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Loan Committee: China - General

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China - General - Loan Committee Project File

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## OFFICE MEMORANDUM

DATE: January 15, 1987

TO: Mr. Attila Karaosmanoglu, Vice President, AEN

FROM: Ernest Stern, SVPOP *ES*

SUBJECT: Interest Rate Issues in China

I agree that it is not fruitful to address the interest rate issue in China on a project basis and the proposals outlined in your memorandum of December 15, 1986, are broadly acceptable as a temporary step towards gradual adoption in China of standard Bank guidelines on interest rates. The temporary nature of this position should be made clear to the Chinese authorities. At the same time, the Region should endeavor to clarify the time-frame within which reform is expected, and establish some benchmarks against which progress can be monitored.

For our further discussions in China on this subject, it is important to understand the relationships between the different interest rates on various sources of foreign capital. The memorandum does not adequately present the situation. The World Bank's lending rate reflects three things - the market cost of long-term maturities, protection against volatility in interest rates and some protection against exchange rate variations. The rate is based on the average cost of funds to the Bank over time. To compare this to the cost of LIBOR funds to the BOC is obviously not sound. The LIBOR funds are marginal cost funds with interest rates varying based on the 180-day costs, their maturity is much shorter than ours and the BOC bears the full foreign exchange risk. The difference between the rates on Bank and LIBOR funds reflects the difference in maturity, interest rate risk and foreign exchange risk. It surely is not captured by a 0.7% spread. To the extent the BOC is onlending funds at such a rate, or uses this to establish the cost of long-term foreign funds for investment, it is subsidizing the borrower.

China, like other developing countries, should have a strong interest in minimizing its debt at variable rates (our rates vary too--but based on changes in average costs which are small) and to maximize the maturity profile. The cost of this protection is small, particularly when compared to the potential risk. It is essential in our discussions that we keep these considerations in mind and avoid the trap of accepting the conclusion that our funds are expensive compared to LIBOR-based dollars. That can only be said if the premia embodied in our rate are thought to be excessive, which clearly is not the case. I have asked the Industry Department, in consultation with the Financial Policy and Analysis Department, to prepare a note elaborating on these points for the guidance of staff.

Your memorandum suggests that much of the Region's discussion with the Government on domestic interest rates has been concerned with the cost of funds to the final borrower, and very little with questions of domestic resource mobilization. In pursuing this dialogue, the structure of interest rates should receive due attention.

IDA resources are not intended, as you know, to soften onlending rates to ultimate beneficiaries. The practice of blending IDA with Bank funds for this purpose (para 19 of your memorandum) should be discontinued.

The discussion in the memorandum on infrastructure deals with questions of organization rather than of economic distribution. Whether a port is an independent entity or not is less relevant than the fact that it is a revenue-earning entity.

THE WORLD BANK INTERNATIONAL FINANCIAL CORPORATION  
**OFFICE MEMORANDUM**

- RC  
- file General  
② China

DATE January 14, 1987  
TO Mr. Ernest Stern, SVPOP  
FROM Barbara N. Opper, FPAMA **BNO**  
EXTENSION 75000  
SUBJECT Comparing Market Interest Rates and the Bank's Debt Cost

1. At our meeting yesterday, we discussed interest rate aspects of the competitiveness of the Bank's lending rate. I agreed to supply information on the behavior of LIBOR, the Bank's own average cost of debt, and the variable lending rate. These are provided in the attached table.
2. One of the points discussed had to do with credit risk premiums. We agreed that as the Bank is viewed as a very strong AAA by the bond markets, the Bank's credit risk premium over a "riskless rate" was likely to be lower at any given point in time than that for most other issuers for any given set of terms (maturity, currency, call provisions, etc.). For example, in the US bond market, for any given maturity World Bank issues tend to trade at about the same risk premium as agencies of the US Government (roughly 1/4% above the "riskless" rate, direct obligations of the US Government). Virtually no commercial borrowers, and very few other governments, can issue debt with so small a risk spread. (By the way, LIBOR is not a "riskless" rate; the US dollar LIBOR is the commercial banks' Eurodollar interbank bid rate plus a small spread. To illustrate, during the week of December 19, the 3-month US T-bill yield averaged 5.54%; the 3-month commercial bank dollar CD yield averaged 5.99%; the 3-month Eurodollar CD yield averaged 6.16%; and 3-month dollar LIBOR was 6.28%.)
3. The World Bank lending rate is a simple, direct cost passthrough. The lending rate is 50 basis points over the average cost of debt (including the effect of swaps) issued since FY82 and still outstanding during each 6-month period.
4. Another point discussed related to the market sensitivity of the Bank's lending rate. The average cost basis for the lending rate means that it lags market developments in the same way as would any "portfolio" of fixed-rate instruments. This relative stability in the Bank's lending rate was valued, when the fixed lending rate system was ended, because the resulting stability in cash debt servicing was viewed as compatible with long-term development purposes and as consistent with the long term relationship the Bank has with its borrowers. What that stability means, however, is that when market interest rates fall sharply as they now have, any spot market rate would be lower than the average cost of the Bank's debt; for the same reason, however, following sharp increases in market interest rates any spot market rate would be above the Bank's average debt cost. This is clearly illustrated in the table.

