the Yellow Plateau, and in the flood prone areas along the Yellow River.

annual per capita incomes in over six hundred poverty counties to at least Y500 (in constant 1990 prices) by the turn of the century. This will be done principally by increasing the allocation of farmland; providing each household with a minimum plot (0.5 to 1 mu) for forest, orchard or cash crop cultivation; assisting households in setting up businesses; and providing an enclosed meadow or pasture for each household. The Government will also make efforts to: (i) provide clean drinking water for the rural poor; (ii) improve and expand primary education and health facilities in rural areas; (iii) provide basic infrastructure (e.g., roads, electricity, telecommunications and water) in poor counties and townships; (iv) protect and preserve the environment in remote mountainous areas, the Yellow Plateau and the Yellow River basin; and (v) enhance opportunities for the poor to gain employment in township and village enterprises (TVEs).

63. Since the implementation of the "Eight-Seven Poverty Eradication Plan" began in July 1993, about 15 million people have been brought out of absolute poverty. At this rate, the Government's current strategy should help raise the incomes of between 35 and 40 million people above poverty line by the turn of the century. By these estimates, the PRC will still have about 40 million absolute poor in the year 2000.

64. The Government will also give greater emphasis to social development over the next fifteen years. Apart from direct poverty reduction efforts, the other major tasks include: (i) controlling population growth within the 1.3 billion limit by the year 2000 and 1.4 billion by 2010; (ii) upgrading human capital by acquiring science and technology from abroad and developing indigenous science and technology; (iii) expanding employment opportunities in urban and rural areas through livelihood training programs and development of the service sector; and (iv) establishing a multilayer social security system, combining social insurance, pension, medical care, and other forms of social relief.

### **C. Utilization of Foreign Capital**

65. Most of the capital required for PRC's development will come from domestic sources. Of the \$200 billion of annual budgeted investment, only about \$6 billion is financed from international sources. The Government plans to continue its policy of borrowing foreign funds in a prudent manner and of ensuring these funds are efficiently utilized. Between 1979 and 1995, the PRC used \$242 billion of foreign capital, of which long- and medium-term external debt (borrowing) was \$110 billion and direct foreign investment amounted to \$132 billion. Of the long- and medium-term borrowing, borrowing from bilateral sources amounted to \$24.2 billion (or 22 percent of total borrowing), while that from multilateral agencies amounted to \$17.6 billion (or 16 percent). At the end of 1995, the debt ratio was 15.8 percent and the debt-service ratio was 9.1 percent. Such sustainable debt indicators will be maintained over the NFYP period.

66. The Government's policy is to invest foreign borrowings secured on "hard" terms in financially viable projects that can generate the incremental cash flows necessary to service the loans. Priority will continue to be placed on the development of infrastructure (energy, transport, communications and water resources) and on the build-up of export capacity to create employment and to generate foreign exchange earnings. Other areas in which foreign resources will be allocated include importing raw materials that are scarce in the PRC; textiles/light industry/processing industries; and environmental protection. Concessional foreign borrowings will be used to fund projects that cannot service loans on OCR terms such as those in the social sectors, which address poverty as a primary objective, most agriculture projects, health, education and many environment projects. Under the NFYP, more than 60 percent of

concessional loans from international aid agencies will be invested in the central and western regions.

#### **D. Bank Assessment of the Government's Approach and Key Risk Areas**

67. The broad thrusts of the planned reform program and sectoral developments envisaged under the NFYP provide grounds for optimism regarding the future growth and stability of the economy. The initiatives that have been launched so far in the reform of fiscal, financial, and monetary policies are fundamentally sound. Market forces are increasingly being used to allocate factors of production and competition is increasing in the economy. Progress has been made in introducing commercially oriented management practices in SOEs, which are being subjected to greater financial accountability. However, the reform program remains incomplete because of the Government's desire to balance the twin objectives of economic and social stability. Consequently, there is a tendency for the economy to experience sharply fluctuating cycles of inflation and growth. Even as the Government seeks to steer the economy towards a sustainable growth path within an environment of social stability, reversals or prolonged delays in reforms related to enterprises, financial, fiscal, and price reforms could jeopardize the country's transformation to a market economy. In this context, the following factors continue to be risks to the overall success of the reform program in the PRC.

68. First, the SOE sector still faces a host of problems that make many SOEs unprofitable, such as highly leveraged capital structures, outdated technology, weak management systems, overstaffing, and the responsibility for providing social services (e.g. health, education, social security, and housing).<sup>1</sup> The reform of SOEs is essential because of the burden the loss-making SOEs place on Government finances and the negative influence of directed credit to the SOEs on the banking system. The reforms are also required to complement the reforms in other key areas especially financial and fiscal reforms. The restructuring of the SOEs coupled with efforts to establish a social security system, develop housing markets, and expand the tertiary sector to absorb surplus labor, are crucial for the success of the reform program in the PRC.

69. Second, the bottlenecks in infrastructure will need to be addressed to support efficient and sustainable economic growth. The funds required to finance the infrastructure needs in the PRC exceed the amounts available through traditional sources of financing (e.g., Government funds and official development assistance). New methods of financing infrastructure, including mobilizing private long-term financing, need to be explored and developed.<sup>2</sup> A number of perceived risks have deterred both domestic and foreign private investors from investing in long-gestation infrastructure projects in the PRC. Such risks are related to factors such as the absence of clear legal and regulatory frameworks; different perceptions of risks and expected returns between investors and the Government; the enforceability of contracts; limited availability of domestic term finance; and underdeveloped capital markets. Unless efforts are made to create an environment for private sector investment in infrastructure through the development of appropriate financial instruments and institutions as well as a predictable, transparent policy/legal/regulatory framework, it will be difficult to mobilize the resources necessary to finance the planned infrastructure investment. The absence of adequate infrastructure would have serious economic implications and result in avoidable costs to the economy by increasing production costs, limiting efficiency increases, increasing the cost

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<sup>1</sup> See the "Public Enterprise Governance Reform Study" prepared by under TA 1924-PRC.

<sup>2</sup> For an agenda on new approaches to infrastructure financing, see Peter Lanjouw, *"Infrastructure: A Ladder for the Poor"*, Finance and Development, March 1995.

of trade, causing urban living conditions to deteriorate, retarding development in rural areas, and perpetuating regional inequalities.

70. Third, rural development and agricultural growth and productivity need to be accelerated. Given the huge demand for grains in the PRC, production needs to increase by 50 million metric tons during the NFYP to ensure that total national grain production reaches 500 million metric tons by the year 2000. Grain shortages in the PRC could disrupt the world market for grain because the total grain traded in the world market is about 50 million metric tons. Slower economic development in rural areas has also contributed to widening rural-urban income disparities. This has resulted in an increase in the migration of largely unskilled and underemployed workers to urban centers. Despite the high rate of economic growth, the new jobs created in urban centers have not been sufficient to absorb the surplus rural labor. Also, urban infrastructure has been placed under increasing pressures as a result of this migration. Unless these issues are addressed, the deterioration in the socioeconomic conditions in the urban centers could potentially lead to social discontent.

71. Fourth, despite some improvements in the fiscal position because of the improvements in revenue performance and stricter controls on expenditures, the sustainability of this trend is uncertain because the enterprise reforms have not been completed and the revenue sharing arrangements between the Central Government and the provincial governments have not been fully clarified. Excessive deficit financing could fuel inflation. To ensure that budget deficit targets are met, the Government must control expenditures and strengthen revenue collection and administration further. Because the delivery of social services is dependent largely on local governments and community funding, effective revenue sharing and fiscal equalization (involving a redistribution of revenues in favor of poorer provinces) would help improve the provision of social services in poor areas. If appropriate reforms related to revenue sharing are not undertaken, this could have an adverse impact on the delivery of social services at the local level in the poorer regions.<sup>1</sup>

## **E. Future of Hong Kong**

72. Hong Kong will revert to the PRC on 1 July, 1997. The transition is expected to be smooth and most of the issues regarding Hong Kong's legal and political institutions set up under British rule are expected to be resolved before the transfer date. Therefore, business confidence should not be affected by the transition and Hong Kong is anticipated to continue to play a pivotal role as a global financial center, as the main window for the PRC to the outside world through which to draw significant foreign direct investment for mainland PRC and new technology and management expertise. Companies in the PRC are likely to increase their share of the Hong Kong economy. The economic interlinkages between Hong Kong and PRC has been significantly strengthened during the reform period and this is expected to intensify. The PRC and Hong Kong are each other's biggest investors and trade partners. During 1995, half of Hong Kong's exports to the PRC and three quarters of its imports involved the operations of Hong Kong firms in the PRC. PRC companies account for 15 percent of Hong Kong's economy. By 1997, PRC companies are expected to dominate the banking, transport, construction, tourism and external trade sectors. Sixty-three companies controlled by the PRC account for 5 percent of capitalization on the Stock Exchange of Hong Kong. Planned listings of more mainland firms will increase this to 15 percent by the time of the handover. The Bank of

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<sup>1</sup> See Financing Local Government in the PRC, prepared under TA 2118-PRC: *Study of Subprovincial Fiscal Relations*, August 1995.

China controlled 23 percent of all bank deposits in Hong Kong in 1994, second only to the 33 percent controlled by Hong Kong and Shanghai Banking Corporation. By the end of 1996, the Bank of China issued 20 percent of Hong Kong's banknotes. Tourists from PRC made up 22 percent of arrivals in Hong Kong in the first seven months of 1995, more than those from any other country, a trend which is likely to continue. The PRC helped formulate Hong Kong's 1996-1997 and 1997-1998 budgets, which were drawn up in cooperation with the United Kingdom. Major infrastructure projects and contracts extending beyond 1997 are now subject to approval of the Government of the PRC, including the new airport at Chek Lap Kok, land reclamation projects, and the long-distance telephone monopoly. Because of these extensive economic interlinkages, the reversion of Hong Kong to the PRC is expected to be smooth without any disruptions to the financial and stock markets. Hong Kong will continue to play a leading role in mobilizing and channeling FDI into the PRC economy. A survey covering six business sectors ranging from banking to manufacturing, indicated that 74 percent of the Hong Kong business leaders surveyed, indicated that they would continue business as usual, 19 percent would increase investments in 1997 and only 7 percent would reduce their business presence in Hong Kong or relocate.

## Chapter III

### DEVELOPMENT ASSISTANCE EXPERIENCE AND OUTLOOK

#### A Assessment of Bank Operations

##### 1. Bank's Past Role and Impact (1991-1996)

73. The Bank's operational strategy for the PRC originally formulated in 1991 emphasized three broad objectives: (i) improvements in economic efficiency; (ii) poverty reduction; and (iii) environmental protection and natural resource conservation. These strategic objectives were selected to support the Government's development objectives during the Eighth Plan (1991-1995) and its initiatives to improve living standards, achieve efficient and sustainable economic growth, and improve the environment.

74. By promoting market-based reforms that enabled rapid economic growth and targeted poverty, the Government's efforts contributed to the increase in average incomes, and the reduction in the incidence of poverty, particularly in the rural areas. The number of absolute poor declined from 270 million to 97 million between 1978 and 1985. By 1995, the number of absolute poor had decreased to 65 million (5.4 percent of the population). Thus absolute poverty is no longer widespread in the PRC, except in the remote, mountainous and resource-poor areas. Because PRC does not have access to ADF, the Bank has not been able to finance any specific poverty reduction, education or health projects in the PRC. However, the Bank, has supported the Government's objective of reducing poverty through strategies aimed at promoting economic growth and improving productive efficiency in poor areas. In the absence of concessional loans for lending to the PRC, the Bank has adopted a broad strategy that targets an increasing proportion of its lending operations to the less developed inland provinces where most of the absolute poor live. Many Bank-funded projects have addressed poverty reduction indirectly by providing infrastructure in less developed provinces, designing agriculture projects so that the poor are direct beneficiaries, and using the operations in the financial sector to increase the flow of credit to poor areas.

75. To promote efficient economic growth, the Bank's Operational Strategy supported the Government's effort to improve macroeconomic management by promoting the use of effective fiscal and monetary policy tools and by supporting reforms in the financial sector and nurturing the growth of capital markets. In supporting efficient sustainable growth, the strategy also addresses critical issues arising from the rapid economic growth such as removing bottlenecks in infrastructure and improving the management of the environment. The pursuit of such objectives has been achieved by designing loan projects to incorporate these objectives, providing technical assistance for the formulation of policies and institutional strengthening, and using the economic and sector work program to support the Bank's policy dialogue.

##### a. Physical Infrastructure

76. With rapid economic growth, there has been a need to develop a well-integrated transport and communications network that can facilitate the flow of freight and passenger traffic and information more efficiently and can promote economic linkages among the regions, particularly between the provinces on the east coast and the provinces in the interior. The Bank's

operational strategy has supported the expansion, rehabilitation, and interconnection of existing facilities.

77. The Bank's operations in the transport sector have focused on reducing key bottlenecks in the country's main transport modes (highways, railways, and ports) and strengthening urban transport operations and management. During the 1991 to 1995 period, the Bank provided \$3,482.3 million for 29 physical infrastructure projects, energy, transport and communications, and water supply, which is equivalent to 66.0 percent of the Bank's total loans to the PRC. The Bank has financed 18 projects in the transport sector amounting to \$1,986.0 million of which the road and highway subsector accounted for \$1,289.0 million or 26.5 percent of total Bank lending to PRC during the 1990s. Since 1991, the Bank has financed seven highway projects covering about 1,100 kilometers (km) most of which has been in the northeast transport corridor from Beijing to Heilongjiang Province. The urban transport projects included two bridges in Shanghai, connecting the east and west banks of the Huang Pu River, which facilitated the rapid development of the Pudong area.

78. The Bank has approved four loans totaling \$456.9 million for railway projects, which financed the construction of 1,047 kms of track. While most of the Bank financed investment in the railway sector has increased the capacity on the strategic Guangzhou to Beijing Corridor some of the projects have been located in poor interior provinces. Capacity expansion, technological modernization and institutional development have been the primary thrust of the Bank's operational strategy in the railway subsector.

79. In the telecommunications subsector, the Bank supported two telecommunications projects amounting to \$200.0 million during 1991-1996. The Bank strategy recognized the vital role of telecommunications services to support the growing marketization in the economy, and the need for restructuring the sector to promote competition and enhance the efficiency of the network. The Bank's operations in this subsector financed the installation of 12,800 km of optical fiber cable trunk transmission routes and the supply of optical fiber equipment. The Bank-financed telecommunications projects have linked inland growth centers such as Wuhan, Xian, Taiyuan, Hohhot, Hefei, and Xian with Beijing, Guangzhou and cities on the east coast.

80. The Bank's strategy in the energy sector has focused on expanding capacity to reduce power shortages, and developing cleaner energy sources such as gas, hydropower, and clean-coal technology in power generation. In the energy sector, the Bank has supported ten projects amounting to \$1.1 billion, which will create 1,414 megawatts (MW) of new electricity generating capacity. This includes a private sector power project, the Guangzhou Pearl River Power Company. In addition to power generation, improvements in pollution control, and district heating networks will be important by-products of the thermal generating projects. The Bank has also financed hydropower projects, which are a more environmentally friendly source of energy than thermal power.

81. In the water treatment and supply subsector, the Bank has financed one project amounting to \$160.0 million in Dalian for the construction of two new pumping stations, 173 kms of pipelines, and a new water treatment plant with a capacity of 150,000 cubic meters per day (cu. m/day). The project will expand existing water treatment facilities with an incremental capacity of about 180,000 cu. m/day.

82. The performance of the Bank's operations in the physical infrastructure sector has been outstanding in terms of project planning, project implementation, and project impact.

The Bank-financed projects have been successful and have helped to alleviate the bottlenecks in infrastructure. The completed infrastructure projects financed by the Bank have generally proven to be economically and financially viable. The Bank has gained substantial experience about the development of infrastructure in the PRC. Similarly, the Government has also built up a substantial institutional capacity in terms of good project design and experience in the implementation for infrastructure projects. Given the large investment requirements for physical infrastructure and the good implementation experience, the Government has expressed a preference for OCR loans to be concentrated in this area.

#### **b. Agriculture and Agro-Industry Sector**

83. The Bank provided a total of \$345.0 million for five agriculture projects during 1991-1995. The Bank's agriculture strategy emphasized increasing productivity, reforming enterprises, improving natural resources management, and reducing poverty in rural areas. The agriculture projects were designed to generate the financial returns necessary to service OCR loans. Improvements in natural resource management have been addressed by establishing economic buffer zones near forests, improving forest management and reforestation, and bringing degraded arable land into production. In addition to financing agriculture projects, the Bank has also provided loans for agriculture credit, which are designed to create employment in poor areas by providing long term credit for new and existing small- and medium-size agro-industries and industries in rural areas.

#### **c. Financial Sector**

84. In the financial sector, the Bank has supported the development of a more competitive and diversified financial sector. The Bank's strategy has aimed at specific interventions to: (i) strengthen the policy and regulatory framework of the financial sector; (ii) improve credit access for the non-State sector, particularly TVEs; and (iii) support selected thematic objectives of the country strategy such as environmental improvement, regional development, and poverty reduction. By providing technical assistance, the Bank is making a significant contribution to the implementation of reforms in the financial sector and to the development of capital markets. Recent examples of such policy-oriented TA includes those for nonbank financial institutions, cooperative banking, foreign financial institutions, and securities markets. The Bank has been requested to continue to support the development of capital markets in the PRC. The Bank is also focusing on assisting the smaller banks and nonbank financial institutions while the World Bank is taking the lead role in assisting the large State-owned banks.

85. The Bank has approved a total of seven credit lines for \$620 million to two banks and five nonbank financial institutions. The utilization of these credit lines has been generally satisfactory. Advisory TA was provided to all recipient financial institutions to strengthen their capabilities in project appraisal and credit management.

86. The Bank's operations in the private sector complement its other assistance and includes loans without guarantees and equity investments in privately owned and controlled enterprises in priority sectors, particularly in the financial sector. The Bank has made equity investment of \$10.3 million in the Xiamen International Bank (the first joint venture Bank in the PRC), \$4.0 million in China Assets (Holdings) Ltd (a venture capital fund), and \$20 million in the Everbright Bank of China (the first equity investment by only international financial organization in a domestic bank).

87. The Bank's experience in implementing projects in the financial sector in the PRC, as in other sectors, has been satisfactory. The Bank's operations in the financial sector have demonstrated that a strong demand for loans is ensured through market-based interest rates, realistic borrowing criteria, and sustained efforts by financial institutions to develop and maintain a continuous pipeline of subloans. A more general finding from the Bank's credit lines in the PRC has been the importance of: (i) in-depth analysis of the subloan and managerial and financial capacity of the subborrower; and (ii) frequent and systematic supervision of subloans during implementation. Further, it has been demonstrated that commercially viable lending opportunities exist in less developed, high poverty areas, and can be profitably implemented by the subborrower when lending programs are properly designed, subloans are rigorously evaluated, adequate loan supervision is carried out, and projects receive good local support.

#### **d. Industrial Sector**

88. With the increase in the reliance on markets and greater exposure to domestic and foreign competition, enterprise reform has become a critical part of the economic policy framework in the PRC. Although the Bank initially provided loans to support SOEs, during the 1990s, the Bank no longer provided loans to SOEs unless accompanying reforms are put in place to make the enterprise subject to the discipline of the market place. A number of reform measures have made SOEs more autonomous, profit-oriented, and subject to a hard budget constraint. Besides supporting enterprise reforms, the promotion of energy conservation and pollution abatement measures have been the primary thrusts of the Bank's operational strategy in the industrial sector. Industrial energy conservation, pollution control, and environmental mitigation measures by improving industrial process technology, coupled with market-based resource pricing and an appropriate regulatory framework to promote resource conservation and environmentally-friendly behavior, have been key elements of the Bank's operations in the industrial sector. This was accompanied by policy support to the management of improved enterprises through corporatization and diversification of ownership structures and to ensure fair competition between the State and non-State enterprises.

89. The Bank's support for enterprise reforms has subjected SOEs and utility companies to competition, greater market orientation and greater accountability and has improved their performance. To achieve the high growth rates targeted under the NFYP, the SOE reforms must be continued to improve efficiency and to reduce loss-making activities. Because the SOE sector still accounts for almost 45 percent of total output, support for enterprise reforms will continue to be an integral part of achieving the strategic objective of improving economic efficiency.

#### **e. Environment**

90. The environmental problems in the PRC that were present prior to the reform period have been compounded by the rapid economic growth over the past 18 years. The Government is undertaking projects to improve the environment in 52 key cities, a number of which have been, or will be assisted under the Bank's operational program. Institutional strengthening of concerned agencies is a key feature of the Bank's capacity-building and policy support program in the environment sector. The dominance of coal as a major energy source has led to severe environmental problems. Most of the Bank's assistance for the environmental sector has addressed "brown" pollution issues although some components of agriculture projects have addressed "green" issues. The Bank has financed several environmental improvement projects in coastal cities and where urban and industrial pollution is most severe. The main features of Bank interventions have been to reduce air and water pollution from both

industrial and municipal sources, promote energy conservation and diversification technologies, and improve the management of the urban environment.

91. The degradation of the environment is being addressed through increased budgetary allocations and improvements in environmental management. The Bank has helped finance the acquisition of environment-friendly technology and equipment to reduce industrial and urban pollution and to strengthen institutional capabilities in such areas as environmental impact assessment and monitoring, legislative planning and procedures for environment protection, and energy conservation and demand-side management.<sup>1</sup> The Bank has also financed the development of alternative forms of energy such as hydropower, natural gas, and coal gasification and promoted cogeneration and district heating.

## **2. Bank Operations and Implementation Experience**

### **a. Bank's Operational Program**

92. The PRC became a member of the Bank in March 1986. As of 31 December 1995, the Bank had approved 48 loans amounting to \$5,276.7 million. The Bank's lending to the PRC amounted to 9.3 percent of the cumulative lending amount (including lending without government guarantee) at the end of 1995. The PRC is sixth largest recipient of Bank loans and fourth largest recipient of OCR loans. More than half of the Bank loans to PRC (26 out of 48) have been made since 1993. The Bank's lending program has been complemented by a total of 212 technical assistance (TA) grants amounting to \$90.5 million as of 31 December 1995. Project preparatory TAs have accounted for 26.9 percent of all the TAs. Unlike in other countries, the projects in the PRC prepared by Government agencies. Thus, project preparatory TAs in PRC are usually for reviewing project preparation, particularly in areas related to environmental impact assessment and relocation.

93. During 1987-1989, two-thirds of the total lending was for the industrial and development finance sectors. During the 1990s, the Bank's operations in the PRC were refocused and two-thirds of the lending was for infrastructure development. Between 1990 and 1996, transport and communications accounted for 40.0 percent of total lending, the energy sector for 24.7 percent, and social infrastructure for 3.3 percent. The Bank has been making an increasing effort to finance projects in the provinces in the interior, consistent with the Government's position that investments in infrastructure in less developed provinces can stimulate the local economy and can reduce poverty. Over half (54.8 percent) of the projects financed since 1992 were located in provinces in the interior compared with about a quarter (27 percent) during the 1987-1992.

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<sup>1</sup> The Bank has provided technical assistance in this area, including TA 987-PRC: *Institutional Strengthening of National Environmental Protection Agency*, and TA 2090-PRC: *Legislation Planning and Procedures for the Protection of the Environment and Resources*.

