

International Bank for Reconstruction and Development
International Development Association
International Finance Corporation
Multilateral Investment Guarantee Agency

87613

FOR OFFICIAL USE ONLY

EDS97-80
March 18, 1997

Board Meeting of March 18, 1997
Statement by Jean-Daniel Gerber

CHINA: Country Assistance Strategy

1. We endorse the basic elements of the proposed CAS and commend Bank's staff for the good quality of this document. The clear presentation complemented by the helpful summaries give the reader a good overview of the situation in China as well as the objectives which the Bank Group plans to achieve with its assistance program. Moreover, there is a strong sense that the measures and instruments of the Bank/IDA, IFC and MIGA complement each other and arrive at a well-balanced strategy. The complexity of the development issues, as well as the challenges and risks, are well outlined. Nevertheless, a sharper analysis of potential and actual tradeoffs between the dynamics of economic development and investment on one side and concerns for their environmental and social sustainability on the other side would have been useful.

2. The Economy. China seems to have successfully achieved its soft landing. Inflation has declined significantly with only a modest slowing of real GDP growth. The risk of a pick-up in inflation has, however, not disappeared. With sizable inflows of foreign direct investment likely to continue, official reserves will possibly grow further and represent an increasing challenge for monetary policy. Another source of disturbance is the build-up of inter-enterprise arrears stemming from the tight money policies and constraints on bank lending. Moreover, almost three years of comparatively tight macroeconomic policies have exacerbated the structural problems China is facing. Problems in state-owned enterprises (SOEs) and the banking sector are growing. These concerns have already led the local authorities to ease monetary policy in mid-1996. They could very well drive them in the near future to relax their restrictive policies again. Sustaining rapid growth with low inflation will therefore require more than demand management policies. Progress in addressing weaknesses in SOEs and the financial sector, infrastructure bottlenecks and agriculture should be achieved. These priorities areas will, however, require higher public expenditure. Since the authorities expect to balance their budget by the year 2000, the success of their plans will depend on their capacity to generate sharp increases in revenues. It is of utmost importance that recent progress in tax administration and streamlining of tax exemption be consolidated and the tax revenue ratio increased. In this respect, the Bank's support to public finance reform, especially its fiscal technical assistance in close coordination with the IMF, will be crucial.

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. It should not be distributed without the consent of the Executive Director concerned.

3. China has experienced an enormous reduction of poverty since economic reforms began in 1978 but, as noted in the CAS, progress has been unsteady. Improvements in the quality of life for the poor moved rapid in the early 1980s, following reforms in agriculture and driven by fast rural growth. Since 1985, poverty incidence has apparently continued to decline, but at a much slower pace as the locus of expansion shifted to urban and coastal regions. The result has been increasing rural-urban disparities in income, with the growth process leaving much of the rural poor behind. While the trends are apparently clear, how many Chinese are considered poor depends on the controversial poverty line definition. The national definition of poverty yields some 65-100 million poor, whereas the figure jumps to 350 million if international norms of minimum acceptable living standards are used. Such a discrepancy in the definition of poverty standards reflects not only different perceptions of the minimal standard of living, but raises some serious questions about the adequacy of the current poverty reduction monitoring. Additionally, the fact that the Government's "8-7 National Poverty Reduction Program" of targeted intervention to lift the remaining poor out of poverty by the year 2000 remains *underfunded* is a source of concern and jeopardizes the feasibility of the national objective to eliminate poverty.

4. The Bank Group's CAS for FY97-99 continues to concentrate on four key areas already defined as priorities in the last CAS (1995). This proves the consistency of the approach and the appropriate selection of objectives earlier on. In addition, agriculture and rural development has been added as a fifth key area which is in line with China's own development objectives and the Bank's renewed agenda. We very much welcome that China and the Bank are incorporating this aspect into their objectives, as this area should not be neglected in view of its utmost importance regarding the reduction of poverty and the contribution to food security.

5. We welcome the Bank's increased assistance to the health sector reform and its pro-active role in this area. As underlined by the recent Bank Report, *Issues and Options in Health Financing* while China's overall health status is excellent compared to other countries of similar income level, recent trends in child mortality are a cause of concern. It is unclear how much of the stagnation in child health from 1985 onwards is due to the decline in the availability of basic health services in rural areas following the dismantling of the rural Cooperative Medical System, to the persistence of rural poverty, or to other factors. But it is obvious that there are serious problems in recent health sector performance. Access to health care is inequitable, with especially deep divisions between the urban and rural population. Public spending on health is skewed towards hospitals, while priority public health programs are increasingly underfunded and prices of most services and inputs are fixed well below costs. Reforming the health finance system is therefore a top priority, in particular with regard to strengthening national programs for high priority public health activities, including disease surveillance, environmental monitoring and improvement, mass immunization, and health education; ensuring essential services for the poor; and, reforming prices and provider payment mechanisms.

6. We support the emphasis which is being placed on increased IBRD assistance to the poorer provinces of the interior, but are concerned about the possible constraints to Bank lending. As it is outlined in para. 49, introducing more IBRD lending in the social sectors over the next few

years, will not be an easy undertaking as it is effectively restricted to projects with satisfactory repayment capacity or to cases where the provincial entity can repay. We wonder what exact resource transfer mechanisms for activities and projects with less capacity to repay the Government will put in place to achieve the objective of directing funds to the remote resource-deficient rural areas -- primarily in the upland regions of the interior provinces of central and western China -- where they typically comprise entire poor communities. This situation reinforces the urgency to restore the health of the fiscal situation and to shift public expenditures towards health, education, poverty reduction, infrastructure and environmental protection and towards provincial and local governments that have the least capacity to finance these programs.

7. SOEs and financial sector reforms are inextricably interlinked. The most serious problems of SOEs are their misallocation of resources and contribution to macroeconomic instability. The Government can accelerate its gradual reforms with a pragmatic program that focuses on two elements: (i) a policy framework that provides strong incentives for SOEs to improve their performance, primarily by restricting automatic access to finance for creditunworthy companies, promoting competition, and enhancing autonomy in corporation governance; (ii) a program to reorganize the state enterprise sector, including the transfer of social services to government, transferring small- and medium-sized enterprises to the non-state sector, restructuring large, viable SOEs, and liquidating nonviable loss-making companies. Progress in these areas has been insufficient so far. As emphasized by the document an acceleration of such fundamental reforms implies many tradeoffs, in particular in terms of rising urban employment (which is already currently underestimated) to levels considered intolerable by policymakers. As a consequence, a labor redeployment strategy is a priority, focusing first on retraining activities and second on moving workers into subsidiaries of the original employer, severance payment and self-employment. In this context we would appreciate Staff's preliminary assessment about the generation of realistic alternative employment opportunities in the regional economy of selected metropolitan areas and of the workers' perspective to resolve their employment mainly through individual initiative.

8. Environmental protection is recognized as a priority by the Government and, most important, by public perception and many initiatives have been undertaken by international agencies as well as by China to implement environmental protection measures. However, the balance may tip in favor of industrial development rather than environmental protection when these two are competing against each other. We therefore raise the question how the Bank could contribute effectively to the reconciliation between the dynamics of economic growth/development and sound environmental measures. In this connection we miss any reference to a strategy of appropriate price mechanisms, which helps to absorb the costs associated with environmental protection. A shift in economic valuations will require a transition to more realistic prices for energy, materials, water and food. This shift could be speeded up by an assessment of the magnitude of existing economic losses caused by the environmental pollution and degradation that accompany the production and consumption of these vital commodities.

9. Finally, with regard to infrastructure development (notably transport) there appears to be a certain discrepancy between strategic considerations (focus on railway/environmental impact of infrastructure projects, para. 22) on the one hand and the Bank's lending focus on highways

(para. 32) on the other. With regard to transport there are no indications about model split between transport systems and calculations of external costs. This is of particular importance also with regard to both the efforts of attracting private investment in infrastructure and the implementation of environmental objectives. In this context it is also somewhat regrettable that the urban transport sector has been dropped from priority. In the 1995 CAS urban transport was identified as a strategic focus to improve urban environment. This sector offers an ideal entry point for enhancing links between environmental and urban development management and infrastructure development.