China Country Assistance Strategy Progress Report

The China CAS Progress Report under consideration today provides a good overview of important macroeconomic and policy developments in China over the last year. I would like to briefly take this opportunity to note U.S. support for China’s macroeconomic management by reiterating Secretary Rubin’s remarks at this week’s China – U.S. Joint Economic Committee meeting:

China has made excellent progress in improving the management of its macroeconomic instruments, having ended the stop-and-go economic cycles of the early reform period and brought price stability along with a growth rate that is the envy of the world, despite its recent moderate decline. In this respect, we believe that China’s exchange rate policy remains appropriate; a devaluation would not be in China’s best interests, as it could threaten trade and investment flows, invite a return of inflation, and, of course, have a major impact on the other currencies in the region, including that of Hong Kong.

The CAS Progress Report highlights well the magnitude and complexities of the challenges facing China. We agree that resolution of three inter-linked reform efforts -- financial sector, state-owned enterprises, and social protection – are essential. China has little time to spare as it addresses these issues, and we agree that the Bank should be responsive to its client’s emerging needs. At issue, however, is the appropriateness of China’s steps, and how the Bank’s response can best play to its own strengths to meet the priorities of its borrowers and shareholders.

For example, we cannot emphasize enough the importance of financial sector reform. The state of China’s banks is cause for serious concern. In this area, the Bank is already responding to China’s requests for an array of non-lending services, which we find highly appropriate. Maximum engagement is called for, but we believe that the Bank’s impact in this sector derives from the quality of the advice that it offers, rather than the volume of lending it provides. We have been somewhat reassured by consultations with staff, which indicated that they are taking a cautious orientation on new financial intermediary lending.

The wisdom of Bank lending in the financial sector is complicated by China’s stance on openness to financial services. International banking, securities, and insurance firms have a great deal to offer the Chinese economy, both to its businesses and to modernizing its own financial
sector. This is an issue directly related to China's desire to accede to the World Trade Organization, and we hope that China will allow foreign firms to compete to supply the needs of Chinese customers, and to help improve the capitalization and skills base of the Chinese financial sector. We believe this can be done while at the same time satisfying China's concerns on appropriate sequencing of reforms and fostering growth of the indigenous financial services industry.

Another example of the challenges facing China and the Bank is the management of new infrastructure spending. The CAS Progress Report rightly notes the need to maintain an adequate level of economic growth to alleviate the pressure on the financial sector, absorb workers released from unproductive state-owned enterprises, and keep tax revenues up. Insofar as China has decided to stimulate domestic demand to meet this objective, however, we have serious concerns about the manner in which it appears to be moving, and the Bank's role in the process.

As in the financial sector, a key question for the Bank in infrastructure finance comes back to whether high lending volumes are necessary to advance the reform process, and whether they may be in fact undermining the process. We are receiving a growing number of complaints from the U.S. business community in China that the Bank is increasingly - however unwittingly - competing with the private sector for infrastructure projects, especially in the power sector. We welcome the conference that the Bank plans in China later this year on this and related topics, which can hopefully go some distance towards clarifying the facts.

Without discounting the rationale of its macroeconomic objective in promoting infrastructure development, we believe that the authorities need to rethink their tactics in this area. On the one hand, China does not have the fiscal space to finance extensive infrastructure development from the budget. On the other hand, the foreign private sector has long sought increased access to the Chinese market. We believe that China should be courting foreign participation and direct investment. However, we understand that China has instead recently restricted procurement for all power plants 600 mw and under to Chinese suppliers, and that China's State Power Corporation has given U.S. power equipment suppliers a list of planned power projects that will not be allowed to use imported materials. The list includes three World Bank projects, including a project under which firms have already gone through the bidding process. This recalls the cancellation of the $440 million Qinbei World Bank project, which was withdrawn by China after extensive work by Bank staff because foreign firms won the contract awards under an International Competitive Bidding process. Clearly, the Bank cannot support projects that violate fundamental Bank policies. We ask the Bank to take another look at this issue in light of recent developments in the procurement area. At present, we find that the Bank has yet to make a fully compelling case for maintaining high lending volumes in infrastructure.

We commend the quite positive record of implementation that China has achieved, which is likely to be reinforced by the Bank's decentralization under the leadership of an active Country Director. The close relationship of Bank staff and their counterparts can only increase the effectiveness of the Bank's investments and non-lending services, including EDI programs, in diverse areas from pension system reform to housing finance. The Board is still coming to terms with how the Bank should be financing its non-lending activities, but we are certain that non-
Lending services are high leverage investments which we are using with increasingly good results.

I would also like to welcome and encourage the growing attention in China to environmental protection, well reported in this update. This has major economic, health, and social dimensions with impacts beyond China's borders. While it can be very difficult in the near term, with many competing pressures for public investment, to give priority to environmentally sound practices and environmental protection, the costs and consequences of deferring this are prohibitively high.

As Board members and management know, I am instructed by domestic legislation to abstain on projects which do not meet basic human needs. I therefore request to be recorded in the minutes as abstaining on three of the China projects under consideration today: 1) Second Inland Waterways; 2) Third National Highway; and 3) Guangzhou City Transport.