**Table 3: Sectoral Distribution of Bank Lending to PRC, 1987-1989, 1990-1996<sup>a</sup>**

Sector	Cumulative up to 1989			TOTAL (1990-1996)		
	No. of Loans	Amount (\$ million)	%	No. of Loans	Amount (\$ million)	%
Finance	2	200.0	48.9	3	270.0	5.5
Transport and Communications	1	39.7	9.7	1	1,946.	40.0
Industry and Non-Fuel Minerals	1	86.8	21.	2	488.0	10.
Agriculture and Agro-Industry	1	49.6	12.	3	400.0	8.2
Energy	1	33.3	8.	6	1,203.	24.7
Social Infrastructure	-	-	-	1	160.	3.3
Multisector	-	-	-	3	400.0	8.2
<b>Total</b>	<b>6</b>	<b>409.4</b>	<b>100.0</b>	<b>35</b>	<b>4,867.3</b>	<b>100.0</b>

<sup>a</sup> Includes loans to private sector without Government guarantee.

## **b. Project Implementation Experience**

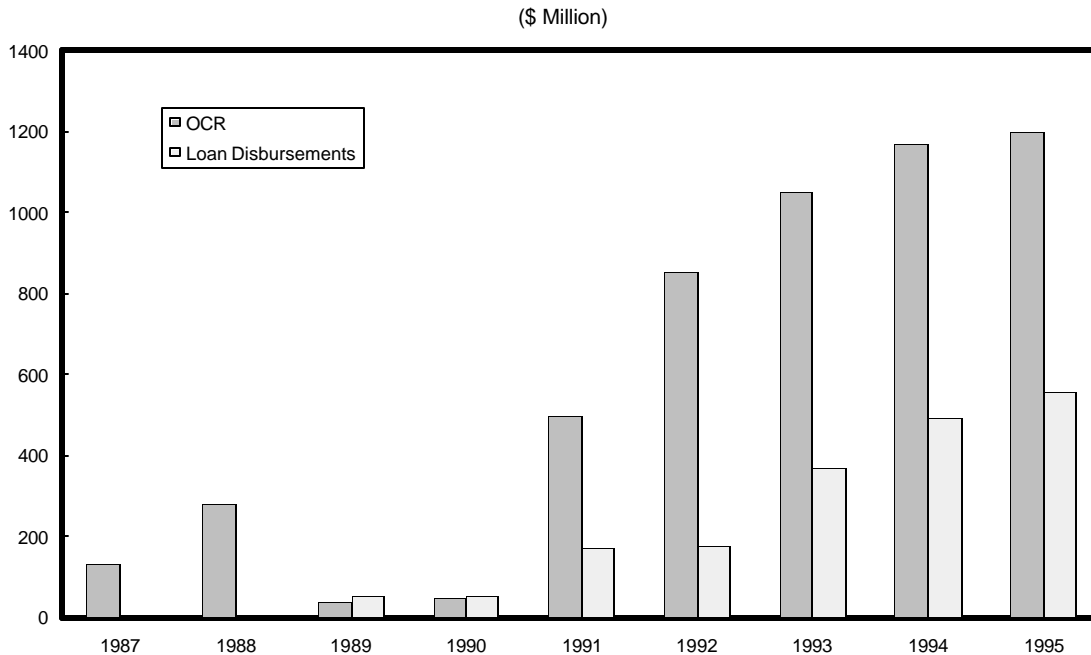
94. The good performance of the Bank's loan portfolio in the PRC reflects several factors: (i) rigorous screening of projects before they are proposed for Bank financing; (ii) strong technical capabilities of the executing agencies; (iii) substantial progress on project planning and detailed design before the Bank approves the loan; (iv) availability of counterpart funds; (v) sound institutional arrangements for implementation of projects; (vi) strong ownership of the projects by executing agencies, local governments, and Central Government authorities; (vii) clear accountability for project implementation and operation; (viii) strong commitment to financial responsibility for loan repayment; (ix) constant monitoring of the portfolio by PBC; (x) good capability for design and construction; and (xi) effective use of advance procurement and retroactive financing. While major problems related to project implementation and absorptive capacity are not expected to arise in the short term, the institutional capabilities of local governments in the provinces in the interior where the Bank will be playing a more active role will need to be addressed by providing TA and including capacity building components during the processing of projects.

95. The quality of projects continues to be the Government's paramount consideration in the selection of projects for Bank assistance. An assessment indicates that the Government is making progress in improving management and accountability in the public sector and developing the legal framework necessary for a market economy. The good project implementation experience to date has been reflected in a rapid increase in Bank lending to PRC during the 1990s.

96. Although the PRC is classified as a Group A country, past operational experience has shown that the Government has taken a judicious approach in project financing projects by financing a large portion of Bank-assisted projects and limiting the use of local cost financing (LCF). During 1987-1996 the Bank financed about 39.2 percent of the estimated total cost of projects. This is far below the allowable 80 percent ceiling for Group A countries. During the same period, about \$230 million was allocated for LCF, which represented only 6.4 percent of total Bank financing. While the PRC is not expected to request substantial amounts of LCF in the near term, given its trade surplus and the buildup in its foreign exchange reserves, the use of LCF could be justified on a case by case basis for projects located in the less developed

provinces in the interior where increased Bank assistance is envisaged and to address social development and environmental concerns.

**Figure 5: PRC: Annual Bank Lending and Disbursements <sup>a</sup>**



<sup>a</sup> Includes loans to the private sector without government guarantee.

97. The country's performance in the award of contracts and commitments has increased steadily, corresponding to the increase in the number of new loan approvals. During 1995, contracts amounting to \$748.6 million were awarded, the highest amount of contract awards since the Bank began lending to the PRC. The contract award performance ratio,<sup>1</sup> another useful performance indicator, has also improved since 1992 and reached 32.4 percent at the end of 1996, slightly above the original projected level.

98. The performance of loan disbursements has shown an increasing trend in line with the volume of lending. Disbursements for 1996 amounted to \$558.3 million and exceeded the target by 20.5 percent. The 1996 disbursement ratio was 20.3 percent, well above the Bank-wide ratio of 18.2 percent. The disbursement performance ratio in the PRC has always been better than the Bank-wide average ratio, except in the early years of lending to the PRC. This reflects the strong implementation capability in the PRC. The cumulative yearly disbursements reached \$1,933.1 million on 31 December 1996, showing that a majority of projects will be completed on or ahead of schedule.

99. Bank lending to the PRC from 1987 to December 1996 totaled \$5.27 billion, while the disbursements for the same period amounted to \$1.93 billion and loan cancellations amounted to \$46.9 million, equivalent to 0.9 percent of the net loan amount. The low loan cancellation ratio was attributable to: (i) timely implementation of projects within the appraisal cost estimates; (ii) advance and detailed design of projects prior to appraisal; (iii) realistic cost

<sup>1</sup> Defined as contract awards divided by the uncontracted net effective loan amount at the beginning of the year.

estimates; and (iv) early identification of loan savings which, when appropriate, were utilized to enhance project benefits.

100. The net resource transfer to the PRC has remained positive and has increased steadily since the Bank commenced lending. In 1996, loan disbursements to the PRC amounted to \$558.3 million, while loan service payments amounted to \$158.6 million, resulting in net positive transfer of \$399.7 million.

### **c. Bank's Support for PRC's Economic Reforms**

101. The Bank's economic and sector work program in the PRC has covered: (i) research on macroeconomic or sectoral issues directed at improving policy making capacity and expediting policy reforms; (ii) support for the formulation of sectoral strategies; (iii) assessment of country performance to identify and rectify problem areas; and (iv) utilizing material available through INTERNET to increase the Bank's institutional knowledge. Strategic areas in which the Bank has provided policy advice include enterprise reforms, financial sector reforms, capital market development, fiscal reforms, promotion of growth in the poorer inland provinces, and promoting the use of foreign capital for infrastructure investment.

102. The strategic use of TA has helped provide an analytical basis for policy dialogue and has promoted Bank involvement in fiscal and financial reforms and industrial restructuring. The fiscal reform package announced on 1 January 1994 is consistent with the policy advice provided by the Bank.<sup>1</sup> Building on this success, another TA study subprovincial fiscal relations and identify expenditure responsibilities at the lower levels of Government, evaluate revenue sources, estimate fiscal gaps, and recommend means of closing these gaps was successfully completed in 1995. A series of TAs to support the Government's initiatives in implementing fiscal reforms have been included in the Bank's operational program in the medium term.<sup>2</sup>

103. The reforms in the financial sector are being supported by a series of TAs to develop the capital markets and to improve the regulation of nonbank financial institutions. Studies of nonbank financial institutions, foreign financial institutions, trust and investment companies and cooperative banking development<sup>3</sup> are aimed at strengthening the supervision of these institutions as well as improving the control over base money creation. The proposed PRC Country Program includes further support to the Government in its efforts to deepen reforms in the financial sector.

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<sup>1</sup> TA 1593-PRC: *Supporting Policy Analysis in the Ministry of Finance*, for \$599,000, approved on 2 January 1992 and TA 1850-PRC: *Conference on the Roles of Planning and the Market in Economic Management*, for \$100,000, approved on 24 February 1993.

<sup>2</sup> TA 2118-PRC: *Study of Subprovincial Relations*, for \$500,000, approved on 28 June 1993, TA 2383-PRC: *Fiscal Policy and Regulatory Framework for Social Security System Reform* for \$540,000, approved on 23 August 1995 and TA 2743-PRC: *Study of Extrabudgetary Expenditures and Revenues* for \$600,000, approved on 31 December 1996.

<sup>3</sup> TA 2214-PRC: *Cooperative Banking Development* for \$600,000 approved on 1 December 1994; TA 1941-PRC: *Study on Nonbank Financial Institutions* for \$249,000 approved on 26 August 1993.

104. The Bank's support for reforms in enterprises includes two TAs on Public Enterprise Reform and Social Welfare and Labor Adjustments completed in 1994.<sup>1</sup> The former was to assist the Government in developing strategies for restructuring the management of SOEs to promote greater efficiency and to enhance competitiveness. The latter TA provided guidance on alternative methods of the setting up an adequate social safety net to support employees dislocated by the reforms. The TAs for the Study of TVEs, and State Enterprise Insolvency Reform, and other specific institutional TAs have addressed enterprises and assisted in creating a more efficient industrial sector.

## **B. External Assistance**

### **1. Coordination with Other Aid Agencies**

105. The PRC does not have a formal aid group to coordinate its external assistance. External assistance is handled by several agencies such as the People's Bank of China for the Bank and the International Monetary Fund (IMF), the Ministry of Finance for the World Bank and the Ministry of Foreign Trade and Economic Cooperation for the United Nations Development Programme (UNDP) and the bilateral agencies. The State Planning Commission, under the guidance of the State Council, acts as the coordinating arm of the Government in matters related to external assistance, including the review and approval of projects proposed for external assistance. To promote aid coordination, the UNDP Office in Beijing arranges informal meetings among major donors and publishes an annual report on development assistance in the PRC based on the information submitted by major donors. However, because of the lack of formal aid group meetings, difficulties in obtaining statistical data and other information on the assistance program of each agency have usually delayed this publication. The Bank maintains regular consultations and frequent exchanges of view with major donors and contributes to the UNDP development assistance report.

106. The World Bank Group provides the largest multilateral development assistance in the PRC. Its operational strategy focuses on poverty alleviation, environmental improvement, alleviation of infrastructure bottlenecks and macroeconomic and enterprise reforms which are consistent with the Bank's own strategic objectives. Main sectors of operations include agriculture, transport, energy, industry, education, water supply and health. Its current annual lending program is \$2.6 billion which includes about \$2.2 billion in International Bank of Reconstruction and Development (IBRD) loans, mainly for infrastructure and energy projects, and about \$400 million in International Development Association (IDA) credits mostly for agriculture, social sector, environment and poverty reduction projects. The current program is lower than the 1995 program of about \$3.0 billion because of the 50 percent reduction in the IDA allocation. The World Bank annual lending program to the PRC is estimated at \$2.7 to \$2.8 billion in the next two years with the share of IDA credit expected to decline further. UNDP assistance to the PRC under its third country programming, which ended in 1995, amounted to \$145 million. For its fourth country programming (1996-2000), the UNDP will continue to focus its assistance on human resources development including gender equality, environment and social development, resource conservation, poverty reduction including jobs creations in inland areas, and public administration and management. In addition to its periodic assessments of the economy, IMF has provided advice on macroeconomic management, including the development of the legislative framework for strengthening the central bank and commercializing of the banking sector.

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<sup>1</sup> TA 1924-PRC: *Public Enterprise Reform Study*, for \$600,000, approved on 3 August 1993; TA 1932-PRC: *Social Welfare and Labor Adjustment for Enterprise Reform*, for \$573,000, approved on 3 August 1993.

107. Japan through its Overseas Economic Cooperation Fund is the major source of bilateral financing to the PRC and is mainly involved in physical infrastructure (ports, road and railways, telecommunications and energy development), water resource development and environment improvement projects. The Fourth Yen Credit (1996-1998), signed in early 1995, amounts to 580 billion yen (\$5.5 billion equivalent) which will be used to finance about 40 projects. Other sources of bilateral funding are Germany, Australia, Canada, France, Italy and the United Kingdom. These respective financial assistance programs consist of mixed credits to support commercial interests. The technical cooperation programs of most of these bilateral agencies are focussed on technological and management improvement, environment improvement, strengthening institutional capabilities and social development.

108. The broad sectoral focus of the four main multilateral and bilateral assistance agencies, the Bank, the World Bank Group, OECF, and Exim Bank are shown in Table 4. The major sectors in which bilateral donors are involved are given in Table 5. The sectoral focus will continue to shape the respective lending and technical assistance programs of the three agencies in a flexible manner during the NFYP period.

Table 5  
Bilateral Assistance by Sector – 1994

Bilateral Source	HRD Educ.	Health	Social Develop. ----- ----WID -Water supply -urban dev.)	Nat. Res.	Agric.	Industry	Energy	Trans.	Dev. Admin.
Australia	x	x							
Canada	x	x	x		x	x	x	x	x
France	x								
Germany	x		x	x	x	x	x	x	x
Italy	x		x		x	x	x		
Japan	x	x	x	x	x	x	x	x	x
UK	x		x	x	x	x	x	x	x
US									

## 2. Cofinancing

109. Bilateral programs are fully committed and some are being reduced for fiscal reasons in the donor countries. The Bank is actively pursuing other cofinancing sources, with a strategic emphasis on commercial sources, either through syndicated loans or bond issues. The Bank is expected to continue to playing a catalytic role in assisting the PRC in mobilizing external resources to meet its huge investment requirements, particularly for the development of infrastructure. This strategy of mobilizing greater external resources through cofinancing arrangements will be an integral part of the Bank's new operational strategy for the PRC.

110. The Exim Bank of Japan, the European Investment Bank (EIB), commercial banks, and other financial institutions have expressed interest in cofinancing projects with the Bank in the PRC. To facilitate the involvement of both the Exim Bank of Japan and EIB in

cofinancing Bank-assisted projects, the Bank has played an active advisory role in the drafting of general framework agreements on cofinancing with both of these institutions and the Government.

111. As of 31 December 1996, the Bank had arranged a total of \$740.8 million in cofinancing for the PRC for ten loan projects including \$453.0 million from commercial banks, \$155.0 million from the Exim Bank of Japan, \$60 million from France, \$72 million from EIB, and \$0.75 million from the UNDP for two TAs. Cofinancing in the PRC has been concentrated on commercial cofinancing rather than on official resources. This pattern of cofinancing is expected to continue because the pipelines of most of the projects for bilateral agencies in PRC are full and there is little additional financing available to cofinance Bank-assisted projects. Commercial cofinancing, using both in parallel cofinancing and the complementary financing scheme, has accounted for the largest share of cofinancing activities (\$453.0 million or 61.2 percent of total cofinancing). The remaining 39 percent was from official sources. Because of the Government's desire to use international competitive bidding, the Government





does not favor tied export credit financing. Consequently, the type of cofinancing in PRC differs from Bankwide experience as shown in Table 6.

**Table 6: Cofinancing in PRC**

31 December 1996

(Amounts in \$million)

	Official Cofinancing	Export Credit	Commercial Cofinancing			Total Cofinancing
			Parallel	CFS	Subtotal	
<b>PRC</b>	287.75 (38.8)	-	248.00 (33.5)	205.00 (27.7)	453.00 (61.2)	740.75 (100.0)
<b>Bankwide</b>	15,189.00 (69.3)	4,325.11 (19.7)	1,787.56 (8.2)	619.58 (2.8)	2,407.14 (11.0)	21,921.25 (100.0)

Note: Figures in parenthesis represent composition in %.

### C. Review of PRC's Absorptive Capacity

112. The Bank's operational experience in the PRC has shown that the country's absorptive capacity and implementation capability are high. The Bank's loan portfolio in the PRC is performing well in all sectors. Contract awards, disbursements, speed of project implementation and compliance with loan covenants are good. Projects are being implemented efficiently and some are being completed ahead of schedule. Because of the good portfolio performance, there has been no need for a spring cleaning exercise in PRC. However, Country Program Review Missions have been useful in identifying issues that need to be addressed to improve project implementation. Besides the financial and economic viability of projects, the repayment capacity, the implementation arrangements, and the availability of counterpart funds are some of the more important criteria considered in rigorous internal project screening process in the PRC.<sup>1</sup> To date, the Bank has postevaluated three projects in PRC, all of which were rated as "generally successful" on the basis of their efficient implementation, achievement of the objectives, and satisfactory economic and financial returns. The Bank will continue to hold annual consultations with Government about the implementation status of ongoing projects.

113. Between 1991-1996, the PRC was the Bank's second largest borrower after Indonesia and accounted for 19.0 percent of total lending. The PRC was the largest borrower in 1994 and 1996. The PRC is expected to continue to be one of the major recipients of OCR loans for some years to come. Of the 48 loans, 9 have been closed, and 39 loans were under implementation, including 10 waiting to become effective as of 31 December 1996. All ongoing projects in the PRC are classified as "AAA" i.e. satisfactory projects. Bank assistance to the

<sup>1</sup> The positive features of the project implementation experience in the PRC were highlighted and discussed during the Regional Workshop on Improving Project Quality held in the Bank in November 1994. This experience was transferred to other countries under TA 2462-PRC: *Study of Project Planning and Management*.

PRC is modest in comparison with the developmental needs of the country. The good country performance would justify sustained increase in Bank lending to the PRC subject to the Bank's overall resource constraints.

114. In 1996, the PRC opened up several key sectors to FDI, notably the transport and the energy sectors. This will provide the Bank with the opportunities to help promote private capital investments. Responding to this change in PRC policy, the Country Program for the PRC includes several TAs that will help implement BOT/BOO schemes in the power, transport and water sectors. During 1987-1996, total Bank funds in private sector investment amounted to \$67.3 million for four projects including \$50.0 million in loans and \$17.3 million in equity investments and lines of equity. Given the large requirement for funds, the Bank's private sector operations in PRC have been modest and should be increased.

115. Taking into account the PRC's good economic performance, strong absorptive and project implementation capacity, and large investment requirement, a lending level averaging \$1.2 billion per annum is considered realistic and operationally feasible over the medium term. In addition, concerted efforts should be made to increase cofinancing to \$300 million a year and to increase significantly private sector operations.

#### **D. Governance: Sound Development Management**

116. The assessment of development management in the PRC must be made in the context of the economic reforms the country has undertaken in its transition towards a market-oriented economy. This transition involves a massive and radical change in the systems of development management and governance. Since 1978, the Government has adopted a series of reforms to improve economic efficiency by reducing its role in economic decision-making and by increasing the use of market forces in the economy. These reforms have improved governance and development management in PRC. Despite the significant progress that has been made, more progress is required. The speed with which further improvements will be achieved will depend in part on the progress made in the implementation of the overall reform program. It will take about 15 more years for PRC to complete its full transition to a market economy.

117. To improve *accountability*, Government agencies have been reorganized and reforms in the civil service have been made. Significant efforts have been made to improve the management systems of SOEs by increasing their response to market forces. Accounting and auditing systems have been improved and brought closer to international standards, and fiscal management has improved. Building the type of Government capacity that is appropriate for a market economy is an ongoing process that will require attention beyond the turn of the century. To encourage participation in the development process, the Government has established public participation mechanisms to reflect the views of the population, especially when resettlement and compensation issues are involved. Although non-government organizations (NGOs) are not active in the traditional sense in the PRC, there are many public consultation mechanisms through which the interests of special groups are represented. To increase *predictability* the Government is establishing a legal system that will be responsive to the needs of the "socialist market economy" by the year 2000. This is a major task and while significant progress has been made more progress is required. Since 1993, many market related laws have been formulated. Business risks, particularly those related to foreign investment, can now be assessed more rationally. In addition, transaction costs have been lowered and arbitrary Government actions have been reduced although not totally eliminated. Despite the progress that has been made, the legal and regulatory framework in the PRC does not meet international standards yet in such key

areas as predictability and transparency. The Government is addressing these problems and by the end of 1997 the Eighth National People's Congress plans to formulate 30 more market and economy related laws. To increase *transparency*, the Government has improved the access of the public to information although it still controls the media and release of information. Statistical data and other information on the economy are regularly published in Chinese, English, and other major languages and have become widely available. The Government recognizes that there is a greater need for access to accurate, timely economic information in a market economy than in a command economy. Despite the progress that has been made, economic information is still more inaccessible in the PRC than in some other countries.

118. Since the PRC became a member country in 1986, the Bank has provided assistance to address development management and governance issues that are related to its operations in the PRC. The Bank's assistance has supported efforts to improve the legal and regulatory framework, for example, supervision of the financial sector and capital markets; develop a framework to promote foreign investment in the development infrastructure; formulate environmental legislation and regulations; build the capacity of executing agencies and central agencies; promote enterprise reform; strengthen fiscal, finance, accounting, and auditing systems; and develop better statistical systems. The Government has been willing to engage in policy dialogue with the Bank and has welcomed the policy advice provided by the Bank through studies, seminars, and conferences. The Government has also seriously considered the recommendations and findings arising from studies undertaken under the Bank's economic and sector work (ESW) program that were designed to improve development management and governance.

## Chapter IV

### FUTURE ROLE FOR THE BANK

#### A The Previous Operational Strategy (the 1991-1996 period)

119. The central theme of the Bank's current operational strategy, formulated in 1991, is to promote economic growth in an efficient, sustainable, and equitable manner by: (i) improving economic efficiency; (ii) enhancing environmental protection and natural resource management; and (iii) reducing poverty.

120. In support of efficient growth, the strategy emphasizes implementing market-oriented reforms in the fiscal and financial sectors, developing competitive financial markets, restructuring SOEs, improving agricultural productivity, and removing key infrastructure constraints (e.g. transport and communication bottlenecks; and energy shortages). The environment objective is being addressed by ameliorating pollution in major urban centers, promoting energy conservation and pollution control technologies in industrial enterprises and power plants, developing clean fuel alternatives, and formulating agricultural projects that address natural resource management. The poverty reduction objective is being addressed indirectly by financing projects in poorer provinces in the interior of the PRC to help create conditions to facilitate economic growth in regions where poverty is more prevalent than the national average; and incorporating specific criteria (e.g. investment cost/job created and use of local raw materials) to ensure that the rural poor will benefit. Because the PRC does not have access to ADF resources, it has not been possible to pursue fully the poverty reduction objective. However, the operational strategy, by improving the overall macroeconomic environment and by enhancing efficiency and productivity at the microeconomic level, has supported the poverty reduction objective by creating better supply responses and income-earning opportunities. The TA and ESW programs have supported the Bank's role as a financial intermediary by strengthening institutional capacities and policy and regulatory frameworks in the key sectors in which the Bank is involved.

#### B. The Need For Fine-Tuning

121. The Bank's operations in the PRC in the 1990s have evolved to meet emerging priorities of the Government and the realities concerning resource availability from the Bank. These priorities and realities include: (i) the lack of ADF resources; (ii) the growing disparities in income levels and growth rates between the interior and the coastal provinces; (iii) the implementation of the environmental objective; (iv) limiting financial support to SOEs, unless major enterprise reforms are undertaken; and (v) the emphasis given to reducing infrastructure bottlenecks in a rapidly growing economy. Since the current operational strategy has been gradually modified to take these priorities and realities into account, the Bank's annual operational programs have been consistent with the Government's development priorities over the last five years. Consequently, no radical change in the strategy is necessary. However, in formulating the new strategy, it is recognized that the economic reform program remains uneven and incomplete, industrial efficiency remains below the optimal level, and factor markets remain distorted. Hence, improvements in economic efficiency will continue to be an important thrust of the new strategy. The continued pursuit of a high growth strategy and the legacy of environmental problems currently confronting the PRC, makes environmental protection and natural resource management another important tenet of the previous strategy that will be retained. The main change from the previous strategy relates to poverty reduction. Because

ADF resources for specific poverty reduction projects are not available, the strategic objective of reducing poverty will be addressed indirectly. There are several important dimensions to the poverty issue in the PRC. First, the 65 million people classified as absolute poor are mostly located in remote, mountainous and resource-poor areas. Second, several studies have indicated that there is a strong correlation between average income levels at the provincial level and the stock of physical infrastructure available. The previous strategic thrust of reducing poverty will be replaced by promoting economic growth to reduce poverty in inland provinces. By strategically locating traditional growth projects in officially designated poverty counties, developing transport and communication linkages between rural areas and urban growth centers, providing better access to credit in poor areas and spreading the examples of successful market-based reforms into the provinces in the interior, the poverty reduction objective will be addressed indirectly by generating new employment opportunities, providing better access to markets and credit, and promoting labor mobility. (The poverty counties in the PRC are illustrated on Figure 1)

### **C. Gradual Approach To Reforms**

122. The reform program in the PRC is closely related to the task of promoting efficiency. Central planning of a vast and complex economy such as the PRC was unable to achieve the efficient allocation or the optimal utilization of the resources. To accomplish these purposes, the market is more effective. Reforms in the PRC were first undertaken on an experimental basis in some localities before they were applied to the whole country. This gradual approach to reform had several advantages. First, major disruptions to the economy were avoided, and in case the policies were not effective, they could be modified on the basis of experience to suit local or national conditions. Second, implementing those policies first that were likely to be successful built up support in the population at large for further reform. This was particularly important to avoid social unrest that could derail the reform process. Third, for certain reforms to be effective, it was necessary to build new institutions, to set up new legal and regulatory frameworks, and to train personnel to become familiar with the new practices, all of which are time-consuming tasks. Fourth, the administrative structure of the planning system continued to be available until the new system became effective.

123. A distinguishing feature of the reforms in the PRC is that they preserved some of the socialist characteristics of the planned economy. Thus, the Government has not pursued a strategy of mass privatization as in some of the other transitional economies in Eastern Europe and the former Soviet Union. However, the constraints this may have imposed on reforms have been diminished by limiting the concept of socialism to the control of strategic sectors in the economy and the dominance of public ownership supplemented by non-State and private ownership. This has allowed the authorities considerable leeway in implementing policies that promote the development of the market system. The "household responsibility system" in agriculture is one example of this approach. Although land continues to be owned publicly, its use and management are contracted out to individual households. This approach has allowed the authorities to implement changes in SOEs such as reducing the involvement of the State in management, investment planning, finances, and operations of the enterprises. This has helped to transform SOEs into autonomous units responsible for their own profits and losses. Another important aspect of the new framework is the highly successful policy of promoting the development of the non-State sector, which includes collective enterprises, individual private businesses, foreign-funded enterprises, and jointly-owned enterprises. The rapid growth of the non-State sector has strengthened the economy and facilitated the efforts to transform the State sector.

124. The market-oriented reforms have resulted in the progressive decentralization of economic decision-making. This decentralization has stimulated some aspects of the reform process, notably in agriculture and the external sector. However, decentralization has complicated other aspects including the implementation of demand management through indirect macroeconomic means in a more market-oriented setting. A consequence of this partial approach to reform has been the tendency for the economy to experience cycles of macroeconomic instability as the authorities have relinquished direct control over the economy, although the indirect instruments of control have not yet been fully developed. As decentralization proceeded, the traditional administrative system of macroeconomic control became less effective as local authorities and SOEs gained greater autonomy to pursue their objectives within a relatively weak framework of financial discipline. So far, the authorities have managed to regain control of the economy on each occasion by combining economic policy actions with direct administrative intervention. The revised strategy of the Bank aims to support the Government's efforts to complete the reform program and to establish a more effective system of macroeconomic management consistent with the market-oriented economic system.

#### **D. Future Strategic Objectives**

125. The Bank's new operational strategy for the PRC will emphasize three broad objectives:

- (i) improving economic efficiency;
- (ii) promoting economic growth to reduce poverty in inland provinces; and
- (iii) enhancing environmental protection and natural resource management.

126. The strategy stresses these three objectives to help alleviate infrastructure bottlenecks, create employment, further eliminate factor market distortions and structural rigidities, and address the market failures caused by rapid growth by spreading the benefits of growth more evenly and minimizing the degradation of the environment. This strategy is consistent with the objectives of the NFYP and fully supportive of the Government's objective of preserving social stability and maintaining public support for the implementation of market-based reforms.

##### **1. Improving Economic Efficiency**

127. Improvements in economic efficiency will be supported through three market-based approaches:

- (i) Using the Pricing Mechanism:** Prices provide market-based signals that encourage service providers and users to achieve maximum efficiency. Market-based pricing helps eliminate congestion and better allocates scarce resources and capacity. Adopting prices and tariffs that fully recover operating and capital costs, as well as some of the external costs related to congestion and pollution, has another major advantage in that it helps create the conditions necessary for private sector investment by providing the basis for generating the necessary profitability and cash flows. While the PRC has made progress in this area, further upward adjustments in tariffs for public services, utilities and pollution charges are still required.
- (ii) Introducing Competition:** Introducing competition improves efficiency and results in better service and more choice for users than is achieved by regulated monopolies.

**(iii) Commercializing Operators:** Reforming enterprises and management systems so that they respond to market forces can result in significant improvements in efficiency.

128. Besides the measures to redress inefficiencies that are structural in nature, improvements in economic efficiency also require measures to remove the bottlenecks in infrastructure. In the case of the PRC, issues concerning efficiency center around: (i) lack of infrastructure, which constrains efficient economic growth; (ii) utilizing inappropriate, often outdated technology, which impedes the efficient development of industry; (iii) a financial sector that is not fully developed to meet the needs of a market economy; and (iv) other factor market rigidities and institutional weaknesses that increase costs. Thus, the enhancement of efficiency and productivity should continue to be the focal point in alleviating bottlenecks in key sectors of the economy, especially energy, transport, communications, water supply, and industry. Designing projects that help improve economic efficiency will simultaneously support the strategic thrusts of environmental protection and poverty reduction as well as the promotion of growth in the poor inland provinces. The realization of the economic efficiency objective will depend on other factors as well, such as: (i) continuing the market-based reform; (ii) opening further to the outside world to improve competitiveness; and (iii) improving the legal and regulatory framework and managerial and institutional capacities. The Bank's efforts to operationalize the strategic objective of improving economic efficiency will also entail promoting adjustments and reforms to sector policies to comply with World Trade Organization (WTO) requirements. This will help avoid longer term economic and social costs and speed up the country's transformation to a full-fledged market economy. As an efficient payments system is an essential part of the financial infrastructure in a market economy, reform of the payments system will be a top priority in the financial sector to expedite the transition to a market economy and to increase efficiency.

129. The strategy recognizes that as the implementation of economic reforms gains momentum, the investment requirements and the cost of adjustments both in financial and social terms will increase. The Bank's involvement, while relatively small in quantitative terms, is perceived by the Government as important in supporting the country's high growth target for GDP, in bringing about improvements in the quality of life of the people, and in helping the economy to complete its transformation to a market economy. Projects financed by the Bank have positive demonstration effects in promoting the replication of successful project designs nationwide as well as in encouraging market-based reforms in the interior provinces. Despite the high growth target set under the NFYP, the Government has resolved that achievement of this target will not be at the cost of macroeconomic or social instability. The Bank's strategic thrusts to support the Government's objective will be to:

- (i) help expedite the implementation of macroeconomic structural reforms to remove inefficiencies;
- (ii) promote the use of policy and regulatory frameworks that permit greater competition, market-based pricing, and the continued growth of the non-State sector;
- (iii) introduce new technology in Bank-financed projects; and
- (iv) support institutional strengthening and management development to underpin the implementation of structural reforms as well as improvements in productivity.

## **2. Promoting Economic Growth to Reduce Poverty in Inland Provinces**

130. The adoption of reforms in the special economic zones (SEZs) on the east coast stimulated high growth rates in these areas. These high regional growth rates have contributed

to the macroeconomic imbalances that have arisen. Although there were several phases of decentralization and recentralization in the period before 1979, the regional pattern of development and the growth performance of the regions were largely determined by central direction and was subject to nationwide priorities. Since the late 1970s, decentralization - under which local authorities and enterprises acquired increasingly greater autonomy in the allocation of fiscal resources, investment, production, and trade - has linked each province's development more directly with its resource endowment and priorities. The Government has encouraged initiatives at the provincial level and the widespread application of market-related reforms. These policies have been successful in generating the strong growth in the provinces on the coast. Factors that contributed to the rapid growth include: (i) the extent of openness of the province; (ii) the relatively low degree of State ownership in the province; (iii) the limited Government intervention in microeconomic policies; (iv) the higher amount of fiscal resources retained in the province; (v) the increase foreign direct investment; and (vi) the relatively better stock of physical infrastructure. In contrast, many of the provinces in the interior do not have these advantages. These provinces also lack natural trade and investment partners, poor infrastructure, inadequate managerial skills and an inadequately trained labor force. While all the provinces have benefited from the reform process and the accompanying rapid economic growth, the provinces in the interior have lagged behind the provinces on the coast.

131. Although absolute poverty is no longer widespread in the PRC, most of the remaining poor are concentrated in the remote, resource-poor upland areas, where both gains in agricultural productivity and development of township and village enterprises (TVEs) have proven more difficult and infrastructure is not well developed. Most of these poverty areas are associated with minority populations, higher birth and death rates, lower agricultural and industrial wages, low educational levels, poor infrastructure, and inadequate access to credit.

132. The strategic thrust of promoting economic growth to reduce poverty in inland provinces as part of the Bank's operational strategy, supports the Government's objectives of reducing regional disparities and of eliminating poverty by the end of the century. In the PRC: (i) the level of physical infrastructure development is correlated to the differences between the levels of development among provinces; and (ii) there is a strong correlation between average income levels at the provincial level and the adequacy of physical infrastructure.<sup>1</sup> As people try to improve their living standards, significant migration is taking place from the provinces in the interior to the cities on the coast, which is placing considerable strain on urban infrastructure (see Figure 2).

133. To help address these problems, the promotion of economic growth to reduce poverty in inland provinces will be an important element of the Bank's operational strategy. The promotion of this strategic thrust, however, does not imply that the Bank will support the introduction of preferential policies and incentives that exacerbate or create new factor market distortions and misallocation of resources. Instead, this will be addressed by:

- (i) promoting market-based policy changes in the interior provinces to attract greater foreign and domestic investment;
- (ii) creating conditions to foster growth in interior provinces (e.g. provision of adequate infrastructure and access to credit);
- (iii) improving the environment and infrastructure in urban centers,<sup>2</sup>

<sup>1</sup> Liu Deshun, "A Comparative Analysis of Regions of China in Infrastructure and Economic Growth," Development Research, Issues 5 and 6, 1994.

<sup>2</sup> Particularly in the cities on the east coast to which the excess labor is migrating.

- (iv) promoting rural job creation (e.g., TVEs, revitalizing agriculture); and
- (v) improving the transport, communication, and marketing linkages between the provinces in the interior and the rapidly growing centers on the east coast.

134. Efforts to locate traditional growth projects in officially designated poverty counties or in areas where the average income is well below the national average will be an integral part of the operational strategy.<sup>1</sup> While attempts will be made to increase the share of Bank supported projects in the provinces in the interior, this does not rule out support for key projects in the provinces on the coast especially when such projects will help alleviate the bottlenecks in infrastructure, improve the interlinkages between the urban centers and the rural hinterland, and address social or environmental concerns.

### **3. Enhancing Environmental Protection and Natural Resource Management**

135. Environmental protection and natural resource management will be the third pillar of the Bank's operational strategy because the PRC's long-standing problems of population pressure and limited resource base have been exacerbated by the emergence of severe environmental problems associated with rapid economic growth. These problems are caused by the large heavy industry sector that uses outdated polluting technology and the predominant use of coal as a major energy source. Although a legal and regulatory framework, which was virtually nonexistent before 1980, has been gradually put into place, enforcement needs strengthening. The Bank's previous strategy for the environment sector emphasized building the capacity for environment protection and natural resource management. The Bank has financed the acquisition of more environmentally friendly technologies and has helped to strengthen the country's capacity in environmental management.

136. The involvement of the PRC in global environmental initiatives and in the implementation of Agenda 21 has been facilitated by the Bank's TA program. By carefully selecting projects that can generate financial revenues to service OCR loans, the Bank has been able to support projects that address environmental problems in urban areas and promote energy conservation. The Bank will also seek to promote sustainable natural resource management. This strategy will continue to be adopted in the Bank's operations over the medium term considering the large amount of work that needs to be done in both cleaning up and improving the environment. Unless environmental protection concerns are an integral part of the strategy, rapid economic growth will not be sustainable. The Government's environmental policy in the NFYP, which is fully supported by the Bank's new operational strategy, has five main strategic thrusts:

- (i) improving the policy, legal, and regulatory framework to strengthen environmental management;
- (ii) building capacity in key agencies, including the National Environmental Protection Agency, the State Science and Technology Commission and local environmental protection bureaus;
- (iii) improving the quality of the environment in selected urban centers;
- (iv) promoting the efficient utilization and conservation of soil, water and marine resources; and

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<sup>1</sup> About two thirds, by number and volume of lending, of location-specific projects in the 1996-1999 operational program are in inland provinces compared with about one third during the 1987-1995 period.

- (v) promoting the use of cleaner, more energy efficient process technology and clean coal technology for industrial production and power generation.

137. Based on the Bank's previous experience, these strategic thrusts merit continued support both through the TA program and carefully selected environmentally oriented investment projects that can generate the financial returns to service OCR loans.

## **E. Bankwide Issues**

### **1. Social Sector Development**

138. The Government's external debt management policy limits foreign borrowings to concessional sources for projects in the social sectors, which generally yield low financial returns. The Government's policy is that it prefers to finance projects in the social sectors using its own budgetary resources, unless it can be demonstrated that such projects can yield returns sufficient to service loans on OCR terms. Given these operational constraints, three approaches will be used to address the Bank's cross-cutting concerns of poverty reduction and human development. First, efforts will be made to identify projects in agriculture, rural development, human resource development, environment, and social sectors that yield adequate financial returns to support loans on OCR terms. Second, the Bank will, through its TA and ESW program, help to strengthen the institutional and management capabilities of key agencies in social development and environmental management as well as the policy environment prevailing in these sectors. Third, the strategy will also emphasize maximizing social development benefits from identified projects. The criteria used to select projects for Bank support will reflect strategic aspects related to their design and location, and contribution to regional development, human development, and poverty reduction. Where feasible, human development and poverty reduction components, including components that promote the advancement or employment of women, will be incorporated into the projects. The Bank will continue to work with the Government through its TA program to develop practical ways that can best contribute to the achievement of the country's strategic priorities in the education sector: (i) making compulsory nine-year basic education universal; (ii) expanding and improving technical education; and (iii) expanding higher education, especially science and engineering courses as well as finance, business, and trade courses.

139. The Bank's strategy for the urban infrastructure and services sector will aim at improving living conditions and standards of residents in the rapidly growing cities and urban areas through improvements in urban planning, industrial and urban pollution control, natural resource management, and conservation as well as improvements in the delivery of urban/social infrastructure services through both policy and physical interventions at the municipal level. Bank assistance for the urban transport will help to improve transport planning and traffic management, upgrade the capacity and operations of public transport, and minimize the environmental impact of transport development projects. Projects in basic urban infrastructure facilities for the supply of natural gas, towngas, district heating, water and wastewater treatment, and solid waste disposal will include provisions for capacity building of municipal utilities to improve their management, financial performance, and ability to operate successfully in the context of a market economy. In addition, TAs will be carried out to develop cost recovery and revenue generating mechanisms to enhance the financial viability of social/urban infrastructure projects. Policy support TAs to strengthen the urban environmental planning and implementation capacity in medium to large cities with the potential to develop investment projects will also be provided to cities with urgent requirements to improve and expand urban infrastructure. Bank

involvement in urban development projects will probably be in the cities on the east coast because of their rapid growth and their relatively strong management capabilities and financial positions compared with cities in the interior.

## **2. Gender Issues**

140. The Bank recognizes the PRC's continuing efforts to improve the health, education, economic, and social status of women. Substantial progress has been made since the 1950s. While Women in Development (WID) indicators in PRC compare favorably with other countries, there has been some concern that women as a group have not benefited from the economic reform program as much as men. In view of the country's lack of access to ADF, the Bank has not been able to deepen its involvement in the social sectors which could offer opportunities for the Bank to design and implement specific interventions (e.g. health; education; microcredit; and direct poverty alleviation) aimed directly at women. Given these operational constraints, the strategy recommends that the Bank should continue to monitor the policy developments that may have an impact on the status of women and to ensure that WID considerations are incorporated in the design of lending and TA projects that have a direct impact on beneficiaries. Under the ESW program, a study of WID in the PRC will be completed in 1997, which will enable the Bank to gain a better understanding of the issues affecting the status of women and assess the impact of the economic transition process on women in the PRC. As required, the future ESW work program will address selected WID issues that are relevant to the Bank's operations in PRC. The Bank will continue to monitor interventions to other multilateral and bilateral agencies and institutions in order to determine the scope of possible collaboration with agencies in this area.

## **3. Private Sector Development**

141. Given the importance of creating new jobs, improving the efficiency of SOE operations, and strengthening domestic resource mobilization, the continued growth of the non-State sector will be a major area of focus under the new strategy. As the non-State sector expands, the Bank will seek to increase its private sector operations in the PRC. The Bank's operational strategy covering private sector development will focus on:

- (i) promoting conditions favorable to non-State sector led growth;
- (ii) improving transparency and predictability by strengthening the legal and regulatory framework for investment and financial and capital market development;
- (iii) promoting BOT/BOO projects and joint ventures for infrastructure;
- (iv) promoting foreign capital inflows and investments in the PRC through capital market operations, particularly for infrastructure and unlisted enterprises.
- (v) strengthening the financial management and commercial orientation of SOEs to facilitate their restructuring and enhance their prospects for private sector equity participation;

142. The Bank's private sector lending operations in the next three to five years will be mainly focused on infrastructure development, capital market operations, and support for enterprise reform.

## **4. Regional Cooperation**

143. Over the last two decades, the Asia Pacific Region has become the world's most economically dynamic area. Economic interdependence among the Asia Pacific countries has increased steadily, as have efforts for greater regional cooperation for development. The underlying rationale for regional cooperation is that it helps exploit complementarities among groups of countries and areas to generate a greater momentum of growth. Economic complementarity arises when differences occur among neighboring countries in the availability of natural resources and other inputs, such as labor and capital. Complementarity can also exist when countries are of different stages of economic development and possess different degrees of technological and labor skills. In such an environment, cooperation can lead to a more efficient use of resources and promote intra-regional trade and investment.

144. With its rapid economic growth, size of its economy and increasing emphasis on trade, PRC is exerting a major impact on the Asia Pacific Region. PRC's goods and services are being exported to the Asia Pacific Region and PRC is a large potential market for goods, services and capital from the Region. These underlying factors suggest that regional cooperation involving PRC will be an increasingly important trend during the remainder of the decade.

145. The opening of PRC has enabled the rapid growth of economic cooperation in Greater China (e.g., Hong Kong, Taipei, China and two of PRC's southern provinces -- Guangdong and Fujian). Many manufacturing activities have moved from Hong Kong and Taipei, China to Guangdong and Fujian in search of lower labor and land costs. This has enabled the Hong Kong and Taipei, China economies to move up the technological ladder to higher-value activities, such as packaging, marketing and financial intermediation. These developments represent a new form of cooperation that differs significantly from conventional, arms-length trade. Participants are engaged in a vertically-integrated production structure crossing national borders, benefiting all of them. Market forces and cultural factors are driving this regional cooperation and there is little catalytic role for the Bank to play in fostering regional cooperation in Greater China.

146. There are three major regional cooperation initiatives involving PRC in which the Bank can play, or is playing, an important catalytic role:

- (i) Greater Mekong Sub-Region: This sub-region involves the promotion of economic cooperation between Thailand, Indochina, Yunnan Province in PRC and Myanmar. The Bank has played a leading role in promoting regional cooperation in this area by financing strategic studies, project preparatory studies and projects and promoting the inflow of international capital. The PRC and Yunnan Province are active participants in RETAs for promoting cooperation in the Greater Mekong Subregion. The Bank will continue to seek projects in Yunnan Province that will promote regional cooperation in the Greater Mekong Sub-Region.
- (ii) Tumen River: The Tumen River Area Development Program in North Asia includes PRC's Jilin province and northeastern area, parts of Siberia in Russia, the Democratic People's Republic of Korea, Mongolia, the Republic of Korea and Japan. The UNDP is the main donor sponsor of the Tumen River Area Development Program. The Bank is monitoring these developments and has been represented at various conferences. However, most of the investment will take place in Russia and the Democratic People's Republic of Korea which are not members of the

Bank. The Bank will monitor the development of the Tumen River initiative and attempt to identify projects in Jilin Province that will support the Tumen River Development Program.

- (iii) Eurasian Landbridge: The Eurasian Landbridge follows the ancient Silk Road from Jiangsu Province on the East Coast of PRC through Xian and central PRC to the Xinjiang Uygur Autonomous Region and then through the Central Asian Republics and on to Europe. Supporting the Eurasian Landbridge provides an opportunity for the Bank to take the lead the donor community to support regional economic cooperation between the Central Asian Republics and PRC. The Bank will continue to support this initiative by providing technical assistance and will attempt to identify projects that will turn the Eurasian Landbridge into a reality.

147. The PRC views regional cooperation as an essential part of its strategy for integration with the world economy and supports the initiatives already underway that involves its territories. The Bank will continue to support regional economic cooperation initiatives that involve PRC. The PRC also supports the Bank's initiatives to foster regional economic cooperation. However, most of the resulting projects involves only one or two of PRC's 30 provinces. Projects which are designed to support regional economic cooperation will have to compete with other projects of national priority before they are proposed by PRC for Bank financing.

## **5. Performance Indicators**

148. A framework for reviewing the performance of PRC should include macroeconomic indicators; progress in implementing market reforms; budgetary allocations to key economic and social sectors; poverty indicators; and progress in implementing gender programs, population targets, environmental guidelines, and project performance. The set of indicators proposed by the Bank in the paper "Bank Operations and Country Performance" are used as a guide to establish such a framework. The specific indicators are reported annually in the Country Economic Review (CER).

149. In the context of the PRC, the performance review will include a comprehensive assessment of short- and medium-term economic management indicators focusing on key macroeconomic indicators, particularly growth of real GDP, fiscal balance, external current account balance, monetary and price stability, and the on-going structural adjustment program under which a wide range of sectoral reforms have been or are being implemented. The performance review will also include an assessment of social indicators. These performance reviews will provide inputs to the design of the Bank's operational program and will ensure that the Bank's assistance supports efficient economic growth of the economy and improves in the quality of life of the population.

150. Longer term socioeconomic concerns will constitute an integral part of the performance review. The main indicators will be: (i) the sectoral allocations and real expenditure increases under the annual budgets of the Central Government; (ii) shifts within the public expenditures for key economic and social services, particularly education, health, and rural infrastructure; (iii) improvements in the budget allocations for promoting growth in the poor inland provinces; (iv) maintenance of an exchange rate that supports the competitiveness of the export sector and prevents distortions in factor markets; (v) performance in the cross-cutting areas of poverty reduction, women in development, human resource development, non-State sector

development and environmental protection; and (vi) sound development management covering measures to resolve administrative bottlenecks, strengthen institutions and establish a sound macroeconomic policy framework for a market-oriented economy.

151. While macroeconomic aggregates as reported in the CER will continue to be monitored on an annual basis, socioeconomic indicators will be reviewed on a three to five year basis because it would take time for the Government's social programs to have an impact. Nevertheless, a qualitative assessment will be undertaken of the Government's priorities and expenditures designed to reduce regional and gender disparities, the adequacy of educational and health facilities, particularly in rural areas, the social costs of the transition to a market economy, and the delivery of social services, including population planning measures.

152. Project implementation performance relating to Bank projects will be monitored through the semiannual country performance review missions, project review missions, midterm reviews as well as using the annual disbursement ratio, the cumulative disbursement ratio, the net transfer of resources and other measurements used in the Bank to evaluate project quality.

## **F. Access To Asian Development Fund (ADF) Resources**

### **1. Introduction**

153. The PRC's economy is in the midst of a deep and dynamic change. However, the PRC is a poor country with a GDP per capita of only \$574 in 1995, significantly below the threshold for Group A countries (\$665 in 1993). The PRC has not had access to ADF resources. Even though the economy has grown at over 9 percent a year in real terms for the last one and a half decades, 65 million people still live below the poverty line. While the reforms have resulted in significant economic achievements and improvements in well being, there have been costs in terms of adverse social and environmental impacts. Significant investments are required in the productive, infrastructure, and social sectors to improve living conditions further, and provide the employment opportunities that are necessary to eradicate absolute poverty and to keep the social costs of transformation within manageable limits. The structural changes in the economy offer new and important challenges for both the country and the Bank. These challenges include dealing with issues at the core of the Bank's mission: poverty, the environment, and human development. While these can be addressed in a limited way with tools at the Bank's disposal, the Bank would be more effective if the PRC were granted access to concessional funding.

### **2. Social Indicators and Poverty Reduction**

154. Although significant progress has been made in reducing poverty and improving living standards, the key socioeconomic indicators mask a somewhat uneven process, both geographically and over time. Since the mid-1980s, the weakening of social safety net as a result of the reforms caused an increase in relative poverty, and led to a deterioration in some socioeconomic indicators. Although these adverse trends were rectified to some extent in the late 1980s and early 1990s, they underscore the importance of monitoring and adjusting basic public services and policies that have an impact on income distribution. This social concern continues to remain as a key policy concern because the widening disparity of living standards within and among regions. Many parts of the country, especially the poorer regions in the interior, have not benefited fully from the high economic growth.

155. The Government's commitment to address issues in social sectors is exemplified by the significant increase in expenditures in the social sector which have grown at an average

annual rate of 16 percent compared with the 10 percent growth rate for total expenditures. Thus, the proportion of the Government budget allocated to the social sectors has increased. The Government has also taken the initiative of developing a time bound strategy to eradicate absolute poverty by the year 2000. The "Eight-Seven Poverty Eradication Plan" is an ambitious undertaking with a potential positive impact on millions of people. The actual results of program in the first years of implementation have been positive and is a program that deserves the full support of the aid community because of the need, performance, and commitment.

156. Closely related to the issue of living standards and poverty is the issue of the environment. The transition to a market based economy offers new opportunities for increasing economic efficiency and using resources more effectively. In the past, the pricing of natural resources did not adequately reflect environmental costs such as the severe air, land, and water pollution. The Government's current policies reflect its increasing sensitivity towards the environment and its commitment to protection and rehabilitation. Investment in environmental improvement projects increased from 0.67 per cent of GNP during the Seventh Plan period (1986-1990) to 0.8 percent during the Eighth Plan period (1991-1995). Planned environmental expenditures are expected to increase further to 1.5 percent of GNP during the Ninth Plan period (1996-2000). The Government has also adopted the National Environmental Action Plan and Agenda 21 program, which provide direction for environmental improvement efforts until the turn of the century. Large investments are, however, required for environmental improvement projects. In view of the public good nature of such projects, and the inability of many to meet OCR terms, using resources from ADF for these projects would be justified and would contribute significantly towards meeting the objectives of the national Agenda 21 program, and hence the overall global Agenda 21 objectives.

### **3. PRC's Access to and Use of ADF Resources**

157. The speed, depth, and direction of the development process in the PRC will have direct and widespread implications for the rest of the world, financially, economically, and environmentally. It will be critical for PRC to prioritize investments; mobilize resources, domestic as well as external; and further enhance its capacity for sound development management. The Bank has a role to play in all of these areas. However, the lack of access to ADF has prevented the Bank in the past from playing a more comprehensive role in addressing social development and environmental concerns in the PRC. The Bank has made strategic use of its TA facility to prepare social sector and poverty reduction projects in the rural areas, but the Government is concerned about the capacity of such projects to generate the financial returns necessary to meet the terms and conditions of the Bank's traditional OCR-based loans. Thus, from the Bank's operational point of view, the provision of ADF resources on a temporary basis, for specific sectors and activities, would enable the Bank to address more directly cross-cutting issues and would strengthen the Bank's capacity to conduct the related policy dialogue.

158. Without prejudging the outcome of future discussions regarding the use of ADF, there exists a strong case for redefining the Bank's terms of assistance to the PRC. While the Bank's operational strategy seeks to sustain the dynamism of the PRC economy, simultaneous support should also be provided to minimize the social and environmental costs, maintain public support for the reform program, and preserve social stability. To this end, concessional assistance focused on the areas where the costs of reform have been the highest and where future social and environmental returns would be significant, is warranted.

## Chapter V

### OPERATIONAL THRUST OF THE STRATEGY AND INSTRUMENTS OF BANK SUPPORT

159. The Bank's operational strategy for the PRC will focus on: (i) strengthening macroeconomic management to support the continued implementation of market-oriented reforms; and (ii) addressing issues and constraints principally in three key sectors, which apart from having been accorded high priority under the NFYP, offer the best prospects for the Bank to achieve the three strategic objectives discussed in para 121. The three key sectors are:

- (i) physical infrastructure (covering transport, communications, energy, and water supply);
- (ii) finance and industry; and
- (iii) agriculture and rural development.

#### A Strengthening Macroeconomic Management

160. To achieve macroeconomic stability and investment efficiency during the transitional period when critical policy reforms are being formulated and implemented, the Government will need to continue to: (i) develop greater expertise in the use of market oriented fiscal and monetary policy tools; (ii) establish efficient financial markets; (iii) implement systemic changes in the management of the State economy through enterprise reform; and (iv) strengthen the legal and regulatory framework. These four areas have been the focal point of past Bank policy advice, which was well received by the Government. Given the importance of these major policy reforms in the pursuit of economic efficiency, the Bank will continue to be involved in strengthening the Government capacity for macroeconomic management through economic and sector work and advisory TA programs. The Bank will sponsor high-level conferences with the participation of senior Government officials and recognized international experts to discuss selected major policy issues. The focus on capacity building for macroeconomic management in an increasingly market oriented economy will reinforce the operational thrusts of the Bank to bring about the desired development impact at the sectoral level.

161. Macroeconomic reforms that need to be completed include: (i) the changes in the tax structure; (ii) the improvements in the enforcement of tax laws, through the institutional strengthening of the National Tax Service; (iii) the reforms in social security and housing; (iv) the additional reforms in prices and tariffs; (v) enterprise reforms; (vi) financial sector reforms and the development of capital market; (vii) the replacement of policy loans by explicit subsidies; (viii) the commercialization of banks; and (ix) the development of a market in Government securities.

#### B. Sector Strategies<sup>1</sup>

<sup>1</sup> More detailed sector strategies are given in Appendixes 1 through 7.

## 1. Physical Infrastructure

162. Because bottlenecks in infrastructure impede efficient growth, the energy/power, transport, communications, and water supply sectors will continue to dominate Bank assistance in the PRC and account for between one-half and two-thirds of lending in any given year. Recognizing that substantial investments are needed to remove the constraints in infrastructure, the Government has opened these sectors to foreign investment to complement the financing from domestic, multilateral and bilateral sources. In addition to its traditional role of providing long-term financing directly for priority infrastructure projects in the PRC, the Bank will promote the use of other sources and methods of financing such as BOT/BOO and joint-ventures to meet the massive investment requirements in these sectors. The Bank will: (i) mobilize additional resources using cofinancing and the Bank's guarantee facility; and (ii) act as a catalyst in project financing (through loan and/or equity investment) involving private sector participation. The Bank will also provide advisory TA to strengthen the policy framework to promote the flow of foreign investment into these sectors and to develop further the domestic capital markets, including the bond and domestic mutual fund markets.

### a. Energy

163. In the energy sector, the power subsector will continue to be the focus of Bank assistance given the need to overcome the prevailing power shortages. The Bank will finance power projects (hydro, thermal and transmission) with priority given to those located in the provinces in the interior and those that would involve the Bank in facilitating the transfer of advanced technology. Bank assistance to expand generation capacity will be complemented by operational activities to promote energy conservation and reduce system losses. The Bank will ensure that the design of power generation projects incorporates appropriate environment protection technology. In addition to the opportunities for commercial cofinancing with or without Bank guarantee, the Bank will also pursue its ongoing efforts to create a favorable environment to attract private sector capital in the power industry. The Bank will also promote the institutional development of power utilities, including their corporatization and commercialization of their management in line with the reforms in enterprise. The Bank will coordinate closely with the World Bank to ensure policy advice in the power subsector is consistent.

164. Specifically, the Bank's strategy in the energy sector will focus on:

- (i) expanding capacity to reduce energy shortages;
- (ii) supporting improvements in the transmission and distribution systems to promote systemwide efficiency and reduce losses;
- (iii) developing cleaner energy sources such as hydropower, clean-coal technologies and gas; and
- (iv) renovating and retrofitting existing facilities to improve efficiency and reduce pollution..

### b. Transport and Communications

165. Developing an efficient and integrated transport and communications network will require substantial investment and policy and institutional reforms. The scale of the required investment is beyond the capacity of the country's own resources and the major sources of

external assistance including the World Bank, OECF and the Bank. The lack of a well-developed, transparent legal and regulatory framework has inhibited the flow of foreign investment needed to bridge the financing gap. The Bank will provide policy advice to develop an environment conducive to private sector participation. The need is most apparent in the road subsector, which constitutes the weakest link in the transport sector because of the low investments in the past and the reliance on the railway system. Because of the increase in income as a result of the economic reforms and the growing need for a flexible, market-responsive transport system, the vehicular fleet is growing rapidly. The Bank will focus its assistance for the road subsector on: (i) the national trunk highway system (NTHS), a high quality system of interprovincial expressways and high standard highways, (ii) the strategic provincial highways that improve the access of less developed communities and rural areas to regional market centers, and (iii) selected urban transport systems.

166. While the PRC has demonstrated a strong capacity in the implementation of highway projects, the Bank's operational experience has revealed that expert services financed under TA can: (i) help improve project design and address the environmental and social measures to be carried out during the implementation of projects, and (ii) provide the analytical support to help address key policy issues. The selection of highway projects for Bank financing and the provision of TA will take into account the operational programs of the World Bank and the OECF. Projects will be selected in transport corridors after analyzing the geographic location of the projects of other aid agencies. The Bank-financed road projects will be mainly located in northeast and southwest parts of the PRC.

167. In recognition of the increasing importance of road transport, the new operational strategy will support:

- (i) the construction of highways that connect major growth centers and promote linkages with hinterland economies;
- (ii) further institutional strengthening to increase the commercial orientation and managerial efficiency of expressway corporations;
- (iii) the improvement of highway planning, evaluation techniques and safety standards;
- (iv) the adoption of appropriate pricing policies to ensure optimum utilization of road transport capacity;
- (v) the utilization of alternative methods of investment financing, including private sector participation to meet the huge financing requirements of the highway development program;
- (vi) the promotion of road traffic safety which has emerged as a major issue in the PRC transport system because of the rapid increase in traffic volumes in relation to the existing road network; and
- (vii) the integration of the network so that the NTHS is adequately supported by a system of feeder roads that can provide proper access for the population at the provincial and county levels to the main economic centers.

168. In contrast to the large scope for assistance in the road subsector, Bank involvement will be on a relatively smaller scale the other transport modes such as railways, ports and inland waterways. Among the major aid agencies, the World Bank and OECF have been involved in the national railway system and major ports since the early 1980s. The Bank has developed its own niche in financing the construction of strategic local railways and the expansion of smaller ports. Projects are expected to continue to be allocated among aid

agencies in a similar way in the future. These projects have been accompanied by Bank support to strengthen the commercial orientation of provincial railway companies and port authorities.

169. Recognizing the continuing role of railways as the backbone in the internal transportation system and in promoting regional development, the Bank's strategy for the railway subsector will focus on:

- (i) expanding the railway system through the construction of important provincial lines, including those that will indirectly contribute to the reduction of poverty in the less developed inland provinces;
- (ii) increasing the capacity on key routes of the national railway system;
- (iii) modernizing the technological aspects of railway operations including the use of energy-efficient and faster locomotives, improved telecommunications and signaling and the introduction of computerized reporting and record-keeping;
- (iv) improving the operational and managerial efficiency and the commercial orientation of railway companies; and
- (v) diversifying sources of investment financing, including greater private sector participation.

170. To support the growing domestic and international trade, the Bank's strategy for the ports and inland waterways subsector will focus on:

- (i) modernizing and expanding the capacity of the relatively smaller but important ports handling foreign trade that generally have not utilized loans from the World Bank and OECF;
- (ii) improving the operational efficiency and financial management of port authorities through developing human resource and upgrading systems;
- (iii) optimizing the utilization of inland waterways for freight and passenger transport by developing ports and related facilities along the main waterway system.

171. Compared with a command economy, a market economy is information intensive. The demand for modern telecommunications services is growing very rapidly in PRC. The Bank will continue to support the development of a well-integrated telecommunications network to facilitate the efficient flow and exchange of information. An efficient telecommunications sector will help to promote growth in the poor inland provinces, speed the delivery of social services, modernize banking and financial services, and promote efficiency gains throughout the economy. The priority areas for Bank assistance in the telecommunications subsector will be the less developed provinces in the interior. The Bank's strategy for the telecommunications sector will focus on:

- (i) improving the quality of local and long distance services;
- (ii) providing modern technology and equipment to enhance overall sector efficiency;
- (iii) accelerating telecommunications development in the poorer inland provinces; and
- (iv) promoting sector reform aimed at developing a more market-responsive sector, including formulating an effective policy and regulatory

framework, improving financial management, promoting competition and private sector involvement, and rationalizing the tariff structure.

172. In support of the strategy for the telecommunications sector, the policy dialogue will focus on: (i) commercializing operating entities; (ii) increasing resource mobilization through private sector participation; (iii) developing market pricing mechanisms; and (iv) increasing competition. The Bank will play the lead role among multilateral financing agencies in the telecommunications sector.

### **c. Water Supply**

173. Improving water supply and sanitation facilities in the rapidly expanding urban centers is important to improve health conditions, arrest environmental degradation and sustain rapid economic growth. Lending operations will be selectively pursued with identified executing agencies that have strong repayment capacity. Policy support and sector analysis will be needed to: (i) strengthen the capacity of municipal planning officials in incorporating cost recovery techniques in urban water supply projects; and (ii) promote alternative methods of financing for water projects, including BOT.

174. In 1992, the Government issued new guidelines for the rational development of the sector. These guidelines emphasize:

- (i) proper planning for, and the inclusion of water supply projects in national, provincial, regional, and local economic development plans;
- (ii) mobilization of financial resources from users and from the different Government sources for the construction of new facilities;
- (iii) full cost recovery from industrial and commercial users and recovery of operation and maintenance costs from residential users by the year 2000;
- (iv) prevention of excessive groundwater extraction;
- (v) conservation of water resources;
- (vi) the use of loans and credits to finance urban water supply; and
- (vii) the application of new technology where appropriate.

175. The Bank's operations in urban water supply and wastewater treatment will support the Government's objectives set out under the Ninth Plan. The Bank's sector strategy of addressing the equity and sustainability objectives will be closely tied to cost recovery, financial capacity, and issues related to the management of water resources. Because of the Government's concern that all projects in PRC generate sufficient cash flows to service OCR loans, Bank operations in this area are likely to be modest. However, efforts will be made to expand this part of the Bank's portfolio.

## **2. Environment Improvement Operations**

176. The Bank's strategy for promoting environment protection and natural resource conservation is aligned closely with Agenda 21 and the Ninth-Five Year Plan objectives for sustainable economic development. The strategy will build on the significant work the Bank has already undertaken and will focus on:

- (i) strengthening the policy and regulatory framework to strengthen environmental management;

- (ii) continuing to implement capacity building programs for key agencies, including the National Environmental Protection Agency, local environmental protection bureaus and the State Science and Technology Commission;
- (iii) financing investment packages (e.g. district heating, gas distribution and wastewater treatment plants) aimed at improving the environment quality of selected urban centers;
- (iv) promoting the efficient utilization and conservation of soil, water, and marine resources; and
- (v) promoting the use of cleaner process technology and clean coal technology for industrial production and power generation.

177. Bank interventions to help improve the urban environment have been largely associated with improvements in air quality by reducing industrial emissions and promoting district heating, fuel switching and renovation or relocation of industrial processes. More recently, the Bank has supported industrial and municipal wastewater treatment. The Bank focus in urban centers with severe pollution and environmental degradation will continue and will be expanded. The Bank will continue to look for viable projects in the urban sector that will address water and wastewater pollution caused by municipal sources and solid waste pollution and management problems. The Bank will focus on urban environmental management, but it will also consider interventions related to natural resource management that can service OCR loans.

### **3. Industry and Finance**

178. While the industrial and financial sectors underwent significant transformation in the 1980s and 1990s, the performance of these two sectors continues to be governed by some of the structures that are characteristic of a State-owned economy. The underlying rationale for Bank's involvement in these sectors is to promote the market-oriented reforms to enhance their operational efficiency, reduce the consolidated public sector deficit accounted for by unprofitable SOEs, and contribute to the management of aggregate demand. Policy advice through the TA and ESW programs will continue to constitute the core of Bank assistance in these two sectors, to be supplemented by selective lending assistance. Specifically, strategic Bank interventions will cover the following:

#### **a. Industrial Sector**

- (i) policy support for reforms of enterprises encompassing improvements in management, corporatization, ownership diversification, bankruptcy, strengthening of commercial accounting systems, and social security reforms,
- (ii) financial and technical assistance, subject to the adoption of enterprise reforms, to promote energy conservation and environment protection because industry is the leading source of pollution and consumer of energy ;
- (iii) financial assistance to promote the development of the non-State sector including TVEs by improving access to credit and possibly Bank equity operations; and
- (iv) financial assistance to promote enterprise reforms.

#### **b. Financial Sector**

- (i) policy support for strengthening the role of the PBC with the corollary lending assistance for financial sector infrastructure;
- (ii) policy support for the development of the regulatory framework and institutional strengthening of smaller banks and nonbank financial institutions, and developing capital markets;
- (iii) support for financial sector reform and promoting competition and efficiency in the financial sector; and
- (iv) provision of credit lines to selected financial intermediaries for relending to subprojects that address Bank cross-cutting concerns (e.g. reduction of poverty and development of private sector) and strategic objectives of environment protection and promotion of growth in the poor inland provinces.

179. The extent of Bank policy support to further deepen the reform process in these two sectors is far-reaching and will entail substantial staff resources to carry and the studies under the TA and ESW programs. There will be continuing consultation with the World Bank to ensure consistency of policy advice. In the financial sector, the World Bank will play the lead role for the larger banks, while the Bank will focus on nonbank financial institutions, smaller banks and the Agriculture Bank of China.

#### **4. Agriculture and Rural Development**

180. The Bank's agriculture and rural development portfolio is modest because the PRC does not access to ADF and the Government's policy of primarily using concessional funds and domestic resources to develop this sector. Thus, the PRC has used funds from the World Bank (IDA), OECF, and bilateral aid agencies, which provide concessional loans for projects in this sector. The Government is concerned about the capacity of agriculture and rural development projects to generate the incremental financial revenues to service OCR loans. Notwithstanding these limitations, the Bank will continue its efforts to broaden the scope of its assistance and to address issues related to rural development, poverty reduction, and environment protection and natural resource conservation. The Bank will make strategic use of TA and ESW program to strengthen policy reform initiatives, develop the capacity for project planning in agencies and help prepare agriculture and rural development projects for external assistance.

181. The emphasis accorded to agriculture and rural development, particularly in the provinces in the interior, during the NFYP will increase Government investments and stimulate more participation by the non-State sector in agro-processing industries. In line with this, the Bank will focus its operations in the following areas:

- (i) assisting in implementing policy reforms relating to enterprise restructuring, the establishment of market information systems, and the development of appropriate policy and regulatory framework for promoting private sector investment;
- (ii) providing financial assistance, either direct lending or channeled through financial intermediaries, to projects that have a significant impact on employment generation, value-added economic activities, and environment protection in rural areas.

182. Bank assistance to the agricultural sector will be operationalized by:

- (i) targeting the poor as the main beneficiaries;
- (ii) helping to remove the remaining administered prices to permit efficiency improvements in agricultural production, processing and marketing;
- (iii) enhancing income-earning opportunities by diversification into cash crop production and creating employment opportunities in off-farm economic activities especially in TVEs;
- (iv) improving the management, development, and rehabilitation of soil, marine, water, and forest resources for sustainable utilization and improving the environment;
- (v) modernizing agriculture by upgrading technology and developing market information systems;
- (vi) expanding post-harvest and marketing facilities, and transportation linkages to urban centers;
- (vii) strengthening institutions, including the restructuring of SOEs in the state farm system and the rural areas, as part of the Government's overall enterprise reform program.

## **5. Private Sector Activities**

183. The PRC has been successful in attracting private funds. Foreign direct investment between 1990 and 1996 amounted to \$149.6 billion. Most of this has been for export oriented, manufacturing located on the east coast. Given PRC's large absorptive capacity and the Bank's limited financial resources for private sector lending, there is a need to be selective in supporting private sector activities. Private sector lending for specific manufacturing projects on the east coast is not envisioned. The Bank's private sector lending in the PRC will focus on: (i) BOT or joint venture infrastructure projects; (ii) capital market debt and/or equity funds that target infrastructure, capital market development, enterprise reform, energy conservation, pollution abatement, and the development of inland regions; and (iii) stand alone industrial or financial sector projects which have strong reform elements.

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## MACROECONOMIC REFORMS

### A. Overview

1. The wide-ranging reforms implemented incrementally since 1978 have improved economic efficiency by using market forces to set prices and allocate factors of production. The reforms also helped to improve the incentive structure for production and trade. The reform program accelerated in November 1993 when wide-ranging new policy reform directions covering agriculture, SOEs, financial, fiscal, trade and social welfare sectors for 1994 and beyond were announced by the 14th Party Congress.<sup>1</sup>

### B. Financial Sector Reforms

2. In the financial sector, key reforms that have been implemented include: (i) promoting indirect instruments of monetary management such as the discount rate and open market operations; (ii) commercializing the banking sector; and (iii) developing capital markets, including the insurance industry and mutual funds, as a means for indirect monetary management and mobilizing domestic resources.

3. A major achievement was the enactment of the Central Bank Law and its ratification in March 1995. This law aims at establishing an independent central bank to effectively conduct monetary policy and supervise the financial system. The policy lending role of specialized banks has been taken over by three newly established policy banks,<sup>2</sup> so that the specialized banks can focus on commercial lending. The Commercial Banking Law, which became effective on 1 July 1995, will further strengthen the role of PBC as the central bank and main regulator of the commercial banking sector. Monetary policy reforms have generally focused on moving to indicative targeting of money, using reserve money as the operational target, and increasingly using open market operations and interest rate adjustments.

4. The nonbank financial system was deepened with the establishment of stock exchanges in Shanghai and Shenzhen in 1991, and the China Securities Regulatory Commission (CSRC) in 1992 to supervise the development of the securities industry. By the end of 1995, 262 companies had been listed on the two stock exchanges. Secondary markets in Government bonds were formally established in 1988. The development of the treasury bonds market was accelerated in 1991 when the Ministry of Finance switched from administrative placement of bonds to marketing bonds underwritten by financial institutions. Short-term treasury bills were issued through a system of primary dealers and institutional investors in 1994. The National Securities Law, although not yet promulgated, will establish the legal and regulatory framework to guide the development of the industry and to encourage formation of limited liability and joint stock companies.

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<sup>1</sup> These reforms are contained in a document entitled, "Decisions on Issues Concerning the Establishment of A Socialist Market Economic Structure". The document highlights the remaining reforms in each sector that need to be implemented to complete the PRC's transformation to a market economy.

<sup>2</sup> The State Development Bank, the Export-Import Bank and the Agricultural Development Bank. of China.

### **C. Price Reform**

5. Price liberalization in the PRC is largely complete. By 1994, it was estimated that the proportion of goods subject to price controls was 5 percent for retail goods, 15 percent for means of production, and 10 percent for agricultural products. In the energy sector, the price of coal was liberalized and transportation charges were adjusted in 1994. Petroleum prices were adjusted in May 1994, while grain and other food prices were brought close to border prices in June 1994. The Government has announced that it will abolish all price controls by 1997.

### **D. Fiscal Reform**

6. To improve public financial management, a major step was taken in July 1993 when a new standard was adopted to bring general accounting and auditing principles in line with international practices. Implementation of a comprehensive fiscal reform program started in March 1994 which aims at improving buoyancy and efficiency of the tax system and distributing the tax burden more equitably. The enterprise and personal income taxes were standardized and simplified. The enterprise income tax was applied uniformly to all domestic enterprises with the maximum rate of 33 percent. Permissible tax deductions and the basis of tax exemptions were also clarified. Personal income taxes, which applied differently to domestic and foreign residents, were unified.

7. Indirect taxes were simplified and unified with the introduction of a broad-based Value Added Tax (VAT) designed to cover production, wholesale and retail trade, and imports. The basic rate was set at 17 percent, with a lower rate of 13 percent for food and agricultural tools. The invoice credit method began to be used as the standard base for taxation. The coverage of the product tax and business tax was simplified, the tax rate reduced and minor taxes were abolished. The National Tax Service (NTS) was established to collect taxes assigned to the central government and taxes to be shared between the central and provincial governments. Local taxes continue to be collected by the local tax bureaus. The Budget Law, enacted in March 1994, established separate budgets for the Central and provincial governments and adopted a more analytical budgetary presentation in line with international conventions.

### **E. Foreign Exchange Reforms**

8. Exchange rate system reforms, introduced in January 1994, resulted in a unified and managed floating exchange rate system that is determined in the interbank market. New regulations were introduced for domestic enterprises with liberalized access for trade and trade-related transactions. Other reforms included eliminating the foreign exchange quota retention system and establishment of an inter-bank foreign exchange market in March 1994. The PRC plans to move to a fully floating exchange rate system and achieve full convertibility of the yuan by the turn of the century.

## **F. Trade Reforms**

9. In the area of trade reform, protectionist measures were further reduced to help retain Most Favored Nation (MFN) status and increase compliance with WTO requirements. The Foreign Trade Law became effective on 1 July 1994. Nearly all existing trade regulations had been rescinded or published as of end 1993. Tariffs on about 3,000 commodities were reduced, lowering the average tariff rate from 40 percent to 36 percent, and tariffs on 235 import items were reduced temporarily for one year, effective 1 January 1994. The weighted average tariff rate is now at 18 percent compared to 15 percent required by WTO for developing countries. Import licensing requirements were removed for nine commodity categories and those for additional 20 categories removed by the end of 1994. Mandatory trade planning was also eliminated in 1994. At the Asia-Pacific Economic Cooperation (APEC) forum in November 1995, the PRC announced that it would lower tariffs on an additional 4,000 items from 1996--cutting tariffs from an unweighted average of 35.9 percent to 22 percent. When fully carried out, the weighted average tariff would fall to under 10 percent, much below the WTO requirements for developing countries. The Government's commitment to liberalize foreign trade and open its financial sector to foreign investment underlines its desire to join the WTO as soon as possible.

## **G. Enterprise Reforms**

10. In the area of enterprise reform, the 'Regulations on Transforming the Operating Mechanism of SOEs' were adopted in July 1992. Two types of shareholding systems, limited liability companies and limited liability stock companies were introduced through corporatization of existing and newly established SOEs. Further progress was made in enterprise reform by the enactment of the Company Law in July 1994, which established the legal framework for the corporatization of SOEs. The law defined enforceable rights for shareholding companies. To expand the shareholding system, ten thousand SOEs have become involved in a program of asset valuation and accounting reform, of which 1,000 have been selected for management reform. The shareholding system has been applied to 100 medium and large scale enterprises including their financial and managerial restructuring and their listing as joint stock companies on the stock exchanges. The successful restructuring models will be replicated nationwide.

11. In addition, the Bankruptcy Law and the proposed Law of State-owned Properties further clarify the role of State and create conditions under which enterprises of various ownership forms can compete or fail in the market place. During 1994 and 1995, work was undertaken to develop an alternative social security system<sup>1</sup> outside of SOEs to provide retirement benefits and unemployment insurance to workers. The Government is concerned about the social costs of a widespread application of the Bankruptcy Law.

## **H. Agricultural Sector Reforms**

12. Agrarian reforms were the basis of the rapid economic and per capita income growth during the 1978-1984 period. The reforms, centering on the household responsibility system and price increases of agricultural output, were successful in raising agricultural production and farmer incomes. The growth of agricultural production from 1985-1995 was less than half the rate of growth from 1978-1984. In 1995, the Government announced a comprehensive program aimed at improving the rural economy including increasing grain output,

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<sup>1</sup> For retirement benefits, provident funds are being established in many cities. Unemployment coverage will be extended to all SOE employees by 1995.

protecting arable land from being used for non-agricultural purposes, improving low-yielding land to boost output, enhancing farmland infrastructure (e.g., water conservation works) and appropriating more Government funds for investment in the agricultural sector. Under the Ninth Five-Year Plan (1996-2000) the Government has identified the agriculture sector as a priority sector. The main objectives are to further increase farmer incomes, improve agricultural production conditions, and integrate all forms of agriculture, so that the PRC would become less dependent on food imports over the medium-term. The Government plans to abolish procurement prices for all agricultural produce by 1997.

## ENERGY SECTOR

### A SECTOR BACKGROUND

1. The PRC's principal nonrenewable energy resources are coal, oil, natural gas and uranium. The most important energy resource is coal, which accounts for about 74 percent of total energy output, followed by oil (19 percent), hydroelectric power (5 percent) and natural gas (2 percent). The industrial sector is the largest energy consumer and accounts for nearly 70 per cent of total commercial energy consumption, followed by the residential sector (14 percent), the transport and agriculture sectors (5 percent each), and other sectors and non-energy use (5 percent). Energy resources are large but their uneven distribution across the country's vast territorial expanse has placed a heavy burden on the country's transport system. Renewable resources comprise hydropower, biomass and geothermal energy. Recoverable coal reserves, estimated at about 900 billion mt, are mostly found in the energy belt in the north which includes the provinces of Inner Mongolia, Hebei, Henan, Shaanxi and Shanxi, and account for about 94 per cent of the total energy resources. Reserves of crude oil and natural gas are estimated at 80 billion mt (in the north and northeast) and 33 trillion cubic meters (cu m), respectively. Because of the decline in proven oil reserves, production from existing fields has reached a plateau. However, new fields are being developed, particularly in the northwest, to augment the domestic supply of hydrocarbons. Production of natural gas has remained constant at about 15 billion cu m per annum although there is scope for increased production. Reserves of uranium are sufficient to sustain 15,000 megawatts (MW) of nuclear power generation for 30 years.

2. PRC's hydroelectric potential is estimated at 1,900 terrawatt hours per annum (located mostly in the southwest), equivalent to about 360,000 MW assuming a 60 per cent plant factor. Only nine per cent of the hydroelectric potential has been developed. The long gestation period for hydroelectric projects has inhibited the rapid development of this resource. However, increasing environmental problems caused by fossil fuel burning have prompted the Government to consider the development of large hydroelectric projects. Although found in many regions of the country, geothermal energy plays only a minor role in energy supply.

3. Biomass fuels represent a major source of energy supply in rural areas. Fuelwood and crop residue provide about 333 million mt of coal equivalent (tce) and account for nearly a quarter of the country's energy supply. Deforestation problems are prevalent in some areas. The Government has been adopting measures to tackle this problem by encouraging efficient use of fuelwood, improving natural resources management preventing deforestation and encouraging tree planting.

4. Per capita energy consumption is low but energy use per unit output value is high, reflecting PRC's status as a low-income developing country with a large industrial sector. Currently per capita energy use is about 696 kg of oil equivalent (kgoe) which is about 40 per cent of the world's average level. Energy use per unit of GDP in the PRC (2,844 kgoe per \$1000 of GDP in 1992) is high compared with that in the Bank's developing member countries (with an average of 940 kgoe per \$1000 of GDP). It is difficult to measure precisely how the energy intensity of PRC's economy compares with that in other countries because of difficulties in energy and GDP accounting. Breaks in the data for official GDP estimates for PRC in US dollar terms in some years mean that energy intensity comparisons vary substantially depending on the year of calculation. This reflects the high share in GDP of industrial output, the structure of industry, the use of inefficient technologies, and inadequate

energy management practices. However, there have been considerable improvements in these areas. During 1984-1994, the PRC's energy intensity per unit of GDP fell by about 30 percent. Further efforts to improve energy efficiency are crucial to sustain economic growth. The Government has made energy efficiency improvements an integral part of its energy sector strategy. Such improvements require continued structural adjustments in industry, technical upgrading, strengthening of energy management, and the adoption of market pricing of energy products.

5. Energy shortages are endemic, particularly in the coastal growth corridor, and are a serious constraint to the PRC's reform and modernization programs. Although the PRC has made substantial progress in developing its energy resources, annual production continues to lag behind actual demand. Recognizing this, the Government began to accelerate its investments in the energy sector in the mid-1980s, and more recently to promote foreign investment in the sector. In 1994, the Government allocated an equivalent of about 7 percent of GNP or about Y80.4 billion (\$14 billion) to the energy sector. This represented 27 percent of state capital construction, compared to 21 percent in the early 1980s. The power subsector accounted for 61 percent of the total. Foreign loans and direct investments finance about 20 percent of the investment requirements of PRC's energy sector.

6. Recognizing the importance of energy pricing, the Government is focusing on price reform aimed at pricing energy at the economic cost of supply and providing market-based incentives to encourage the efficient use of energy and conservation. Price reform in the energy sector has been proceeding steadily, resulting in substantial increases in real energy prices. In the mid-1980s, a dual-track energy pricing system was introduced, in which energy supplies outside the national plan were charged at market prices, which were substantially higher than the administered prices. The proportion of energy priced at market prices has increased and the administered prices have been raised substantially. Except for a few consumer categories, the Government abolished the administered prices for the main forms of energy in 1995.

## **B. GOVERNMENT'S DEVELOPMENT STRATEGY**

7. During the NFYP, the Government plans to: (i) reduce the intensity of the energy use, particularly in the industrial sector; (ii) expand and improve the scale of operations in the energy sector, particularly, in the coal subsector; (iii) accelerate the expansion of electric power, particularly, through large scale hydropower generation, with due consideration to the environment; (iv) facilitate the transfer of appropriate advanced technology and know-how, especially in energy-intensive industries; and (v) diversify the energy mix to lessen the dependence on coal.

8. In the policy area, energy pricing reforms will be continued to enhance competitiveness of energy producing and energy consuming enterprises. Energy enterprises will be more independent of the Central Government and will become self-supporting. Other major measures to be implemented by the Government over the next five years include: (i) simplifying power tariffs so that they reflect economic costs; (ii) reforming the transportation system and reducing the intermediate cost of coal delivery; (iii) deregulating oil and oil product pricing to promote foreign investment and import of oil and natural gas; (iv) promoting foreign investment for energy production including build-own-operate and build-own-transfer, shareholding and other modes for new energy enterprises; and (v) developing new and renewable energy technology to address global environmental concerns.

### **C. BANK'S OPERATIONAL STRATEGY**

9. Reforms of the 1980s reduced the centralized management of the power sector, mobilized and diversified financial resources, and improved cost recovery. However, the partial reforms brought about new challenges. First, although power supply has increased substantially it still does not meet the surging demand. Second, the adhoc approach to reform has yet to establish a coherent, transparent framework for sustained development of the sector. The PRC requires an average yearly capacity addition of between 15 and 20 GW to the year 2000. To meet these challenges, the Government introduced a reform agenda in the early 1990s to ensure that the enterprises are run as efficient commercial businesses and to reduce barriers to entry. The Bank's operational strategy will continue support for the Government's two-pronged energy development program aimed at expanding energy supplies and promoting energy efficiency. The Bank will give priority to the power subsector to: (i) expand generation, transmission and distribution capacity to overcome the prevailing power shortages; and (ii) enhance efficiency and improve the environment through technical renovation of outmoded power plants. The implementation of demand-side management measures to promote efficiency and energy conservation in the power and industrial sectors will also be an integral part of the Bank's operational strategy. The Bank will assist with the development of more environment-friendly energy sources, including hydropower and natural gas, and facilitating the transfer of more advanced and appropriate pollution abatement methods in the design of power plants.

10. The need to develop the power supply to support the growth of less developed inland provinces in the PRC is recognized in the Bank's operational strategy. Bank assistance will continue to support regional and provincial power companies in their transition to autonomous, commercially-oriented entities. Lending operations will involve a gradual shift away from the more advanced coastal provinces to the less-developed inland provinces.

11. The Bank will support the ongoing policy reforms including the adoption of a more rational pricing structure for energy products, and the promotion of private sector participation in the power sector. The institutional development of power utilities, which are being corporatized in line with enterprise reforms, will remain an integral part of the Bank's operations in the power subsector. Through such institutional development, the Bank will assist power companies to adopt modern utility practices that will enable them to operate and manage power generation and supply in a more efficient and commercially viable manner.

12. Because of the PRC's continuing reliance on coal as the major source of energy, the Bank's operational program will aim at developing more environment friendly sources of energy (e.g., hydroelectric power and natural gas) which will help reduce the dependency on coal. The Bank will support the use of advanced clean-coal technologies and pollution reduction equipment especially in areas where other alternative sources of energy are not available or are not cost effective.

### **D. FOCUS OF BANK OPERATIONS**

13. The Bank operations in the energy sector will assist the Government in implementing its power development program, attracting foreign investment, promoting energy efficiency and transforming power utilities into efficient commercial entities. The capacity building needs of the provincial power companies will be addressed through institutional development focusing on such areas as corporatization, financial management, tariff setting, system planning and energy conservation. Bank support for capacity-building will also include the development of an enabling framework to mobilize foreign investment including build-

operate-transfer and build-operate-own financing schemes and joint ventures, and the institutional capacity for appropriate tariff setting, financial management and energy conservation. The Bank's financial intermediary role will include support for hydropower plants, thermal power plants, power transmission project, restructuring of existing power plants and natural gas projects.

## TRANSPORT AND COMMUNICATIONS SECTORS

### A SECTORAL BACKGROUND

#### 1. Transport Sector

1. PRC's transport system includes about 1.12 million kilometers (km) of highways, 1,045,600 km of civil aviation routes, 110,200 km of inland waterways, 53,992 km of railways, and 16,800 km of petroleum and gas pipelines. However, the density of the transport network is among the lowest in the world.<sup>1</sup> Transport bottlenecks are a major constraint for efficient economic growth. Between 1978 and 1994 domestic passenger transport on all modes grew on average by 10.5 percent per year, and for freight by 7.9 percent per year. This rate of growth is broadly consistent with that of the economy, which grew about 9.3 percent annually during the same period. If the present constraints and bottlenecks had not existed, passenger and freight traffic could have grown 12 to 15 percent faster than actual growth. In 1994, road traffic accounted for 47.1 percent of total passenger traffic, followed by the railway (44.3 percent), civil aviation (6.1 percent), and coastal and inland waterways (2.5 percent). The modal split for freight traffic was coastal and inland waterways (47.1 percent), railways (37.5 percent), roads (13.5 percent), and pipelines (1.8 percent). The most rapid growth has occurred in the road and air subsectors.

2. The level of public investment in the transport sector remained unchanged at 1.3 percent of gross national product during the 1980s, which is significantly less than that in other comparable developing member countries of the Bank. As a result of this under investment, the PRC's relatively sparse transport network has to handle rapidly increasing traffic volumes which, in some areas, exceeds the optimal capacity. For example, freight volume per km of railway is more than five times higher in the PRC than in India and seventeen times higher than in Japan. The total transport investment needs to be increased to at least 3 percent of GNP to avoid economic costs related to congestion and transport bottlenecks. The incremental investment in the transport sector needs to be allocated efficiently between transport modes to achieve the maximum capacity expansion at minimum cost.

3. To meet the rapid increase in transport demand, large investments in infrastructure are required – estimated at more than \$500 billion during the next decade. Financing this level of investment is a major challenge and is beyond the funding capability of the Government and sources of official development assistance. Additional sources of financing must be actively sought. A large portion will need to come from the private sector, both domestic and foreign, including joint ventures, equity investments and build-operate-transfer projects. In addition to the increased investment in the transport sector, policy reforms need to be implemented to reduce inefficiencies, capture the benefits of a more balanced intermodal transport system, increase the efficiency with which the existing infrastructure is used, and make the environment conducive to private sector investment in the transport sector. Key measures of the Bank's transport sector policy dialogue include: (i) introducing market-based pricing mechanisms that will help eliminate congestion and allocate scarce resources in an optimal way; (ii) commercializing the operations of public transport enterprises; (iii) reducing Government controls and introducing competitive and better services for users; (iv) eliminating

<sup>1</sup> Per square kilometer of land area, the PRC's transport network is one sixth of India's and one fifth of that of the Republic of Korea.

the uncoordinated transport of commodities and increasing the processing of raw materials before shipment; (v) introducing more modern technology in the transport system, including the use of computerized data processing and planning techniques; and (v) introducing competition by encouraging private sector financing for passenger and freight transport services on roads, inland waterways, coastal shipping, and port operations.

## **2. Telecommunications Sector**

4. PRC has the third largest public telecommunications system in Asia (after Japan and the Republic of Korea). Initial steps were taken in 1978 to accelerate telecommunications development. Targets under the Seventh Five-Year Plan (SFYP, 1986-1990) were directed at development in the coastal cities open to foreign investment and modernization and expansion of the long distance and international networks. During this period the telecommunications sector's growth rate began surpassing that of the national economy (twice the GDP growth rate), marking an important turning point. By 1991 the number of installed telephone exchange lines had reached 10 million. By the end of the Eighth Five-Year Plan (EFYP, 1991-1995), the number of installed telephone exchange reached about 38 million, representing an average annual growth rate of about 31 percent (1991-1995). During the Ninth Five-Year Plan (1995-2000) period, an installed telephone exchange line capacity of about 114 million is expected to be achieved.

5. Development of the local telephone cable access networks has lagged behind that of telephone exchanges, resulting in idle capacity. Nationwide only about two thirds of the exchange lines were connected to subscribers. This major problem has been recognized by the provincial telecommunications authorities and considerable effort and funds are planned to be directed to correcting this situation. Extensive use is made of private branch exchanges (PBXs) to provide telephone service in urban office and residential developments. In 1991, although only about 6 percent of the urban telephone exchange lines in service were used as trunk lines for PBXs, they supported about 47 percent of the connected telephone sets. This percentage is far higher than in other countries where telephone exchange lines are also in short supply and promotes congestion in the telephone network. Rural telephone service is mainly provided by the municipal/city and county telecommunications enterprises. However, many of the rural telephone lines are provided by cooperatives and local governments in townships and villages.

6. The telex network connects about 14,600 telex customers in 118 cities. Telex uses both the public switched telephone network and separate telex switches. Telegraph in PRC continues to be widely used. The annual volume is about 282 million telegrams, with more than 80 percent handled through the use of computer terminals. The use of cellular mobile telephones has grown rapidly, particularly in the coastal cities and special economic zones. This has helped to overcome telephone shortages. By the end of 1993, cellular telephone systems had been put into operation in 400 cities with about 640,000 subscribers. Radio paging systems was available in about 1700 cities with some 7 million subscribers. From January to August 1994, mobile subscribers increased by 530,000 and paging subscribers by 3.1 million.

7. Despite rapid growth, PRC's telecommunications system falls short of meeting growing demand. Local and long distance service quality is poor in many areas, and parts of the system are obsolete and costly to maintain and operate. Telephone service is severely congested and is unusable in many places during peak business hours. When the supply of telephone exchange lines falls far short of demand, the few available lines are in use for excessive periods, which disrupts incoming call attempts. Extensive use of PBXs, while

making it possible to provide service to more urban subscribers than could be otherwise achieved with the small number of available lines, results in average traffic per line well in excess of normal design ranges, contributing to local traffic congestion.

8. Rapid growth in the local exchange networks has led to large increases in the volume of trunk traffic which in turn has strained the long distance network. The Ministry of Posts and Telecommunications (MPT) is moving to modernize the long distance network by replacing obsolete equipment and developing a modern network with adequate long-distance trunk transmission capacity and integrated network services. As part of this strategy, a high-capacity optical fiber cable network using digital technology is being developed to form the backbone of the national telecommunications trunk transmission network. MPT is establishing 16 major transmission axes (eight north-south and eight east-west) covering all regions of PRC. When completed this network will provide a robust, high capacity grid interconnecting interprovincial and autonomous regional networks. The planned network will increase the capacity of the long distance network to accommodate rapidly growing domestic and international telephone and non voice services.

## **B. GOVERNMENT'S DEVELOPMENT STRATEGY**

### **1. Roads**

9. The centerpiece of Government's strategy to meet the transport needs of the PRC economy is the long-term development of the National Trunk Highway System (NTHS). The NTHS is a system of high-quality interprovincial highways comprising 12 key road transport corridors of about 30,000 kilometers (km) in length that are to be built during a 30-year period. The 12 corridors were selected based on population, production, and socioeconomic criteria. The NTHS will connect all provincial capitals and cities with populations of 500,000 or more. During the 9FYP (1996-2000), seven key trunk routes totaling about 12,000 km in length will be completed.

10. A core network of 14,960 km in length, comprising two north-south routes and two east-west routes, will be completed during the Ninth and Tenth FYs. The first north-to-south route will link all the major cities on the eastern seaboard from Tongjiang in Heilongjiang Province to Sanya on Hainan Island. The second north-to-south route will connect Beijing with Zhuhai on the west side of the Pearl River Delta. The first east-to-west route will start from the seaport of Lianyungang in Jiangsu Province, pass through the major cities in northwestern PRC and end at Korgas in Xinjiang Province, near the border with Kazakhstan. The second east-to-west route links Shanghai to Chengdu in Sichuan Province and will pass through Chongqing and other major cities along the Yangtze River. These four priority routes account for nearly half of the total distance of the 12 routes that comprise the NTHS.

11. The NTHS will be supported by the complementary development of new provincial, county, and village feeder roads, including selected interconnecting links between the NTHS corridors and city areas. During the Ninth FYP 125,000 km of such roads will be constructed. By the turn of the century, the total road network will expand to about 1.25 million km of which about 3,000 km will be expressways; 150,000 km of class 1 and class 2 highways; and about 1.095 million km of other roads. The Government's investment plans for the highway subsector have an appropriate regional and social balance and its request for international financial institutions to focus on the NTHS is justified by the need to provide infrastructure support for economic growth, create employment, and reduce poverty.

## **2. Ports and Inland Waterways**

12. To address the problems of port congestion in the face of rapid economic development, port expansion and improvement have been given high priority under the three five year plans since 1980. During this 15 year period about 200 deep water berths, each capable of handling ships of at least 10,000 deadweight ton (dwt) capacity, have been constructed, bringing the total of such berths to about 300 at the end of 1993. Progress has also made in providing additional storage capacity at ports, installing more efficient cargo handling equipment (e.g. for containers and bulk traffic), developing computerized electronic data interchange and other port management information and administration systems, and improving the road and rail links between ports and their hinterlands. The Government's plans for ports to the year 2000 are to: (i) construct about 20 new international deep water berths every year to handle increasing international trade; (ii) develop coastal shipping, inland waterways, and rail and road networks in an integrated manner to improve the efficiency of hinterland distribution systems; and (iii) improve the port finances, management, and operations through a program of human resource development and systems upgrading.

13. Investments are planned to expand the capacity for foreign trade at the 16 main ports for containers, coal, grain, iron ore, timber, and petroleum. Domestic port facilities will also be expanded, especially for coal and petroleum transport from the northern and northwestern production areas to the southern and eastern consumption areas. The development of containerization will be accelerated and port operational efficiency will be improved through greater use of containers, palletization, and modern bulk cargo handling methods.

14. To improve the efficiency and accountability with which capital investment is used in the port subsector, the Government is introducing reforms to foster: (i) self-financing of port operations and investment on a progressive basis; (ii) increased competition between ports; and (iii) increased coordination between port development and the development plans in the port hinterlands.

## **3. Railways**

15. Although the market share of railways has fallen since 1978, rail traffic has increased in absolute terms in line with the increasing demand for the transport of energy and industrial raw materials. The Government's railway strategy envisages the development of adequate rail transportation capacity by addressing the constraints on the system, enhancing the productivity of existing facilities, and constructing new lines. An important feature of the Government's strategy, which the Bank has actively supported, is the construction of local railways to supplement the national railway network. By providing essential local transport links, local railways are able to overcome transport bottlenecks that have constrained development of local economies. The local railways are also an important mechanism for developing and testing reforms in the railway sector.

## **4. Telecommunications**

16. Under the 1991-2000 ten-year program (EFYP and NFYP) the Government aims to increase telephone density, replace obsolete equipment and develop a modern network with adequate long-distance trunk transmission capacity and integrated network services. The primary targets of the EFYP include (i) increasing the density of installed telephone exchange lines from 0.9 percent of the population in 1991 to 3.1 percent in 1995,<sup>1</sup> which involves increasing telephone exchange capacity from about 11 million at the beginning of 1991 to about 38 million in 1995; (ii) expanding the long distance trunk switching capacity from about 280,000 terminations in 1991 to about 1.2 million terminations in 1995; and (iii) increasing the long distance kilometers (km) coverage of trunk radio and optical fiber cable from about 18,000 km to 61,000 km. In total, about 27 million telephone exchange lines, about one million long distance switching terminations and 32,000 km of optical fiber cable were installed during the EFYP. The investment program for the EFYP period amounts to about \$1 billion equivalent. During the NFYP, expansion targets are more ambitious and are anticipated to triple the number of installed telephone exchange lines. The investment required for the NFYP is estimated to exceed \$41.5 billion equivalent which is expected to increase the density of installed telephone exchange lines to about 9 percent by the year 2000 and the number of exchange lines about 114 million.

## **C. BANK'S OPERATIONAL STRATEGY**

### **1. Roads**

17. In recognition of the increased importance of road transport in the development of a market economy, the Bank will facilitate the expansion of the road network. As with other major donors, the focal point of the Bank's assistance to the sector is on the selective development of key sections of the NTHS and support for the development of linkages from the NTHS to hinterland economies. Assistance for the development of urban transport infrastructure will also be considered. The operational strategy also acknowledges the need for further institutional strengthening to increase the commercial orientation and managerial efficiency of expressway corporations and to improve highway planning and evaluation techniques and safety and design standards. The Bank will also promote the adoption of appropriate pricing policies for the highway and road subsector and alternative methods of investment financing, including increased mobilization of domestic resources and support for direct private sector participation, to help meet the huge financing requirements of the highway and urban transport development programs.

### **2. Ports**

18. In the ports sector, the strategic concern of the Bank is to mobilize the capital resources to alleviate port bottlenecks through selective financing of additional berth capacity, support improved productivity through the installation of modern cargo handling facilities and equipment, and to improve intermodal exchanges and hinterland distribution more efficient. The Bank's sectoral strategy for port restructuring is focused on providing assistance to: (i) further decentralize port management and decision making, (ii) adopt market pricing mechanisms, (iii) foster competition and service-oriented management, (iv) commercialize operations, and (v)

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<sup>1</sup> In 1992 comparable telephone densities (main lines per 100 people) were: 0.96 in PRC; 0.81 in Indonesia; 1.05 in the Philippines; 3.19 in Thailand; 11.23 in Malaysia; 36.51 in the Republic of Korea; 48.60 in Australia; and 47.07 in Japan.

develop human resource. Special attention will also be given to mobilizing private sector resources for the development of ports and related infrastructure.

### **3. Railways**

19. In the railway subsector the Bank strategy focuses on efficiency improvements through mitigation of capacity constraints and interconnection of the railway system by financing the construction of provincial railway lines. These railway lines are expected to stimulate the economic development of poor inland areas by improving access to regional markets. The strategy recognizes that the railway subsector will also require (i) technological modernization for greater productivity, (ii) institutional development and strengthening, (iii) improved operational and managerial practices to strengthen commercial orientation of operating enterprises, and (v) market-based tariff reform that will promote financial viability and a more economic modal split of transport. The Bank has assisted the Government in railway planning by identifying the transport bottlenecks and constraints that are limiting development, recommending policy changes in modal allocation, pricing of transport, and prioritizing future investment in the railway subsectors.<sup>1</sup>

### **4. Telecommunications**

20. The Bank's operational strategy for the telecommunications sector focuses on: (i) improving the quality of local and long distance services; (ii) facilitating the transfer of modern technology and equipment to enhance overall sector efficiency; (iii) accelerating telecommunications development in PRC's poorer inland provinces and western regions; and (iv) institutional development and sector reform aimed at developing a more market-responsive sector, including the development of an effective policy and regulatory framework, improving financial management, promoting competition and private sector involvement, and rationalizing the tariff structure.

## **D. FOCUS OF BANK OPERATIONS**

21. Bank's operations in PRC are guided by the strategic development objectives of promoting economic efficiency, protecting the environment and reducing poverty. The Bank operations in the transport sector will assist the Government in creating and/or strengthening infrastructure together with policy changes and building institutional capacity. The Bank's loan and technical assistance projects will focus on reducing key bottlenecks in the highway, railway, port and urban transport sectors to promote efficient economic growth and to support government initiatives to develop a market economy. In the telecommunications sector, the Bank will assist the Government with its ongoing sector reform to promote competition, increase operational efficiency, enhance resource mobilization and promote private sector participation and direct foreign investment. The Bank's priority in transport and communications sector is given to infrastructure projects that improve the access of less developed provinces and poorer interior areas through better transport and communication links between regions and intermodal connections to complement the Government's strategy of reducing poverty.

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<sup>1</sup>

TA No. 1524-PRC: Regional Railway Sector Study, for \$275,000, approved on 20 June 1991.

## **INDUSTRIAL SECTOR**

### **A SECTOR BACKGROUND**

1. Market-oriented reforms began to be implemented in to the industrial sector in the mid-1980s. The reforms in the industrial sector aim at creating an environment that will make of industrial enterprises increasingly responsive to market signals, thus leading to a more efficient industrial structure. To achieve this objective, the role of central planning has been reduced and reforms undertaken in exchange rate and trade policies, price and distribution controls, banking, labor policies, taxation and enterprise governance. The magnitude of the required transformation is large. Industry is the largest productive sector in PRC, accounting for about half of gross national product, employing about one fifth of the labor force and about three fourths of the country's export earnings. In the prereform period, the industrial sector was shaped by centrally planned resource allocation and inward-oriented policies. Emphasis was given to achieving physical production targets, with relatively less attention paid to environmental management, energy efficiency, profitability, product quality, and the use of modern technology. Emphasis on industrial self-reliance at both the national and provincial levels as well as the rigid ministerial controls resulted in complex management and marketing arrangements which inhibited the development of horizontal linkages among industries and the adoption of economies of scale.

2. Primarily as a result of market-based reforms, the industrial sector has grown rapidly, become integrated with the world economy and made significant productivity gains. However, SOE productivity improvement and output growth has been modest and many State enterprises operate with losses, have excess labor and use obsolete equipment. Non-State owned enterprises, foreign funded joint ventures and private enterprises accounted for much of the productivity gains and growth in output and exports since the implementation of reforms. The non-State sector has grown rapidly, leading to a dramatic change in the structure of industrial ownership. In 1978, SOEs accounted for 88 percent of gross value of industrial output and collectives 12 percent. By 1994, the SOE share had declined to 44 percent while the share of collectives had risen to 39 percent. The remaining 17 percent was produced by private and joint-ownership enterprises. Industrial growth and structural transformation have been achieved through a significant gain in factor efficiency and reduced energy consumption. Trade reforms have contributed significantly to export and import growth, resulting in the increased exposure of enterprises to international market conditions and prices, and greater access to modern technology. Manufactured exports grew at over 20 percent a year, increasing 20 times from \$4.9 billion in 1978 to \$98.7 billion in 1994.

3. Within the industrial sector, the most dynamic sector has been the township and village enterprises (TVEs) which, at the end of 1994, accounted for more than a third of industrial output and nearly a third of PRC's exports. The dynamism of TVEs has been the main feature of the industrial growth since the beginning of the 1990s. Measures required to meet their capital and financial needs, upgrade their technological and managerial systems and bring about a better regional balance in their location will exert an increasing demand on the Government's policy formulation resources.

### **B. GOVERNMENT'S DEVELOPMENT STRATEGY**

4. A strategic focus of the Government's Ninth FYP include revitalizing major industries and nurturing high-tech industries and increasing the market orientation of industries as well as absorbing modern science and technology into production processes. The strategy seeks to optimize of the industrial structure by restructuring, readjusting and upgrading the industrial sector and by developing tertiary industry. The strategy also emphasizes the development of basic industries to keep pace with the rapid expansion of the economy. The machinery, electronics, petrochemical, automobile and construction material industries are designed as pillar industries that will lead the overall economic growth and structural upgrading. Processing industries will be restructured, renovated and improved to increase competitiveness in both domestic and international markets.

5. The strategy envisages the reform of SOEs as a central link in the PRC's economic restructuring process during the 9FYP period. The focus of reforms is to set up a management, supervision and operation system for State-owned assets based on clearly defined rights and responsibilities to promote the separation of government administration from enterprise management and to speed up the establishment and improvement of a social security system. SOEs will be made responsible for their profits and losses. There are about 23 million redundant workers in SOEs. The Government will manage the enterprise reform process in a manner that ensures that social costs are not excessive.

### **C. BANK'S OPERATIONAL STRATEGY**

6. The Bank's Operational Strategy in the industrial sector focuses on three key areas: (i) restructuring state enterprises to orient them to the market; (ii) reducing high unit energy consumption, particularly in heavy industries; and (iii) reducing the high level of industrial and urban pollution. The strategy emphasizes support for implementation of macroeconomic and structural reforms including enterprise reforms. The continuation of market-oriented reforms and the development of indirect instruments for macroeconomic management in fiscal and monetary policy are critical to PRC's efforts to enhance efficiency in the industrial sector. Likewise, reform of SOEs is crucial for improving efficiency in most sectors of the economy, facilitating reforms in the financial sector, and reducing the consolidated public sector deficit. This underscores the importance of the proper sequencing of reforms and the adoption of an integrated approach in implementing reforms. The SOEs account for about half of industrial output, absorb the bulk of bank credit and employ 76 million urban workers who depend on them for housing and social benefits. All Bank lending operations in the industrial sector will be contingent on addressing issues relating to supporting enterprise reform.

7. In line with the strategic thrust of economic efficiency improvement, the Bank will support industrial technology modernization, commercialization of industrial research and measures than encourage the market-orientation of enterprises. Major issues in the Bank's agenda for policy reform include market-based resource pricing aimed at removing distortions in factor and product prices, introducing and strengthening competition, separating management from ownership and government regulatory functions, improving financial management, improving energy efficiency, and reducing industrial pollution.

#### **1. Enterprise Reform**

8. The focus of Bank's activities in the industrial sector include: (i) improving the management of enterprises; (ii) subjecting enterprises to market discipline by eliminating subsidies and promoting competition within the state sector, and between the state and non-state sectors; (iii) creating of autonomous corporate enterprises, with clear lines of governance, fully transparent and modern financial accounts, and clearly defined management prerogatives and responsibilities; (iv) separating of the provision of social services including housing, social security, education and health from enterprises to encourage greater efficiency and greater labor mobility; (v) promoting of greater flexibility in ownership to facilitate enterprise restructuring through acquisition of new technologies, management expertise, and financing sources; and (vi) diversifying ownership structures and restructuring SOEs into shareholding entities. Within this policy framework, the Bank will continue to support enterprise reforms by addressing issues in corporate governance, separation of social services, labor mobility, bankruptcy, and rationalization of policy and the incentive environment within which SOEs operate. The Bank will finance pilot projects to demonstrate key principles of enterprise reform. Enterprise reform and restructuring will also be facilitated by Bank support for financial sector reforms, particularly through assisting in the development of investment funds and capital markets.

## 2. Industrial Restructuring

9. Industrial restructuring to promote economic efficiency improvement will complement the reforms in the fiscal, financial, and monetary systems. The key elements of the Bank's operational policy include projects that promote energy efficiency, pollution control and environmental improvements through the use of new and improved technologies, market-based resource pricing, fuel switching and clean coal technologies.

10. A major area of focus in the Bank's operational strategy in the industrial sector is to help PRC safeguard the environment. Prior to the 1980s, PRC strategies paid little attention to adverse environmental impacts. Although these problems are now recognized and implementation of environmental action plans to address them has begun, development pressures on water, air, and land resources continue to intensify. Critical challenges include: (i) managing hazardous and toxic wastes; and (ii) reducing air and water waste output by increasing industrial efficiency in energy and other input use. The Bank operational strategy will assist in developing and implementing national environmental policy through policy dialogue on developing an appropriate regulatory framework to promote resource conservation and environmentally-friendly behavior, industrial pollution control and energy and water resource pricing. The lending program will also support industrial pollution mitigation in urban areas.

## D. FOCUS OF BANK OPERATIONS

11. Bank operations in the industrial sector will focus on policy and institutional support and industrial restructuring to enhance operational efficiency and environmental protection. The Bank's industrial sector operations will promote the development of PRC's non-State sector. The results of policy-oriented TAs will provide direction for further Bank support to deepen enterprise reforms. The role of TVEs in promoting the growth of rural areas and in absorbing the surplus rural labor will also be supported in Bank operations.

12. Most of Bank lending to the industrial sector will be to support the implementation energy efficiency and environment improvement programs in energy-intensive sectors. In addition, support to urban environment improvement will emphasize industrial pollution abatement. The Bank will support to environment management efforts strengthening institutional capabilities of enterprises and the agencies responsible for environmental protection.



## **FINANCIAL SECTOR**

### **A. SECTOR BACKGROUND**

1. The PRC embarked on a gradual but sustained program of financial sector reform in the early 1980s aimed at transforming its previous monobank system that allocated resources according to fiscal directives into a competitive, diversified and decentralized financial system to serve the needs of a more market-oriented economy. The pace of reforms accelerated after March 1994, following the National People's Congress' (NPC) endorsement of a financial sector reform program announced in November 1993. Recent major landmarks in the financial reform process have included: (i) creating of three "policy banks", an important step in separating policy lending from the commercial banks; (ii) ending the practice of financing budget deficits through base money creation; (iii) passage of the Central Bank Law (March 1995), the Commercial Bank Law (May 1995), and the Insurance Law (June 1995); (iv) reducing the scope of the credit plan to cover only the four large State commercial and the three policy banks; (v) adjusting interest rates closer to the rate of inflation and eliminating preferential sectoral lending rates; (vi) unifying the exchange rate; and (vii) opening up the financial sector to foreign and joint venture banks.<sup>1</sup>

2. Developing a sound and efficient financial system is a prerequisite for sustaining rapid economic growth with macroeconomic stability. The PRC's high growth, in the absence of well developed instruments for monetary/credit control, has put strong pressures on macroeconomic balances and resulted in three major cycles of excessive expansion and austerity over the last 15 years. The strong inflationary pressures in 1994, which persisted in the first half of 1995, highlight the need for stable macroeconomic management and sound monetary policy. Further financial reforms are essential for addressing this issue and are linked closely with enterprise restructuring and fiscal reforms.

### **B. GOVERNMENT'S OBJECTIVES AND STRATEGIC THRUSTS**

3. Notwithstanding the substantial progress made in reforming the financial sector, far-reaching changes are required to achieve the objective of developing a financial sector that is appropriate to serve the needs of a market economy. Key challenges to be addressed during the Ninth FYP include:

- (i) Developing indirect monetary policy instruments (e.g., reserve ratios and ultimately, open market operations) which could help dampen the recurrent pattern of inflationary cycles.
- (ii) Liberalizing and rationalizing interest rates to achieve a better balance between interest rates on deposits, loans and bonds, and to reflect terms and risks.
- (iii) Transforming the People's Bank of China (PBC) into a full-fledged independent central bank with powers to control monetary policy more effectively through the use of indirect monetary policy instruments while at the same time eliminating PBC's direct financing of the Government's budget deficit and curtailing its role in the indirect financing of the deficit. This will be achieved by limiting PBC's role in subsidized lending and in directing and allocating credit through policy lending, downsizing PBC's non-central banking

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<sup>1</sup> Many of the financial reforms are first tested in Shanghai which the Government intends to develop into an international financial sector to compete with New York, London, Tokyo, Hong Kong and Singapore. The number of cities eligible for hosting foreign/JV banks was increased from 13 to 23; in August 1995, the Government allowed foreign/joint venture banks in the Pudong area of Shanghai to conduct business in Renminbi on a trial basis .

- functions (e.g., ownership of securities companies and mutual funds), prohibiting it from commercial lending and centralizing PBC's provincial branches.
- (iv) Expediting the commercialization of the four large State commercial banks (specialized banks)<sup>1</sup> to transform them into competitive, autonomous, commercial entities. The balance sheets of these four banks remain weak since a large proportion of their loan portfolios (between 30 to 40 percent) are tied up in non-performing loans to lossmaking SOEs. The SOEs in turn have often incurred debts with each other, resulting in a "triangular debt" problem. The problems of the specialized banks are exacerbated by inadequate margins on lending rates and inadequate provisions for non-performing loans. The 1994 reforms have attempted to address this problem by separating the commercial lending operations of the specialized banks from policy lending and transferring the latter to the three newly established policy banks. However, specialized banks continue to lend to strategic industries. In addition, all working capital loans, including those to loss-making SOEs, continue to be a part of the portfolios of the specialized banks.
  - (v) Developing and further deepening capital markets to mobilize resources and link reward with risk. The development of PRC's capital markets involves continuing support to the development of the stock, bond, interbank and money markets, as well as new financial instruments. A strong capital market is necessary for enterprises to mobilize equity and debt financing for longer-term investment, especially infrastructure development. Attractive term instruments are also needed to mobilize long-term savings. The participation of foreign investment in PRC's securities markets should be encouraged. Capital markets can play a significant role of primary resource mobilization and channeling large volumes of savings between alternative users. To achieve these conditions in the PRC, reforms affecting all segments of the financial system are necessary (e.g., interest rate deregulation, phasing-out the credit plan, commercializing banks, and reform of SOEs).
  - (vi) Improving the regulation and supervision of banks, nonbank financial institutions (NBFIs) and capital markets. While the Commercial Bank Law establishes a basis for the prudential regulation of commercial banks, the regulations accompanying the Law are yet to be finalized and a number of banks remain undercapitalized. Because NBFIs are not covered by the Commercial Bank Law, there is a pressing need to develop a proper legal framework governing the operations of NBFIs. The legal framework for the regulation and supervision of capital markets also remains weak. Passage of the Securities Law is critical to strengthen the oversight of securities markets, both functionally and institutionally
  - (vii) Improving the conditions under which foreign financial institutions operate. Foreign and joint venture banks have been an important channel for bringing in foreign capital into the PRC in the past decade. The scope of their operations has, however, been limited. While the Government has recently decided to allow a few foreign banks in Pudong to conduct business in Renminbi, most foreign and joint venture banks are not permitted to do so. While foreign banks are permitted to conduct foreign currency transactions with PRC enterprises, they cannot conduct such transactions with PRC citizens. The scope of operations of foreign and joint venture banks should be expanded so that they can contribute more significantly to economic growth, domestic resource mobilization/allocation and improved banking sector practices. The

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<sup>1</sup> The People's Construction Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of the China and Bank of China.

regulation/supervision of these banks also needs to be strengthened and regulations made more clear and transparent.

- (viii) Promoting competition in the financial sector requires developing a transparent and equitable policy framework and incentive structure for the entry and operation of domestic and foreign financial institutions.

### **C. BANK'S OPERATIONAL STRATEGY**

4. The broad thrust of the Bank's financial sector strategy in PRC is to: (i) improve the policy, regulatory and supervisory framework for the operation of banks, nonbank financial institutions and capital markets; (ii) create the necessary financial sector infrastructure (e.g. payment systems; financial instruments to mobilize long term saving; (iii) encourage the commercialization of banks; and (iv) promote competition among banks and between banks and nonbank financial institutions.

5. Through extending lines of credit to selected development finance institutions - particularly to smaller banks and nonbank financial institutions - the Bank will continue with its efforts to promote a diversified and competitive financial sector. These loans will be designed to channel credit to the non-State sector including TVEs and to those SOEs which are in the process of being restructured/reformed. The Bank's financial sector projects will encourage the growth of the non-State sector and enterprise reform by specifying eligibility criteria with respect to the ownership/management structure of sub-borrower enterprises. In addition, these loans will help address cross-cutting concerns such as environmental improvement, balanced regional development and poverty reduction. The efforts will be made to develop suitable financial conduits for energy conservation, environment and agriculture sector projects.

6. Through the use of technical assistance the strategy will further support the development, regulation and supervision of capital markets, particularly securities markets, and the development of new types of financial instruments/institutions for long-term Renminbi financing for infrastructure. Both loans and technical assistance will be used to promote the development of nonbank financial institutions and to assist the development of mutual funds and insurance industry with a view to developing new channels for mobilizing long-term savings. Opportunities will also be sought for equity and debt capital market operations which are consistent with the Bank's strategic objectives.

## ENVIRONMENTAL PROTECTION

### A Sector Background

1. Prior to the 1980s, the strategy of industrial growth and agricultural intensification in the PRC relied on mandatory central economic planning without paying attention to the efficiency of resource utilization or the effects on the environment. This resulted in a serious legacy of environmental problems nationwide. Some of the major environmental concerns in the PRC include: (i) urban air pollution caused by heavy dependence on coal-use; (ii) water pollution caused by organic pollutants; (iii) air and land pollution caused by industrial toxic and hazardous wastes and urban refuse; (iv) comparative shortage of surface water resources in the northern part of the PRC and serious lack of water in many cities; (v) soil erosion and desertification; (vi) low forest coverage rate, depletion of natural forests and degeneration of grassland; (vii) reduction of wildlife habitats and biodiversity; and (viii) interprovincial pollution issues such as the fragmented management of the large river basin systems. In general, the high population density imposes a heavy burden on the environment, especially in a country heavily dependent on agriculture and natural resources. The long-standing problems of population pressure, rapid economic growth and a limited resource base have exacerbated the environmental problems.

2. The loss of farmland and grassland is a pressing problem in the PRC. Deserts occupy 15.9 percent of the country and are expanding at an annual rate of 1,500 to 2,000 square kilometers. Soil erosion washes away 5 billion tons of fertile soil every year. Urbanization reduces farmland by an average of 0.53 million hectares (ha) a year (700,000 ha in 1994). Because of overgrazing and poor management, 39 percent of grassland are declining and the quality of grass and land productivity. About 26 million hectares of grassland have been turned into farmland and one third of this area has become desert.

3. The water resources in the PRC are under pressure. The available per capita fresh water resource is 2,400 cubic meter/year, which is only one fourth of the world average. Because of deforestation and climate change, the already dry northern part of the PRC is becoming drier. Yields of farmland are adversely affected by persistent drought. There are 300 cities that have a shortage of fresh water, and about 80 million people do not have adequate drinking water. Rapid population growth and the increase in agricultural and urban demands have exacerbated the water shortages in the PRC.

4. Water pollution is widespread as a result of the unplanned disposal of waste, untreated industrial and municipal effluents and the use of inappropriate levels of agricultural inputs such as fertilizer and pesticide. The annual wastewater disposal in the PRC is 35.6 billion metric tons (t). Of this total, 21.9 billion t are industrial waste, of which about 72 percent is being treated. All the rivers in the large cities are heavily polluted by industrial wastes. The quality of water is declining and the annual occurrence of red tide has increased from once or twice a year in the 1980s to thirty to fifty times a year in the 1990s, inflicting considerable damage to ocean fisheries and the aquaculture industry. Fish resources have declined rapidly both because of pollution and overexploitation with some important commercial species on the verge of extinction. The discharge of industrial solid waste slowly increased from 0.57 billion in 1988 to 0.6 billion t in 1993; household waste has increased rapidly.

5. Air pollution problem that is a major concern in the largest cities in the PRC is the poor quality of urban air as a consequence of the widespread and inefficient combustion of low-quality coal and use of inappropriate technology. Airborne concentrations of particulate matter and dust in urban and industrial areas often surpass the environmental standards. Chronic pulmonary diseases, which are linked to exposure to fine suspended particulate matter and dust, are a leading cause of death in the country, especially during winter. Respiratory diseases accounted for about 17 percent of all deaths in urban areas in 1993. A survey of 56 cities throughout the world, conducted as part of the Global Environment Monitoring System found that 9 cities in Asia were among the 20 most polluted cities in terms of suspended particles, and 12 in terms of sulfur dioxide. Five cities in the PRC - Beijing, Guangzhou, Shanghai, Shenyang and Xian - were among the 20 most polluted cities in the world based on both of these measures of air pollution.

6. The PRC government has for a long time made unremitting efforts for biodiversity conservation, formulating the PRC Program for Nature Conservation and PRC's Action Plan for the Conservation of Biodiversity, containing the policy, strategy and key fields and priority projects for biodiversity conservation. PRC has adopted the on-site conservation and off-site preservation methods to protect biodiversity. Currently, there are 612 national-level rare and endangered species of flora and fauna listed as key protection species, including 258 species of wild animals and 354 species of plants. Artificial reproduction has been successfully implemented for more than 60 species of rare and endangered wild animals, and through propagation, such species as David's deer, wild horse and *saiga tatarica* have been re-introduced. Establishing nature reserves is the most effective method for the *in situ* conservation of wild plants and animals. By the end of 1995 799 nature reserves of rather diversified types, covering a total area of 71.9 million hectares (or 7.2 percent of PRC's territory) had been established in PRC. There are 99 national-level reserves, of which ten -- Jilin's Changbai Mountains, Sichuan's Wolong, Guizhou's Fanjing Mountains, Hubei's Shennongjia, Fujian's Wuyi Mountains, Xinjiang's Mt. Bogda, Guangdong's Dinghu Mountains, Inner Mongolia's Xilingol, Jiangsu's Yancheng and Yunnan's Xishuangbanna -- have been listed in the International Network of Man and Biosphere Reserves. Another six nature reserves -- Zhalong in Heilongjiang, Xianghai in Jilin, Boyang Lake in Jiangxi, East Dongting Lake in Hunan, Bird Island in Qinghai and Dongzhai Harbor in Hainan -- have been included in the list of the world's important wetlands. At present, a total of 512 historic and scenic sites has been designated, of which 119 are at the national level, 256 at the provincial level and 137 at the city or county level, covering a total area of 9.6 million hectares. Forest parks total 710, of which 248 are at the national level. Scenic spots at Huangshan Mountain, Wulingyuan, Jiuzhaigou and Huanglong are listed as parts of the world natural and cultural heritage by the United Nations Educational, Scientific and Cultural Organization. The establishment of nature reserves has put a number of representative and typical natural eco-systems with scientific research value as well as rare and endangered species under effective protection.

7. Establishing zoological gardens, botanical gardens and various artificial breeding centers is an effective method for off-site preservation of various species of wild animals and plants. By the end of 1995 PRC had set up 175 zoological gardens and zoological exhibition sites in public parks, 227 artificial breeding centers for wild animals, more than 60 large botanical gardens and 255 wild plant gene and cell banks to ensure the continuation of rare and endangered species of plants and animals, including the giant panda, Chinese alligator, Chinese sturgeon, white-flag dolphin, Manchurian tiger, crested ibis, Cathay silver fir, dovetree, *Cycas revoluta* and *camellia chrysantha tuyama*. In addition, PRC has established some dozen specimen centers, one gene bank and two cell banks for wild animals, which have helped genetic polymorphism research and preservation work. The medicinal use of and trade in

rhinoceros horn and tigerbone are strictly prohibited by the government, and the illegal hunting of rare wild animals is severely punished by law.

8. The government has placed much stress on the preservation of the genetic materials from domestic animals and fowls, as well as germ plasma resources from crops. There are 596 species of livestock and poultry in PRC, of which over 70 percent are native species. The government has appropriated special funds for preservation of some endangered or sharply diminishing species of livestock and poultry and established a germ plasma gene bank for livestock forage grass. PRC had initially formed a preservation system for germ plasma resources from crops, including one national germ plasma bank for long-term preservation and a duplicate one, 23 local germ plasma banks for mid-term preservation, and 25 national germ plasma nurseries, of which two are for test-tube culture. The germ plasma resources of most agricultural plants in PRC are preserved, including 330,000 specimens of germ plasma for various species of crops, of which 300,000 have duplicates.

9. Although these urgent environmental concerns have been recognized and implementation of environmental action plans have begun, the increasing population density and rapid economic growth may deplete further the already scarce natural resource base and intensify environmental degradation.

10. The Government has made significant efforts to clean up the urban environment and to control industrial pollution. On the supply side, considerable attention is being given to improvements in efficiency such as rehabilitation, retrofitting, and reducing conversion loss and adopting environmentally sound technology. Demand-side management is also being actively promoted. Pricing that reflects the cost of supply and environmental externalities is a necessary precondition for efficient energy use and the containment of environmental pollution. Although the price reforms have almost been completed, energy and water prices are still subject to price controls that create distortions and inefficiencies in the demand for energy and water in the economy. The Government intends to liberalize fully the prices of coal and other energy products over the next three to five years and to develop alternative sources of energy that are more environmentally friendly. Water prices will gradually be increased. Also in the rural areas in the PRC, the Government interventions, both policy-based interventions and physical investments, cover the soil, water, forestry, and the expansion of protected areas.

## **B. Government's Objectives And Strategic Thrusts**

11. The main objectives of the Government under the Ninth Five Year Plan (NFYP) are: (i) to bring environmental pollution under control; (ii) to improve the quality of the environment in major cities; (iii) to reduce the degradation of natural ecological systems; and (iv) to integrate environmental planning with economic and social development efforts.

12. An Environmental Protection Law was implemented in 1979 and enacted in 1989. The National Environmental Action Plan and Agenda 21 programs have provided directions for environmental improvement efforts and have been integrated into the NFYP. To meet the national objectives for environmental improvement, the Government plans to allocate about \$34 billion up to the year 2000 to improve the environments in urban areas. The Government recognizes that it will take another 30-40 years beyond the year 2000 to reverse the trend of environmental degradation and for the country's overall environmental conditions to meet internationally accepted standards.

13. The Government has adopted three general principles in protecting the environment: (i) to give priority to prevention; (ii) to hold those who cause pollution responsible for cleaning it up; and (iii) to strengthen environmental control and management. The three main strategic thrusts of the Government under the NFYP are to:

- (i) strengthen the legal, regulatory, and institutional framework for effective environmental management;
- (ii) control environmental pollution, improve the environment, and protect the resource base for sustainable development; and
- (iii) promote the role of science and technology in environmental protection and resource conservation.

### **C. Bank's Operational Strategy**

14. Addressing the Bank's crosscutting environmental and natural resource management concerns will continue to be an important element of the Bank's Operational Strategy in the PRC. The Government's three main strategic thrusts under the NFYP merit continued Bank support both through the technical assistance program and through investments in selected financially viable and environmentally-oriented projects. Environment protection and natural resource conservation will continue to be a major theme in the policy discussions in the PRC.

15. The Bank's strategy is premised on the fact that environmental protection can be realized through concerted actions to strengthen institutional capacities and to integrate environmental considerations in development planning and project designs. The Bank will assist the NEPA in developing and implementing national environmental policy, and will continue the policy dialogue on industrial pollution control and energy and water resource pricing. The Bank's strategic thrusts in the environment sector include:

- (i) strengthening the institutional capacities of the Government agencies responsible for environment impact assessment and monitoring and for formulating legislative reforms for environmental protection;<sup>1</sup>
- (ii) supporting the improvement of legal and management systems so that there is a legal and administrative framework for encouraging sustainable development;
- (iii) promoting cleaner technology and cleaner production methods for industries and clean coal technologies;
- (iv) supporting the utilization of economic measures (taxes, credit and prices), supply-side measures (integrated resource planning and fuel switching) and other measures (waste minimization and recycling) to protect and to ensure the sustainable utilization of natural resources; and
- (v) monitoring and implementing industrial pollution control mechanisms, including improving land use, protecting farmlands and grasslands, and preserving forest reserves and other areas of biodiversity through promotion of sustainable agricultural practices.

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<sup>1</sup> TA 987-PRC: *Institutional Strengthening of the National Environmental Protection Agency*, for \$340,000, approved on 10 June 1988; TA 1436-PRC: *Environmental Impact Assessment (EIA) and Training*, for \$600,000, approved on 10 December 1990; TA 1988-PRC: *EIA Training Phase II*, for \$900,000, approved on 18 November 1993; and TA 2090-PRC: *Legislative Reform for Protecting the Environment and Natural Resources*, for \$500,000, approved in 18 May 1994.

## D. Focus Of Bank Operations

16. Direct Bank lending for environmental projects has so far been limited because of the Government's concerns about the ability of projects to generate the cash flow necessary to service the loans. Similar to agricultural projects, a major challenge for operationalizing the strategy in the environmental sector would be to identify projects that are financially and economically viable. Several Bank-assisted projects have shown that careful selection and design can help achieve the financial and economic viability of environment-oriented projects. Past experience also has indicated that including environmental components in growth projects would not undermine the financial and economic viability of these projects. The lending program will focus on the following areas:

- (i) addressing the high energy intensity in the industrial sector through appropriate energy pricing reforms and technical renovation of outdated plant and machinery;
- (ii) adopting more advanced technology and high-efficiency equipment and cogeneration in the power sector as part of the Bank overall policy initiatives for the energy sector; Increasing the use of hydropower, natural gas, and other alternative environmentally friendly energy sources will be actively explored;
- (iii) reducing waste output (particularly hazardous and toxic wastes) by increasing industrial efficiency in energy and other input use and supporting industrial pollution abatement; also because PRC relies heavily on coal, special attention will be accorded to the use of clean coal technologies to mitigate transborder concerns about climate change and acid rain. Addressing environmental issues related to coal combustion will be an important element of the Bank's environmental policy dialogue;
- (iv) ameliorating pollution in major urban and industrial centers, including improving sanitation and water quality, increasing waste water treatment, providing safe drinking water, and improving air quality through supplying alternative fuel sources; in addition, the Bank will continue to promote industrial pollution prevention and control by supporting the relocation of severely polluting industries, improvements in water and air quality management, and the adoption of environmentally sound technology;
- (v) institutional strengthening of the agencies involved in environment policy planning, management, and enforcement; considering the weak capacities in enforcing environment regulations, the Bank will assist the Government agencies, particularly at local government levels, in developing more effective enforcement of environmental regulations and management of water and other resources;
- (vi) promoting the sustainable development and management of natural resources, improving land use on degraded and marginal soils, protecting farmlands and grasslands, and preserving forest reserves and other sources of biodiversity through the promotion of sustainable agricultural and forestry practices, and the management of coastal and marine resources; and
- (vii) promoting integrated economic, social, and environmental planning as the best means to identify environmentally sound projects for inclusion in the Bank's lending program.

## AGRICULTURE AND RURAL DEVELOPMENT

### A SECTOR BACKGROUND

1. The size of the agricultural sector and its importance as a direct and indirect source of income (21 percent of total income) and employment opportunities (58 percent of total employment) for the majority of the population, underscores its significance in the development of the PRC.<sup>1</sup> Sustainable development in the PRC requires continuing support for agriculture and rural development. The Government accords high priority to agriculture and rural development under the Ninth Five Year Plan (NFYP). The main constraints to rural and agricultural development in the PRC include the following:

#### (i) Poor Rural Infrastructure

2. Rural infrastructure remains relatively underdeveloped. About 79 percent of the cultivated land fall into the medium or low production categories. Irrigated fields constitute only about half of total cultivated land. Most of the farmlands are tilled using draft animals and manual methods. Rural infrastructure, like transportation, energy and telecommunications, which are required for the development of rural secondary and tertiary industries are poorly developed in many rural areas.

#### (ii) Uncoordinated Township and Village Enterprises (TVEs) Development

3. TVEs face a variety of problems such as poor facilities and equipment, obsolete production technologies, weak management and low levels of technical skills. The consequences of these problems include an inefficient use of resources and damage to the environment. Although TVEs have absorbed more than 100 million rural workers since the reform process began, the surplus rural labor force is still estimated at 130 million, and the figure will most likely rise to 200 million by the turn of the century.<sup>2</sup> Promotion of TVEs represents the best potential to absorb these workers.

#### (iii) Poor Access to Credit

4. Though rural credit is dominated by the Agricultural Bank of China (ABC) and the Rural Credit Cooperatives (RCCs), other financial institutions have emerged to serve the growing needs of the rural economy. However, the current system of locally-based financial intermediaries in rural areas has led to segmentation of financial markets and has constrained the efficiency of resource allocation. The flow of capital between localities in the PRC is limited. Investment resources come mainly from the local community. Available rural credit is mostly for short-term while medium and long-term credit is scarce. The formal credit system has limited capacity to lend for projects aimed at stimulating agricultural growth and diversification. The ability of TVEs to grow and absorb a greater number of surplus rural labor has been constrained by limited access to credit and institutional staffing and management weaknesses.

#### (iv) Focus on Grain Production

<sup>1</sup> This sector includes farming, forestry, livestock, fisheries and sideline production, which refers to the relatively minor rural activities such as gathering of wild plants and medicinal herbs, and hunting of wild animals.

<sup>2</sup> There are different estimates of the labor surplus in rural PRC. The figure used here is taken from PRC's Agenda 21.

5. Because of the past agricultural policy, the PRC's agricultural structure is concentrated on grain production. Agricultural restructuring has achieved some success in diversifying the agricultural base. The production of fruits, vegetables and meat and agro-industrial production has increased in response to market forces. Further efforts need to be made to diversify the agriculture sector.

**(v) Low Productivity**

6. The efficiency of fertilizer and water utilization is below optimal levels and compounded by the increasing input costs and inadequate extension services, the aggregate agricultural productivity is low. The ability to mitigate against natural disasters is low which in turn leads to large fluctuations in agricultural productivity.

**(vi) Environmental Degradation**

7. The per capita acreage of farmland is low because of the limited amount of arable land, and the annual trend of per capita availability of natural resources is decreasing. Pollution of the environment in predominantly agricultural areas is becoming increasingly serious leading to severe land degradation and vulnerability to natural disasters.

**(vii) Regional Disparities**

8. Rural income levels decrease progressively from the Eastern to the Central and to the Western regions of the country. Though the main source of rural household income in the PRC is from farming operations, a major explanatory variable for differences in rural income levels in the Eastern, Central, and West regions is the level of off-farm employment opportunities. Income from farming accounts for a lower percentage of the total income in the Eastern provinces than in the Central and the Western provinces. Currently, 65 million absolute poor live in rural areas, underscoring the importance of agricultural and rural development as a strategic thrust of the Bank's medium-term strategy for eradicating poverty.

**B. GOVERNMENT'S DEVELOPMENT STRATEGY**

9. The Government's main objectives for agriculture and rural development under the Ninth Five Year Plan (NFYP) include: (i) enhancing agricultural productivity; (ii) increasing grain production and security of food supply (grain output by an additional 50 million tons, cotton output by 500 million kilograms, meat output by 10 million tons and seafood by 10 million tons); (iii) promoting balanced development of the rural economy across regions; and (iv) increasing rural incomes by generating off-farm earning opportunities.

10. To achieve these objectives, the Government will adopt measures to ensure adequate acreage under cultivation, increase per-unit-area yields, improve low-yielding land and allow the market to provide incentives for farmers to increase grain production. A comprehensive program will be implemented under the NFYP to expedite the development of the rural economy through restructuring agricultural production, enhancing farmland infrastructure facilities including water conservation, developing rural enterprises, restructuring agricultural enterprises as part of the nationwide program to create a "modern" enterprise system and allocating more budgetary resources for agriculture investment. Efforts will also be made to protect and improve the environment for agriculture, and to improve natural resource management, especially with respect to biological resources and renewable energy.

11. The targeted level of grain production by the turn of the century will be achieved by providing incentives for grain production including the complete liberalization of grain prices, upgrading farm inputs (e.g. seed, fertilizer and pesticides), expanding farm sizes, improving production conditions (especially rural infrastructure), and rationalizing the production and management structures. The objective of increasing farmer incomes will be attained through the creation of off-farm employment opportunities in TVEs, rural secondary and tertiary industries; and promoting integrated farming which includes activities in fisheries, forestry, and livestock management.

12. The Government plans to adopt the following measures to achieve its agriculture and rural development objectives under the NFYP:

- (i) Gradually modify existing laws, regulations and policies to bring about balanced rural development, and better natural resource management for sustainable agricultural development;
- (ii) Rely on both market mechanisms and administrative measures as an interim solution to increase grain production and ensure stable food supplies; but eventually relying only on market mechanisms to elicit grain supply response;
- (iii) Modernize and regulate rural industries and promote the development of TVEs and rural growth centers;
- (iv) Restructure agricultural production by optimizing the use of resources and factors of production to increase productivity and minimize environmental degradation; and
- (v) Promote the use of scientific and technological know-how in agricultural production and processing.

### **C. BANK'S OPERATIONAL STRATEGY**

13. In support of the Government's strategic thrusts and priorities in agriculture and rural development, the Bank's sector strategy will adopt a thematic approach focusing on three key areas: (i) rural development; (ii) sustainable use of natural resources; and (iii) balanced regional development.

#### **1. Rural Development**

14. The strategic theme of rural development will be achieved by: (i) improving agricultural production and productivity; (ii) promoting agricultural diversification; (iii) developing rural enterprises; and (iv) improving the availability and delivery of rural credit.

##### **a. Improving Agricultural Production and Productivity**

15. Improving agricultural production and productivity will require additional inputs, new technology, supporting rural infrastructure and improved agro-ecological management. The availability of supporting rural infrastructure will facilitate the timely delivery of farm inputs (fertilizer, pesticides, irrigation, farm machinery, energy), products, and services (storage, processing, marketing, transportation, information, research, financing). Efforts to increase agricultural production and productivity will focus on eradicating shortfalls in farm inputs, improving rural infrastructure and promoting agricultural research and development. The strategy will support the use of agricultural inputs such as fertilizers and pesticides only in an

environmentally sustainable manner. Increasing agricultural production and productivity also requires better credit access for farmers, the introduction of new technologies, and improved agricultural extension services.

#### **b. Promoting Agricultural Diversification**

16. Diversification through the structural adjustment in agriculture should be consistent with the comparative advantage of the different regions for different agricultural activities. Market reforms and the consequent improvements in living standards are resulting in increasing demand for fruits, vegetables, meat and the products of rural industries. Policies for the sustainable use and management of forest, livestock, and aquatic resources must therefore be developed simultaneously with efforts to diversify agricultural production. The development of downstream processing industries, which combines agricultural activities (like cultivation, breeding and processing) with industrial/commercial operations, will be encouraged to increase rural incomes. A rational production structure will be created by deepening the reforms in the management, pricing, and investment policies in rural areas. The Bank's support to agriculture-related SOEs such as fertilizer manufacturing and sugar refining will be in line with the overall support given to the enterprise reform program. The establishment of databases and technical demonstration sites for different subsectors and the dissemination of successful experiences through training programs and practical demonstrations will be incorporated in project design to help strengthen the institutional capacities at the local level.

#### **c. Developing Rural Enterprises**

17. Developing rural enterprises (mainly TVEs) and reforming SOEs in the agriculture sector are critical for agricultural modernization, rural development, rural income improvement, and balanced regional development. TVEs have given impetus to rural development, especially with respect to the formation and development of village and township centers. To sustain their rapid growth, TVEs need to improve their planning and management capabilities, industrial structures, and efficiency by using energy-saving and environmentally-sound technology. The Bank's strategy will give priority to labor-intensive rural enterprises processing agricultural products. Bank operations will ensure that the necessary environmental mitigation measures are adopted during the development of rural enterprises.

#### **d. Improving the Availability and Delivery of Rural Credit**

18. With the adoption of market-related reform and the wider utilization of agricultural inputs (equipment, fertilizer, seeds and pesticides), agricultural diversification and rapid growth of agro-industries, the demand for credit is increasing. The Bank has previously supported some key policy reforms to expand and improve rural credit availability.<sup>1</sup> The continued restructuring and diversification of the rural financial system is needed to allocate the PRC's high level of savings to efficient investments and to impose financial discipline on rural credit markets. Of particular importance is the need to upgrade the financial management of rural lending institutions, and the adoption of appropriate policies for greater market orientation. Further efforts should also be made to improve debt recovery, establish bank autonomy, and strengthen administration and staffing of agricultural and rural credit institutions.

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<sup>1</sup> The Bank has approved six credit lines totaling \$520 million in supporting, directly or indirectly, the expansion and improvement of agriculture and rural credit availability through banks and non-bank financial institutions (NBFIs). All six credit lines were complemented with advisory technical assistance for strengthening institutional capabilities of the recipient institutions.

## 2. Sustainable Use of Natural Resources and Environmental Protection

19. The destruction and overutilization of natural resources have become a major problem in the PRC. Rapid economic growth has led to the limited agricultural resources being increasingly exploited, such as the non-agricultural use of farmland, over-grazing, deforestation and over-fishing. The lack of adequate measures to protect against these exploitative practices has led to the continuing depletion of agricultural resources and soil degradation. Pollution and environmental degradation in turn accelerates the destruction of agricultural resources. For example, fuel scarcity combines with damage to vegetation and soil erosion to form a vicious cycle in some poorer areas. Due to land constraints, new technologies need to be adopted to improve the efficiency of agricultural production.

20. Factors that promote the sustainable use of agricultural resources include: (i) modifying laws, regulations and standards relating to agro-resources and the environment; (ii) improving agro-environmental assessment and monitoring system to ensure rational use and effective management of natural resources; (iii) pricing agricultural resources correctly; and (iv) developing and utilizing agricultural technologies that promote resource conservation and environmental protection.

### D. FOCUS OF BANK OPERATIONS

21. Direct Bank lending for agriculture and rural development has been limited because of concerns about the sector's ability to generate the cash flow necessary to service OCR loans and the complexity in project management and implementation. Thus a major challenge for operationalizing the strategy in the agriculture sector would be to identify projects that are financially and economically viable, and relatively uncomplicated in terms of implementation arrangements. The four principles adopted by the Government for OCR-based loans for agriculture and rural development during the Ninth Plan period are:

- (i) the executing agencies of such projects will be independent entities with minimum Government control, and with adequate management experience and capability to ensure project success;
- (ii) adequate counterpart funds will be available at the start of project implementation;
- (iii) sufficient financial returns to service OCR loans; and
- (iv) institutional arrangements that are not overly complex, and assignment of responsibility for overall coordination to the Ministry of Agriculture, if more than one province is involved.

22. Translating the Bank's strategic priorities into a consistent framework for agriculture and rural development will require that the Bank and the Government work together to devise means of identifying viable agriculture and rural development projects to increase Bank lending to the sector. Several Bank-assisted agricultural projects in the past have demonstrated that careful selection and design can minimize management and implementation complexity, help achieve the financial and economic viability, and help to simultaneously address the Bank's cross cutting concerns, particularly natural resources management and poverty reduction. The challenge for the medium-term is to identify similar projects and to increase the pipeline of projects in the sector.



## GOVERNANCE: SOUND DEVELOPMENT MANAGEMENT

### ***I. Accountability (Building Government Capacity)***

#### **A. *Public Sector Management and Civil Service Reform***

1. Civil service reform is an integral part of the transition to a market economy. The Government is progressively withdrawing from directing and allocating factors of production and involvement in production. The Government's new role focuses on developing the appropriate policy, legal and regulatory framework for a market economy, and providing the necessary physical and social infrastructure. Within this context the role of the civil service is being radically changed. In line with the market-oriented economic reforms, the PRC Government has introduced many reform measures to improve the functioning of Government agencies. The line ministries and committees under the State Council, have been reformed and reorganized to support market-oriented reforms. These reforms have been designed to separate Government departments from micro economic management and redefine the role of Government departments to concentrate on policy and regulatory matters. Large numbers of productive enterprises have been separated from Government departments, corporatized and made subject to market forces. Significant progress has been made in this area during the past decade. PRC is expected to make continuing progress during the next decade in perfecting the role of Government by strengthening the policy, legal and regulatory functions, eliminating the role of Government departments in micro economic management and increasing the impact of market forces on enterprises engaged in commercial activities.

2. The number of State Council institutions and commissions was reduced from 86 in 1993 to about 60 in 1995. A formal civil service recruitment system was adopted in 1995, replacing the "cadre" system. National civil servants now have to pass an entrance examination set by the Department of Personal Management which should increase the caliber of new entrants. The civil service salary system has been more clearly defined and performance-based promotion and merit pay increases have been introduced. Performance evaluation will become part of the new system based on three categories: (i) outstanding (10 to 15 percent); (ii) qualified (no fixed percentage); and (iii) unqualified (no fixed percent). The reform in government administration and personnel management is expected to affect some 30 million workers at all the levels of government, including managers of SOEs. The Government launched a program in 1993 to reduce staffing at the central government level by 20 per cent and at the provincial government level by 25 per cent. This retrenchment program will be completed by 1996. These measures are important steps in professionalizing the civil service and reducing its size. The Bank has not been involved in helping the Department of Personnel Management in reforming the civil service. The Bank has, however, been involved in helping to build capacity for development management at the macro and micro levels in areas that are related to Bank operations in PRC.

3. For better macroeconomic management, the Central Government's control over fiscal and monetary policy is being strengthened. The Government has introduced several fiscal reform measures since 1994 on both the revenue and expenditure sides. In 1994 a new Budget Law defining the principles of budgetary management was approved and a new tax system was introduced. To strengthen monetary control, the People's Bank of China (PBC) Law was enacted in March 1995. While significant progress has been made in improving the framework for fiscal and monetary management, more progress is required. Short term priorities would include: (i) increasing the buoyancy of fiscal revenues; (ii) addressing the issue of off budget revenues and expenditures; (iii) developing mechanisms to ensure local governments develop mechanisms to ensure sufficient expenditures in the social sectors; and (iv) developing the instruments necessary to exercise effective monetary management in a market economy.

4. The Bank's operational experience indicates that the implementation capacity of PRC institutions is strong. This reflects, however, the rigorous internal screening procedures that are in place in PRC. Only projects that are proposed by strong executing agencies are selected as candidates for Bank assistance. There is a wide variation in institutional strength in PRC. While some institutions are strong, others are relatively weak. In general, institutions in the poorer interior provinces are weaker and are less experienced with the new role of government in a market economy and in dealing with multilateral financing institutions than are institutions in the coastal provinces.

5. Strengthening the institutional capabilities in policy formulation and implementation of executing agencies of Bank-assisted projects to deal with the demands of a market economy has been a cross-cutting theme of the Bank's operations. At the national level, TAs have been provided to strengthen PBC in its role as a central bank (e.g., developing the regulatory framework for nonbank financial institutions, cooperative banks, foreign financial institutions and trust and investment companies; strengthening monetary statistics and the payments system), the Ministry of Finance (a series of TA for fiscal reform and management), the Development Research Center of the State Council (regional development policy support), the State Statistical Bureau (improving national accounts to be suitable for a market economy) and the National Environment Protection Agency (preparing environmental legislation and developing and implementing policies and procedures for environment management and impact assessment). Support to help improve the delivery of public services has been extended to the Ministry of Communications, the Ministry of Post and Telecommunications, the Ministry of Electric Power and numerous executing agencies at the provincial/local level for Bank-financed projects.

## ***B. Public Enterprise Reform***

6. Under the centrally planned system, the Government was responsible for determining prices, planning inputs and outputs, providing employment and planning and financing investments. This system did not provide market based signals to ensure that the goods produced met market demand nor did it provide incentives for SOEs to improve productivity and efficiency. Consequently there was a significant lack of accountability for results in the SOE sector. The Government recognizes that establishing a modern enterprise system is a prerequisite for developing a full-fledged market economy. During the past decade significant progress was made in liberalizing prices, delegating responsibility to SOEs for day to day operational management, introducing a corporate income tax regime and requiring SOEs to finance investments from retained earnings and loans. Corporatization is recognized as an effective

approach to realize the objective of a modern enterprise system for large and medium sized SOEs. The 1988 Enterprise Law legalized many of the measures which granted increased autonomy to SOEs. The 1992 Regulations on Transforming the Operating Mechanism for State Owned Enterprises provided the administrative regulations to implement the enterprise law. Significant progress was made in providing the legal framework to extend the shareholding system with the enactment of the Company Law in 1993.

7. The enterprise reforms adopted during the past decade have helped to create an environment in which SOEs can be held accountable for their results. The Government's public enterprise reforms have resulted in more commercial management in many sectors including industry, energy, transport and communications. Inefficient enterprises can be restructured or, in extreme cases, closed in accordance with bankruptcy proceedings. Despite this significant progress, there are still major problems that are associated with enterprises in PRC. The magnitude of the challenge of SOE reform is illustrated by the fact that in 1995 about one third of SOEs on some 35,000 of them operated at a loss and required financial support. In addition, the SOE sector also has a large number of redundant workers (about 27 million). Given these magnitudes the Government will proceed cautiously with SOE reform to ensure that the related social costs are kept within tolerable limits. Because of the macro economic impact of SOEs, monetary, financial and fiscal reforms cannot be completed until further progress is made in the area of SOE reform.

8. The next step in SOE reform will require addressing the rigidities in the labor market that make it difficult to redeploy redundant workers from SOEs to the jobs that are being created in a rapidly growing economy. Under the centrally planned system enterprises were required to provide social services (e.g., housing, health, education, unemployment benefits, pensions) for their employees. Holding enterprises accountable for commercial performance will require that these obligations are separated from SOEs. This is a complex task as it involves transferring substantial costs to various levels of governments. The State is planning on setting up a social security system to provide retirement benefits, health insurance and unemployment insurance to reduce these social burdens on enterprises. In 1993 and 1994 the State started several social security reforms including pooling enterprise pension funds, standardizing pension contribution rates and introducing illness insurance for retirees. As the social security reforms proceed a major financial burden will be removed from SOE and it will be possible to hold them more accountable for their financial performance. Gradually it will also be possible to make greater use of the bankruptcy law to address problems related to SOEs that have no hope of being commercially viable. However, widespread application of the bankruptcy law will likely be deferred until labor market reforms result in a system that will offset much of the social costs of dealing with redundant workers.

9. The Bank has provided a series of TAs to support the Government's enterprise reform program in the areas of enterprise governance, social security reform, insolvency and enterprise accounting. The Bank has also provided assistance to undertake studies that are designed to help bring enterprises to the market. The State Economic and Trade Commission (SETC) has been supported assistance to enhance its capability to promote enterprise reform by helping to implement reforms in some of the enterprises on SETC's experimental program to corporatize 100 large SOEs. Bank lending operations are also designed to support enterprise reform by: (i) requiring enterprises to adopt reforms as a pre-condition for gaining access to bank financial support; and (ii) supporting capital market funds that are designed to bring enterprises to the market.

### **C. Public Financial Management**

5. Improving public sector financial management is essential to build the Government's capacity to manage the economy efficiently. Under the centrally planned system, financial management, accounting and auditing practices were different from the systems used in a market economy. Developing and implementing an internationally acceptable financial management, accounting and auditing practices is a major challenge for an economy in transition. As part of the transition process the systems that are consistent with the needs of a market economy must be designed and implemented. A major step in this direction was taken in 1993 when new standards were adopted to bring general accounting and auditing principles in line with international practices. Developing the human resources necessary to implement these new standards is a major challenge. Tens of thousands of accountants and auditors must be trained in the new systems which must be implemented in thousands of SOEs, TVEs and financial institutions. Accounting and auditing procedures are being gradually brought up to international standards but it will take time to fully achieve this objective. The Bank has provided assistance to improve the financial accounting and management information systems in a number of executing agencies (e.g., railway companies, port authorities, power utilities, transport enterprises and agro-processing enterprises). The Bank has also provided broader capacity building TAs to train enterprise accountants and to strengthen financial management in power utilities.

6. Institutional reforms for the public expenditure system are focussed on improving budgetary management and expenditure control. A new Budget Law defining the principals of budget management was approved in March 1994. The law calls for the implementation of a dual budgetary system that would bring PRC closer to international practices and improve monitoring and control systems. Regulations to operationalize the Budget Law are being formulated. Particular attention is also being given to strengthening the auditing and monitoring functions of line ministries and agencies.

7. The State Audit Administration (SAA) performs independent audits of project accounts in a timely manner for internationally funded projects. Generally PRC executing agencies have not experienced difficulty in complying with the Bank's auditing requirements. The Bank provided TA for the SAA in 1991 to strengthen SAA's capabilities in carrying out audits of externally-financed projects. Audit manuals covering the industrial, financial, transport and agriculture sectors were produced and are being used by SAA.

8. PRC's fiscal policy framework has evolved with the reform process. However, there are concerns related to the structural weaknesses of fiscal policy, declining revenue buoyancy, a lack of uniformity and transparency in the tax administration system, an erosion of central government control over revenue and fiscal policy and widening regional fiscal disparities. To address these concerns a comprehensive fiscal program is being implemented. Broad reforms were introduced in 1994 to equalize the tax burden, simplify tax administration, and increase revenue buoyancy. The enterprise and personal income tax systems were standardized and simplified and indirect taxes were simplified and unified with a broad based value added tax. The complex contract based intergovernmental revenue system was replaced by a more transparent delineation of revenue sources for the central and local governments. The Government drew on the results of Bank financed studies when formulating these fiscal reforms. The Bank is continuing to provide a series of TAs to the Ministry of Finance to support fiscal reform. A recently completed highlighted the need to continue the fiscal reforms at the sub-provincial levels to ensure that there are sufficient funds available for social expenditures, particularly in the areas of health and educations. The Bank will also assist in developing the fiscal policy framework for social security reform and in identifying ways to address the issue of off budget revenues and

expenditures which are estimated to be roughly equivalent to budgeted revenues and expenditures.

## II. Participation (Participatory Development Processes)

### ***A. Participation of Beneficiaries and Affected Groups***

9. The active participation of project beneficiaries heightens effectiveness and accountability in development activities. Public participation mechanisms in the PRC are designed to reflect the views of the population in formulating government policies, programs and projects. There is a People's Congress in each municipality and province. The People's Congresses reflect the views of the population in commenting on a broad range of government policies, programs and projects. The mass media is also used to inform the public of all major projects in each province. Information describing projects are widely covered in the local media. Major development projects are announced through carefully orchestrated campaigns that work to establish the need for the change and lay out State decisions on how to implement the change. When properly run, this type of campaign provides affected people with a sense of ownership and helps gain acceptance for the project and compensation approaches used.

10. Active public involvement has been encouraged in Bank projects at the formulation and implementation stages. The executing agencies of Bank projects have regular meetings with the general public, local leaders and various levels of local governments, especially when resettlement and compensation are involved. Efforts are made to consult closely with potential beneficiaries and groups likely to be affected by projects. There is a government requirement that the views of the people to be affected by major projects must be surveyed. If the majority of local people are against a project, it is not approved by authorities. In practice, the local governments assist people in putting forth cases to be made by the executing agencies for compensation payments.

11. For Bank projects involving relocation and compensation, the executing agencies are responsible for ensuring that compensation measures provide each household with equivalent living and employment opportunities after resettlement. Recent examples of the Bank projects which include considerable public participation related to resettlement are the Fujian Mianhuatan Hydropower, Dalian Water Supply, Jing-Jiu Railway Technical Enhancement and Hunan Linjintan Hydropower projects. Large scale relocation, involving over 200,000 people in the case of the Jing-Jiu Railway, have been undertaken effectively. Generally people are provided with better housing after the relocation and their living standards improve. Based on the good experience under Bank and World Bank projects, the current resettlement system in the PRC and its performance are better than those of many other countries.

### ***B. Decentralization of Economic Functions***

12. Appropriate decentralization of economic functions can enhance economic performance in a market economy. Under the former centrally planned system, the Central Government controlled all aspects of resource allocation and local governments had little authority. There are four levels of government in the PRC: (i) central government; (ii) provincial governments; (iii) county governments; and (iv) municipal governments. The financial relations between different levels of government have been characterized by a complex arrangement of constitutional principles, laws and regulations, and ad hoc intergovernmental contracts. Since the reform program began in 1978, decentralization has significantly increased in the areas of economic decision making and public expenditures. Local governments are now less dependent on Central Government budgetary contributions and on centrally allocated raw materials and foreign exchange.

13. Although the overall trend has been toward greater decentralization, in the early 1990s it was clear that there was a need to recentralize macroeconomic management functions to improve macroeconomic management, particularly in the monetary, financial and fiscal areas. The Government took necessary steps in 1993 and 1994 that were consistent with policy advice provided by the Bank. For decentralization to be effective, there must be a reasonable balance between the revenue sources and expenditure responsibilities allocated to the various levels of government. The Bank provided a TA which helped the Government to gain a better understanding of the fiscal responsibilities and relationships at the sub-provincial level.<sup>1</sup>

More work needs to be done to promote fiscal reform at the sub-provincial level and to strengthen municipal finance.

### ***C. Cooperation with Nongovernment Organizations (NGOs)***

14. Although NGOs have the potential to represent views and wishes of project beneficiaries and to contribute to project formulation, local NGOs are not well developed in the traditional sense in the PRC. International NGOs are not active on a large scale in the PRC. However, there are many public consultative mechanisms through which the interests of special groups are represented. For instance, every woman becomes a member of the All-China Women's Federation (ACWF) at birth. The Federation is a very large organization, and every enterprise/work unit has its own branch of the ACWF. Another major NGO is the Foundation for the Underdeveloped Regions which has been mobilizing grants and donations to undertake projects in poor areas of the country. NGOs have not been actively involved in Bank projects in PRC.

### ***III. Predictability (Legal and Regulatory Frameworks)***

15. Unlike a central planning system that operates mainly on administrative decrees and directives, a market system requires an elaborate legal and regulatory framework within which market participants can operate competitively and freely. The PRC is working to establish a legal system that is responsive to the needs of a market economy by the year 2000. Significant progress has already been made. However, fully operationalizing the legal framework is a daunting human resource development task. In addition to formulating new laws and regulations, thousands of legal professionals (e.g., judges; lawyers) must be trained to implement the new laws and regulations. Of particular importance for a market economy is a predictable, transparent legal framework for domestic and foreign private investors and enforceable legal contracts. An appropriate legal framework is necessary to allow investors to judge risk and potential profit. Although PRC has made progress in this area, its legal framework still falls short of international standards.

16. Since 1993, the National People's Congress (NPC) has formulated more than 30 laws which relate to setting up the legal framework for a market system. Business risks can now be assessed more rationally, transaction costs have been lowered and arbitrary Government actions have been considerably reduced although not totally eliminated. The enacted market-oriented laws after 1992 include: basic commercial laws (Company Law, Foreign Trade Law); regulatory and consumer protection laws (Law of Protection of Consumer's Interest, Product Quality Law, Advertisement Law, Anti-unethical Competition Law, Trademark Law);

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1 TA No. 2118-PRC: A Study of Sub-provincial Fiscal Relations.

administrative laws (Real Estate Administrative Law); and the Labor Law. Various tax levied have been made clearer and more predictable under the 1993 Law on Administration of Levying Taxes. In the area of banking, People's Bank of China (PBC) Law, Commercial Banks Law, and Insurance Law were approved in 1995.

17. .Despite significant progress in strengthening the legal framework, many more new laws and regulations have to be drafted and older ones annulled, amended and revised. The Eighth National People's Congress (March 1993 - March 1997) plans to formulate 30 additional market and economy-related laws including the Bankruptcy Law and Anti-dumping Law. Regulations on anti-dumping, anti-subsidy and measures to support the implementation of the Copyright Law are being drafted to ensure the protection of intellectual property rights and fair trade. In the area of environment, the nearly 20 existing laws and regulations are being reviewed and revised to make them more comprehensive. In addition to drafting new laws and regulations, PRC is also making considerable efforts to strengthen the related administrative and enforcement mechanisms.

18. Work is underway to develop a regulatory framework to govern investment in infrastructure on a BOT/BOO basis. These regulations are essential to mobilize a large pool of international capital to address PRC's infrastructure bottlenecks. Because of uncertainties in the legal framework, in 1995 some export credit agencies expressed some reluctance to finance proposed BOT infrastructure projects. Areas of concern expressed by the export credit agencies include: the absence of clear legal and regulatory frameworks to cover such issues as convertibility of Yuan revenues for foreign debt service obligation and profit repatriation, transparency and competition, differing perceptions of risks and expected returns between investors and the Government, enforceability of contracts, limited availability of domestic term finance and underdeveloped capital markets. Most of these issues will be addressed by PRC's BOT/BOO regulations which are expected to be published in 1996.

19. .Developing the legal and regulatory frameworks that are appropriate for a market economy is an immense task which will not be fully completed until after the turn of the century. The Bank is providing support by selectively focusing on those which are directly related to the PRC operational program. Areas in which the Bank has provided legal/regulatory support have included: (i) financial sector: a series of TAs to help develop the regulatory framework for non-bank financial institutions, cooperative banks and trust and investment companies; (ii) capital markets: a series of TAs to help strengthen the regulation and supervision of the capital markets; (iii) environment: providing assistance to help draft environmental legislation and providing a series to TAs to help strengthen environmental enforcement and regulation; (iv) BOT/BOO: a series of TAs to help develop the regulatory framework necessary to promote foreign investment in infrastructure (e.g., power; roads; ports); (v) bankruptcy: a TA for improving the insolvency process of SOEs, including the assessment of whether to reorganize or to liquidate SOEs and how to improve the reform of the Bankruptcy Law; and (vi) sector specific legal and regulatory support: assistance in developing the legal/regulatory frameworks related to fertilizer, telecommunications and customs administration (including intellectual property rights). In addition to the Bank's support, the World Bank provided a loan project for economic law reform to assist in the preparation and implementation of a wide range of the economic legislation and to enhance the legal training system. The UNDP has been assisting the Government in the drafting of economic laws and UNIDO has provided support to develop BOT regulations.

#### **IV. Transparency (Information Openness)**

20. There is a greater need for widespread access to accurate and timely information about the economy and government policies and transparency in economic decision making in a market economy than in a command economy. Although control of the media still rests with the Government, public access to information has improved since the 1980s. Statistical data and other information on the economy are regularly published in Chinese, English and other major languages and have become widely available. The Government is taking steps to improve the collection, compilation and publication of socio-economic information along internationally accepted practices and to ensure its timely dissemination. All major international news agencies and television networks have set up bureaus in the PRC. Press conference attended by foreign news media are periodically organized by the Government to disseminate information on important events. There is wide coverage of PRC economic and financial news in the international media.

21. Despite this progress, economic information is sometimes more closely guarded in PRC than in other countries. In 1996 the Government announced that: (i) Internet users must channel electronic communications through ports that are monitored by the Ministry of Posts and Telecommunications; (ii) all Internet users must register with the police; and (iii) Internet users are forbidden to produce, retrieve, duplicate or spread information that may hinder public order.<sup>1</sup> PRC plans to create a national intranet that will be linked in a controlled manner to the Internet. Some of PRC's domestic laws and regulations are inconsistent with the Bank's policy on disclosure. To ensure that bidders offer the lowest price, PRC's regulations prohibit detailed cost estimates and estimated contract amounts to be made public prior to bidding. Consequently, detailed cost estimates are deleted from Bank reports that will be made public.

22. The Bank has provided assistance to help upgrade statistical systems in the PRC. The State Statistical Bureau has been the recipient of two TAs to assist in converting of PRC's statistical system to the United Nations System of National Accounts reporting system and for improving its national accounting systems. Bilateral donors are also actively involved in this area. Assistance has also been provided to help upgrade statistics in areas that are related to Bank operations in PRC. Examples include providing TA for the Upgrading of Agricultural Information Services, the Establishment of a National Securities Trading System, a Seminar on Credit Rating held in Shanghai, upgrading statistics for PRC's hydrocarbon sector and the compilation and analysis of monetary statistics by the Central Bank.

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1 Many countries, developed as well as developing, are struggling with the defining the degree of Government control or censoring that is appropriate for the Internet. Much of this concern relates to pornography. Singapore requires all Internet providers to register with the national broadcasting authority and has issued guidelines as to what is acceptable on the Internet.