Attachment

cc: Mrs. Donovan; Messrs. Wood, Bock, Golan, Lee, El-Maaroufi, Long.  
BNO/kav

Six-month US Dollar LIBOR,  
The Average Cost of Outstanding World Bank Debt  
and the World Bank Variable Lending Rate

		<u>LIBOR</u>	<u>Cost of World Bank Debt</u>			<u>LIBOR</u>	<u>Cost of World Bank Debt</u>	<u>World Bank Variable Lending Rate 1/</u>
1973	III	11.10		1980	III	11.18		
	IV	9.85			IV	15.86		
1974	I	9.13		1981	I	16.52		
	II	11.44			II	17.21		
FY74	Average	10.38	6.70	FY81	Average	15.19	7.39	
1974	III	13.42		1981	III	18.47		
	IV	10.58			IV	14.96		
1975	I	8.00		1982	I	15.36		
	II	7.49			II	15.26		
FY75	Average	9.87	7.01	FY82	Average	16.01	8.19	
1975	III	8.30		1982	III	13.43		11.43
	IV	7.66			IV	10.24		11.43
1976	I	6.33		1983	I	9.44		10.97
	II	6.65			II	9.58		10.97
FY76	Average	7.23	7.09	FY83	Average	10.67	8.72	
1976	III	6.31		1983	III	10.52		10.47
	IV	5.66			IV	10.07		10.47
1977	I	5.65		1984	I	10.38		10.08
	II	6.01			II	11.95		10.08
FY77	Average	5.90	7.47	FY84	Average	10.73	8.70	
1977	III	6.58		1984	III	12.31		9.89
	IV	7.52			IV	10.24		9.89
1978	I	7.72		1985	I	9.50		9.29
	II	8.36			II	8.58		9.29
FY78	Average	7.54	7.59	FY85	Average	10.16	8.37	
1978	III	9.18		1985	III	8.32		8.82
	IV	11.55			IV	8.20		8.82
1979	I	11.37		1986	I	7.90		8.50
	II	10.86			II	7.00		8.50
FY79	Average	10.74	7.47	FY86	Average	7.85	8.41	
1979	III	11.74		1986	III	6.29		8.23
	IV	14.62						
1980	I	16.20						
	II	12.85						
FY80	Average	13.85	7.12					

1/ The variable lending rate is 50 basis points over the average interest cost of all Bank debt issued since FY82 and still outstanding during the semester and is applied to all variable rate loans in the following semester. (Between FY82 and FY84 a "proxy" representing FY82 borrowings was included in the base calculation.)

FPAMA (1/14/87)

December 29, 1986

Messrs. Bock  
Köpp  
Golan

Meeting 1/13/87  
at 12:30 pm

Interest Rates

Mr. Stern asked me to send you a copy of this memorandum from the East Asia Region on Interest Rates Issues in China.

Mr. Stern feels that the memorandum raises some issues of general applicability as well as specific questions on China. He would like to have a meeting with FPA, IND and PPD early in January to discuss the paper.

We will call your office in the near future to set up this meeting.

Rc

Richard Clements

cc: Mrs. Wallich

Attachment

Mr. Stern

China

I think that this paper is welcome in trying to clarify the region's approach to interest rates in China. I have a few comments/queries:

(1) The discussion on domestic interest rates says little or nothing about resource mobilization and the cost of borrowing rather than lending;

(2) The "two-tier" system described in para. 4 sounds highly unsatisfactory and seems to have no rationale;

(3) The spread required by financial intermediaries should be reflected in lending rates to sub-borrowers. The practice of providing IDA funds to help absorb this cost should be discontinued (para. 19);

(4) Is it intended that "commercial" borrowers (category 1, attachment I) carry the full fee. risk, or just the risk on the US \$ - Yuan rate?;

(5) The Bank's repayment terms (grace and maturity periods) are generally much more favorable than those of commercial banks. Is this of no relevance?

(6) The approach outlined in para. 14 to the "premium" on Bank loans seems sensible. The on-lending rate should be at least equal to the Bank's rate.

RC 12/1/86



1/B  
230

December 22, 1986

→ Mr. Clements

Richard -

Broadly, this seems alright to me, though I agree that there are a few questions. It would be useful for you to send this to FPA, IND and PPD, and organize a discussion early in January.

If we accept the line in para 14, presumably, this should apply to all borrowers, not just to China. The same can be said for para 18.

As to the China aspects, we can deal with those after the general discussion. It should include the question you raise on domestic resource mobilization (i.e. (a) how satisfied are we with the current rate structure, (b) how do we monitor the objectives over the next few years); on exchange risk; on the difference in the maturity structure and who benefits from that. Also, we need to review the blending objective. At the end, the paper shifts from an economic distribution to an organizational one. Whether a port is an independent entity or not is less relevant than the fact that it is a revenue-earning entity.

But, let us try to deal with the principles first-hand, rather than with the specific China issues, in a separate meeting.

RS

## OFFICE MEMORANDUM

DATE : December 15, 1986

TO : Mr. Ernest Stern, SVPOP

FROM : Attila Karaosmanoglu, AENVP *AK*

EXTENSION: 69001

SUBJECT : Interest Rate Issues in China

1. The question of interest rates and on-lending interest rates has increasingly become a matter of contention between the Bank and project implementing agencies in China. Most recently in the coal sector, the Ministry of Coal Industry (MOCI) has expressed concern about the high onlending rate proposed by the Bank. We had asked for the adoption of the Bank's standard formula, i.e., the Bank's rate plus a 10% mark-up, which based on the Bank's current interest rate of 8.23%, would result in an onlending rate of 9%. MOCI has argued that the onlending rate is unduly high given current international market conditions. Similar concerns have been expressed in the context of CIB IV, where the 9.75% interest rate originally proposed by the Bank was considered too high by CIB in relation to prevailing interest rates for foreign exchange loans in the domestic market and would have made CIB's lending uncompetitive. Interest rate issues have also been raised in infrastructure projects such as ports and railways, where prevailing local practice for budgetary onlending calls for a lower rate than the Bank's own.

2. The following provides some background on interest rates in China, outlines the Region's current lending practice and proposes policy objectives in different sectors. These objectives, which are summarized in Attachment 1, are consistent across sectors and with the Bank's policy as enunciated in the OMS guidelines.<sup>1</sup> Exceptions are proposed only where strict adherence to the guidelines would give rise to onlending interest rates which are inconsistent with the prevailing structure of

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<sup>1</sup>/ These statements can be summarized as (i) proceeds of Bank loans should be on-lent at rates no lower than if the Bank loan were directly made to the project; (ii) when exceptions to the above are introduced (i.e. government onlending at standard terms) the resulting government onlending rate should be evaluated in relation to the interest rate structure prevailing in the country, and the appropriateness of that interest rate structure to the country; and (iii) commercial borrowers are expected to pay a premium (10% is deemed appropriate) over the Bank's lending rate in order to ensure that they do not derive any competitive advantage by their access to Bank funds. In the case of lending to financial intermediaries, the policy objective is that loans to final borrowers carry interest rates which are positive in real terms and which are consistent with the interest rate structure in the country.

interest rates within China, cause the cost of funds to the project beneficiary to be excessive compared with competing sources of funds available, or imply rates which, given prevailing price distortions, are not sustainable by the beneficiary.

### Historical Background

3. Interest rate policy in China is rapidly evolving. In recent years, increasing use has been made of interest rates to promote the more rational utilization of credit and to promote financial savings. Until 1985, all budgetary investment projects were financed as grants; since then a major reform in financing practices has taken place with loans financing most Plan projects. It is the government's intention to continue this movement towards interest rates which approximate more closely true opportunity costs.

4. However, China is still far from having a unified, market-based structure of interest rates. Essentially there is a two-tier system, one for Plan priority investments and another, more commercially oriented set of rates for commercial projects. For Plan priority projects, a large number of preferential interest rates continue to exist, essentially to compensate for the prevailing price structure, under which the profitability of such projects may not be adequate to support higher rates. Loans for these projects from financial institutions have maturities of up to 15 years, and annual interest rates in the 2 - 4% range. Lower priority projects may pay as much as 8%. If there is budgetary financing for these projects, it takes place at rates of 3.6%, and budgetary grants are still made to "social" as distinct from "economic" projects.

5. For commercially oriented projects which do not receive budgetary support, domestic interest rates are substantially higher, and given current inflation in China (an estimated 5.0% in 1986 and projected at 6.5% through 1990 and 4.5% in 1991-95) can be characterized as positive in real terms. Rates on loans to such projects have been raised on two occasions since 1984; at present working capital loans carry rates of about 8%, while loans for fixed investment carry rates of 8 - 10.8%, depending on maturity.

6. With respect to foreign exchange lending, a similar two-tier situation holds: For priority Plan projects undertaken by Ministries and government bodies, the government allocates foreign exchange as a budgetary foreign exchange grant. In addition, Ministerial units may be permitted to borrow abroad, and may also have access to quasi-concessional foreign funds. For commercial borrowers, the Bank of China (BOC) is the main lending window. Its rates are adjusted monthly, in line with changes in interest rates in the international financial markets where it borrows. Its dollar denominated loans were recently priced at a variable rate of 7.7%. Finally, under certain circumstances, it is also possible for commercially oriented borrowers to borrow directly abroad, and given China's current credit standing, such projects can be financed at attractive rates.

7. While the Government clearly intends to move towards a uniform system of domestic interest rates in the course of reforms, this goal is not likely to be achieved in the near future, but gradually and as more prices are freed from administrative controls. The result is that the Bank will be lending in the context of a distorted domestic interest rate structure for some time to come. The Bank's onlending policy must also be viewed in the context of Chinese borrowers' access to international markets. The Government of China clearly recognizes the benefits of its relationship with the Bank, values its resources and appreciates their non-financial characteristics such as technical assistance, institution-building and support for developmental objectives. The same cannot be expected to be the case for Chinese commercial borrowers who are likely to focus on the purely financial aspects of the transaction, and will be led, if the Bank were to insist on markups, to prefer commercial borrowing. If the Bank is not competitive, the opportunity for non-financial development assistance and continued dialogue with the Government could be lost.

8. The Bank has therefore been flexible in its approach to onlending rates, requiring gradual adoption of the Bank policy. We propose to continue to be guided by Bank guidelines on interest rates, but to give consideration, where necessary, to local practice to ensure that the cost of Bank funds is not out of line in relation to other competing sources of funds available to the borrower. This would mean, in the case of local currency lending, seeking an interest rate which is comparable to some domestic rate, and for foreign currency loans, a rate consistent with international market comparisons.

#### Interest Rate Objectives

9. The following paragraphs outline current policy and proposed approach with regard to commercially-oriented borrowers (industry, power, oil and gas, coal); financial intermediaries; infrastructure (ports, railways, highways, agricultural area development, urban.) and social sectors (education and health). Attachment 1 summarizes the current and proposed approaches.

10. Commercial Projects. OMS guidelines require commercially oriented borrowers to pay a premium over standard Bank rates to ensure that such borrowers do not gain undue competitive advantage from access to such loans. In recent cases, this requirement has given rise to an onlending rate which, based on the Bank's current interest rate of 8.23%, would result in an onlending rate of 9%. This appears very high, given the cost of funds available in international markets and to which commercially-oriented borrowers in China have direct and indirect access. In view of this, the high effective cost implied by the guideline may need to be interpreted flexibly if the Bank is to address the Chinese authorities' concern. The Bank has traditionally held that its lending rate is a proxy for the market, but better in many respects: it is less variable, it is pool-based, and its principal value is diversified with respect to currency. This is indeed the case. However, the Bank's practice of setting loan charges on the basis of an average cost of funds causes the Bank rate, in an environment of falling rates, to lag behind

the market, where pricing takes place on the basis of marginal costs. Thus, it is high compared to the market at the present time.

11. A second aspect to consider is the Bank's 10% onlending markup. Coupled with a Bank rate which lags the markets, this adds a substantial margin to the rate for the final commercial borrower. The resultant margin is far above the spread which foreign commercial banks charge Chinese commercial borrowers on similar loans. As shown in Attachment II, the margins on loans to commercially-oriented borrowers are approximately 25-30 basis points above the rates charged to the Bank of China representing the Government as a sovereign borrower. (The former are in the Libor plus 50 - 60 basis point range, compared to spreads charged to the Bank of China of 20-30 basis points). The difference is about 25-30 basis points compared to an 82 basis point spread implied by the Bank's onlending markup of 10%.<sup>2</sup>

12. The Bank's markup also differs from the practice of commercial banks in that it is defined in terms of a percentage of the interest rate, rather than as a percentage of the face value of the loan. This means that as the Bank's interest rate rises, the markup rises in absolute terms, as the following example shows: Assume Libor to be 5% and that commercial banks are lending to Chinese customers at Libor plus 0.5%, while the Bank's lending rate is 5%, so that it too is requiring a 5.5% rate to commercial customers. If interest rates rise to 7%, the commercial bank loan will cost China 7.5%; the World Bank will require an onlending rate of 7.7%. As a result, at higher interest rates, the Bank's lending becomes increasingly non-competitive. X

13. In sum, where the Bank lends to commercially-oriented borrowers, (such as in the power sector, coal, oil and gas, and industry) the policy for onlending should take into account these considerations. Specifically, the actual markup should be determined keeping in mind the appropriate spread for commercial borrowers (25-30 basis points) and the structure of foreign exchange lending rates in China and to China. These rates are concentrated in the 7%-8% range depending on currency, maturity, and frequency of interest rate adjustments.

14. We would therefore propose that for commercial borrowers the onlending rate should be the Bank rate plus an appropriate spread, perhaps of 25-30 basis points. If this results in a rate higher than alternative sources, the Bank should be prepared to lower this mark-up or entirely eliminate it, i.e. allow onlending to the final beneficiary at the same rate as the Bank's. Otherwise, rather than preventing the borrower from gaining competitive advantage we would be penalizing the borrower for having access to Bank funds. This is further justified because as the

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2/ Commitment and/or front end fees add to the cost of both commercial and World Bank loans; about 50 basis points depending on the sector and disbursement profile in the case of the World Bank, and very slightly more for commercial loans, a difference which does not significantly alter the conclusions.

ultimate subborrower is always a venture wholly owned by the government, the onlending risk to the government does not exist. Should the Bank's rate fall below market rates (which it may, in a rising interest rate environment) the markup could again be applied.

15. Financial Intermediaries. The Bank's current policy in this sector follows the OMS guidelines that final borrowers should pay interest rates which are consistent with the prevailing structure of interest rates in the market and that this structure be 'appropriate'. With respect to domestic interest rates, these have been substantially increased with the financial and interest rate reforms which have taken place in China recently and most of these are now positive in real terms. In defining an onlending policy for domestic currency lending by financial intermediaries, it is therefore increasingly appropriate to look to the interest rates charged by local financial institutions as a benchmark. *but see d7.*

16. In the case of local currency agricultural onlending, the comparator has been the Agricultural Bank of China (ABC), the institution responsible for the bulk of lending in this sector. Its rates are now in the 7.9-10% range. Most recently, in the second Rural Credit project, an onlending rate similar to that of ABC's has been accepted as appropriate. A similar approach will be taken for Rural Credit III scheduled for FY88.

17. In the case of local currency onlending to industrial and commercial borrowers, current practice has also been to use the prevailing market rates charged by local financial institutions as a benchmark. For example, in the case of the Gansu Industrial Diversification Project, the rates of the Industrial and Commercial Bank of China (ICBC), now in the range of 7.9-10.8%, have been used as comparators and a rate of 10% has been proposed.

18. In the case of foreign currency onlending, the variable lending rates of BOC, now some 7.7% in US dollars, have been used as a benchmark and an interest rate - which includes a fixed rate premium and a spread for credit risk - of 8.5% has been tentatively agreed in the case of CIB IV. Thus, for local currency onlending, the Bank has sought onlending to final borrowers at positive real rates; for foreign currency onlending, rates have been targetted at market levels.

19. In order to safeguard and promote the financial integrity of the financial intermediary, we have also focused on the spread earned by the intermediary, which should be such as to enable it to earn an adequate return. As a result, we have tailored the onlending of Bank funds to the intermediary in a way which is consistent with its lending rate and required spread, and have provided funds accordingly on a IBRD/IDA blend basis. In this sector no change in approach is contemplated.

20. Social Sectors. In social sector lending (education and health) our policy has been to follow the local practice for the budgetary funding of such projects. As described earlier, budgetary funding for such projects takes place through non-repayable grants which are provided by the central or local government to the Ministry or Bureau undertaking

the project. Hitherto, the Bank's own lending to this sector has also been passed on by the central or local government in grant form directly to implementing ministries or bureaus and no interest rate has been charged by the government to these ministries.

21. At present, an important aspect of the Bank's dialogue in these sectors relates to user charges and cost recovery issues, and the Bank is actively working with these agencies to improve cost recovery in the education and health sectors. Thus we do not propose to change the current approach at the present time and Bank funds will continue to be passed on to project implementing agencies in these sectors in line with local prevailing practice of grant finance.

22. Infrastructure. The Bank's current lending program includes a number of projects of an infrastructural nature (ports, railways, highways, urban). These are implemented by government ministries, or by a government agency, and under prevailing local practice, ministries and their agencies carry out their investment program using the budgetary funding which they receive. As priority projects, the implementing agencies would obtain such budgetary funding in the form of low interest rate loans or no-interest budgetary grants.<sup>3</sup>

23. Current policy has been to follow local prevailing practice with regard to onlending rates, while emphasizing the need for the government to rationalize its interest rate structure, and our current interest rate policy reflects this transitional stance. In the ports sector, an interest rate of 4% has been applied, following GOC procedures for the ports subsector. In railways, Bank funds were passed on to the implementing agency, the Ministry of Railways, at 3.6%, the rate for budgetary loans to that sector. For the most recent highway project, the implementing agency is the Ministry of Communications itself, and funds were passed on between governmental units in grant form. For the recent urban project (Shanghai Environment), Bank funds are to be onlent (to Shanghai Municipality) at 4.5%.

24. For the future, we will attempt to further differentiate between quasi-commercial revenue-earning, independent entities, and infrastructural projects carried out by a government department. For the former, while establishing financial independence may take some time, we will attempt to reach the target of ensuring that benefiting agencies pay the full cost of Bank funds over the next five years or so (i.e., during the 8th Plan period). As the structure of interest rates in China evolves and the pricing system is reformed - and it is the authorities stated intention to proceed with such reforms, not least to address the investment inefficiencies to which excessively low interest rates contribute - domestic rates will automatically approach our target levels. For the latter non-commercial entities, onlending at the Bank's rate would be inappropriate, and we propose to continue with present prevailing practice, emphasizing cost recovery.

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3/ These loans are provided through the Construction Bank (PCBC) at rates ranging from 2-4%.

25. Through our economic and sector work and country dialogue we expect to have an input into the evolution of interest policy, budgetary management and enterprise reform in China. We are working closely with the Government which seems committed to moving in the right direction. Thus, we would not recommend adopting a strategy that attempts to achieve interest rate targets on an incremental basis through individual projects. Individual projects may serve to make progress in China's reform (and the success of our dialogue) but cannot deviate far from country practice vis a vis similar entities. For this reason, and on the basis of the preceding discussion, we seek your agreement to apply the interest rates as shown in Attachment I to future Bank-financed projects in China.

Cleared with & cc: Messrs. Kaji, Turnham, Linn, Ahmed  
cc: Messrs. van der Meer, Yenai,  
Merghoub (o/r); Lim (RMC)

CWallich:vmk



Table 1

Bank Practice and Objectives

<u>Sector</u>	<u>Current Practice</u>	<u>Future Objective/1</u>
1. Commercially Oriented:		
Industry	Bank rate plus markup* or Bank rate if international rates** are lower.	same
Power	Bank rate plus markup* or Bank rate if international rates** are lower.	same
Oil and Gas	Bank rate plus markup* or Bank rate if international rates** are lower.	same
Coal	Bank rate plus markup* or Bank rate if international rates** are lower.	same
2. IDF/Agric Credit:	market rate/2 /positive real rate	same
3. Social Sectors: 3/	local prevailing practice	same
4. Infrastructure:		
Ports	local prevailing practice	Indep. Entity: Bank rate Gov't Dept. : Local practice
Highways	local prevailing practice	Indep. Entity: Bank rate Gov't Dept. : Local practice
Railways	local prevailing practice	Indep. Entity: Bank rate Gov't Dept. : