



1. Project Data:		Date Posted : 05/17/2004	
PROJ ID: P003585		Appraisal	Actual
Project Name: Shenyang Ind. Reform	Project Costs (US\$M)	355.9	184.6
Country: China	Loan/Credit (US\$M)	175	139
Sector(s): Board: PS - Other industry (69%), General industry and trade sector (24%), Sub-national government administration (3%), Water supply (2%), Solid waste management (2%)	Cofinancing (US\$M)	180.9	45.6
L/C Number: L3788			
	Board Approval (FY)		95
Partners involved :	Closing Date	06/30/2001	06/30/2003
Prepared by :	Reviewed by :	Group Manager :	Group:
Elliott Hurwitz	Roy Gilbert	Kyle Peters	OEDCR

2. Project Objectives and Components

a. Objectives

The project objectives were to (1) Help reform and reorganize Shenyang's industry, especially engineering industry, by creating a modern, corporate-led sector with substantial private participation that would increasingly allocate resources on the basis of competitive market forces; (2) Help create a new model of (state-owned) business organization, with a focus on separating productive economic activities from the government bureaucracy and organizing them into corporate entities; (3) Help redraw the boundaries between government and private economic activity and define a new role for government in relation to the market, and help expand private sector activities; (4) Strengthen enforcement of environmental standards to redress past environmental degradation and ensure that new industrial activity is environmentally sustainable .

b. Components

1. Reform Program Support (IBRD actual expenditure US\$2.3 million)

Training, consulting services, and equipment in 6 areas: (1) training in the principles of a market economy for Shenyang Municipal Government (SMG) officials in the economic and social sectors; (2) labor market information system and training for cognizant staff; (3) strengthening capacity and quality of industrial safety inspectors; (4) developing a property market information system and training key staff; (5) strengthening the State Asset Management Bureau and the State Asset Management Corporation (SAMC) by training their staffs and evaluating the performance of SAMC; and (6) strengthening the teaching capability of the faculty of the Shenyang College of Finance and Economics.

2. Industrial Restructuring--Credit Line (IBRD actual expenditure US\$44.7 million)

A credit line mainly intended for private firms was established through the Shenyang branches of the Industrial and Commercial Bank of China (ICBC) and the Bank of Communications (BOCOM) to finance the modernization and restructuring of industrial enterprises other than the Shenyang Machine Tool Company Limited (SMTCL). These banks were responsible for the appraisal and supervision of subprojects .

3. Restructuring of Shenyang Machine Tool Company Limited (SMTCL): (IBRD actual expenditure US\$81.6 million)
This component was designed to restructure and upgrade the design and management of the state -owned SMTCL's existing facilities. A comprehensive feasibility study for SMTCL restructuring undertaken in 1992 and 1993--based on the "guiding principles" of a market-oriented product strategy--assessed the physical, technical, operational, financial, and managerial aspects of the firm . It concluded with a recommendation for a comprehensive restructuring of SMTCL, including rehabilitation and modernization of existing facilities, rationalization of manufacturing processes, elevation of product quality to international standards, and establishment of an effective management system .

4. Environmental Protection Component (IBRD actual expenditure US\$10.2 million)

This component supported the policy of improving enforcement of existing environmental regulations by financing a waste water monitoring network, extending coverage to pollution sources not adequately covered by financing a hazardous waste treatment facility as part of the introduction of hazardous waste management regulations, and

strengthening the capabilities of the Environmental Protection Bureaus (EPBs) at municipal, county, and district levels through a program of assistance to the EPBs.

c. Comments on Project Cost, Financing and Dates

Overall project cost was US\$184.6 million, or around 52% of the original loan amount. IBRD disbursements were around 79% of the amount intended, while actual expenditures by other participants (Shenyang government, SMTCL, and other beneficiaries) were around 25% of the originally-planned amount. The project was restructured (in 2000) to reallocate US\$20 million from the SMTCL to the Line of Credit component. In addition, US\$10 million was reallocated within the SMTCL component to support reduction of labor redundancies. The project closed June 30, 2003, 2 years later than envisioned. (Government-imposed interest rate ceilings played a role in the under-utilization of the credit line, and SMTCL arrears led SMG to freeze disbursements. However, beyond that, the ICR does not offer a clear explanation for the shortfalls in expenditures or for the delay.)

3. Achievement of Relevant Objectives:

(1) Help reform and reorganize Shenyang's industry, especially engineering industry, by creating a modern, corporate-led sector with substantial private participation that would increasingly allocate resources on the basis of competitive market forces: Achievement in this area (comprising mainly component 2, the credit line) was *unsatisfactory*. While private participation in Shenyang's industrial sector did increase, this occurred principally as a result of enterprises purchased or started by foreign investors, new domestic firms, or privatized firms. Private sector activity expanded more slowly in Shenyang than in most other localities, and there is little evidence that activity under this project contributed to this expansion. Also, 63% of Liaoning Province SOEs were unprofitable in 2001, and the overall SOE portfolio was nearly insolvent. The substantial proportion of non-performing loans under the credit line (see sec 5) suggests that credit was not allocated in accordance with market principles, and that ICBC and BOCOM had inadequate credit appraisal skills.

(2) Help create a new model of (state-owned) business organization, with a focus on separating productive economic activities from the government bureaucracy and organizing them into corporate entities: Achievement in this area (comprising component 3, restructuring of SMTCL, as well as component 1, reform program support) was *unsatisfactory*. Sales and profitability of SMTCL were well below forecast (see sec. 6), and no evidence is presented that this model of SOE reform influenced other firms to adopt a similar course of action. Also, as noted in sec. 5, SMTCL's arrears to SMG were more than US\$32 million by March, 2003.

(3) Help redraw the boundaries between government and private economic activity and define a new role for government in relation to the market, and help expand private sector activities: Achievement in this area (comprising mainly component 1, reform program support) was *satisfactory*. Training for SMG staff was provided as planned (except as noted below), and the government radically changed the manner in which it operates state-owned industry, largely separating enterprise management and supervision from other government activity. Municipal controlled enterprises (MCEs) were corporatized, and around 1/3 organized as shareholding companies. Procedures for bankruptcy and liquidation were established, and around 100 small firms were declared bankrupt. Capacity was bolstered in the area of industrial safety inspection. Project efforts in the area of labor market information were overtaken by several other efforts by local authorities, with uncertain outcomes. And limited progress in strengthening the capacity of the Shenyang College of Economics and in the Key Official Training Program led to the cancellation of these sub-components.

(4) Strengthen enforcement of environmental standards to redress past environmental degradation and ensure that new industrial activity is environmentally sustainable: Achievement in this area was overall *unsatisfactory*. On the one hand, the development of facilities, monitoring and information systems, and training has been a positive development. By highlighting sources and levels of pollution, the Shenyang Environmental Management System financed by the Project could support enforcement of environmental regulations and the imposition of pollution charges. By monitoring 26 major emitters of waste and municipal sewage, the Shenyang Industry Waste Monitoring System will enable better enforcement of regulations on water quality. The Environmental Training Center courses had 5600 participants in 2001 and 2002. However, despite the 8.5-year duration of the project, no evidence is presented that enforcement of environmental standards was *actually* strengthened in practice. Also, the Hazardous Waste Treatment Facility (HWTF) cost more than expected and was completed about 3 years later than planned. The facility has operated at a loss since it commenced operations; during 2003 the facility operated at only 72% of what would be required to break even. Consequently, the HWTF has been a major drain on Shenyang finances, with uncertain benefits in terms of stronger enforcement.

4. Significant Outcomes/Impacts:

- Government radically changed the manner in which it operates state-owned industry, largely separating enterprise management and supervision from ordinary government activity.
- Municipal controlled enterprises (MCEs) were corporatized, and around 1/3 organized as shareholding companies.
- Shenyang's infrastructure for environmental monitoring and protection was significantly improved

5. Significant Shortcomings (including non-compliance with safeguard policies):

- The project comprised a very large drain on Shenyang finances, while yielding few benefits in return :
 - SMTCL suspended loan repayments to SMG in early 2002, and by March, 2003, arrears amounted to US\$32.1 million (SMTCL violated a project financial covenant by failing to meet its debt servicing requirement)
 - As of March, 2003, 50% of the credit line sub-loan repayments were in default.
 - Construction of HWTF was more costly and took much longer than envisioned, and since starting operations, HWTF has operated at low levels of capacity and below its break -even point; 2003 operations were at 18% of capacity and 72% of break-even.
- Given the project objective of bolstering private participation in industry and increasing the allocation of resources on the basis of competitive market forces, the project put too little emphasis on improving the business environment and stimulating more competitive factor markets, e .g., land (key areas that were recognized in contemporaneous analytical work done on Chinese enterprise reform) .
- Rapid reductions in SMTCL's workforce resulted in substantial overtime for some remaining workers, in some cases beyond what was permitted by China's labor law .
- No evidence is presented that environmental standards were strengthened .
- The ICR estimates that the FRR on the SMTCL component was 4%, compared to 20-24% in the SAR, and that even the 4% estimate may be exaggerated

6. Ratings :	ICR	OED Review	Reason for Disagreement /Comments
Outcome :	Unsatisfactory	Unsatisfactory	The project failed to achieve most of its major relevant objectives, and comprised a major drain on Shenyang finances . Without the relatively modest achievements under objective 3, the project would have been considered Highly Unsatisfactory .
Institutional Dev .:	Modest	Negligible	The project had a negligible effect on the country's ability to make better use of its human, financial, and natural resources .
Sustainability :	Unlikely	Unlikely	
Bank Performance :	Satisfactory	Unsatisfactory	<p>The project concept was flawed in three major respects:</p> <ol style="list-style-type: none"> 1. The project had little chance of success in a poor business environment (see sec. 7, lesson 1). 2. Without extensive support, it would be very difficult for a credit line cannot to succeed in industrial restructuring (see sec. 7, lesson 2). 3. Governments are generally not well suited to restructure or govern distressed SOEs. <p>Once having decided to undertake the project:</p> <ul style="list-style-type: none"> • The Bank was remiss in relying on state banks that evidently had inadequate capacity to appraise and monitor sub-loans. The Bank should have monitored lending decisions and repayment records more closely . • Forecasts of SMTCL's sales and profits were excessively optimistic (which was recognized throughout implementation); for example, sales and earnings in 2002 were 25% and 6% of projections, respectively. Forecasts of HWTF utilization were also exceedingly optimistic. • Project supervision ratings were

			overly optimistic. For example, the overall project ratings on DO and IP were satisfactory throughout the entire project, including the final rating in June, 2003. Also, the SMTCL component was rated satisfactory until December, 2002--highly satisfactory in 2000--despite the firm's consistent underperformance of SAR projections. The rating of HWTF was satisfactory for 17 of 18 PSRs despite a 3-year delay in starting operations and very low capacity utilization rates.
Borrower Perf .:	Satisfactory	Satisfactory	SMG and SMTCL staff generally performed well, and Borrower Performance was overall satisfactory; however, the following shortcomings were apparent: <ul style="list-style-type: none"> • ICBC and BOCOM evidently did not use an effective appraisal methodology in assessing sub-loans, nor did they effectively monitor the performance of sub-borrowers • The inability to obtain permits for access roads from local governments was partially responsible for the delay in opening HWTF • There were shortfalls in counterpart funding.
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with '*' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. A project designed to enhance the influence of market forces has little chance of success in a poor business environment characterized by weak corporate governance, inadequate enforcement of the rule of law, weak financial sector regulation, and inflexible factor markets .
2. Without extensive training for corporate managers and major assistance with restructuring, it is unrealistic to believe that a credit line can successfully achieve the restructuring of industrial enterprises .
3. Governments are generally not well-suited to restructure or govern distressed SOEs .
4. Unless they have a strong track record of sound lending, as reflected in a healthy loan portfolio, state -owned banks are not well suited to make unbiased, market-based decisions on sub-loans.

8. Assessment Recommended? ☒ Yes ☐ No

Why? An assessment should be given a high priority, as it would be important to re -examine the project concept and gain a better understanding of supervision, in particular what options were considered as it became evident that the SMTCL component was not financially viable . In that regard, a 6/00 PSR states: "with the benefit of hindsight, it is now obvious that the original projections were unrealistically optimisticBy 1997, the analysis of the Bank's project team indicated that because of ...SMCTL's much lower than anticipated sales revenue, SMCTL would face considerable difficulties servicing its debt, and *raised serious concerns about the capacity of SMCTL to implement the investment as planned.*" (emphasis added) Several tens of millions of dollars were apparently expended on this component after this report .

9. Comments on Quality of ICR:

The ICR is satisfactory, but only marginally so . On the positive side, it presents a great deal of information concerning project performance, and presents an objective and detailed assessment of project shortcomings --an impressive achievement. The presentation of lessons learned is outstanding . On the other hand, the ratings for Bank and Borrower performance do not reflect the assessments that the ICR itself makes, and the ICR Annex 2 does not present total project cost by component . On balance, it is felt that the positive elements of the evaluation outweigh the negative.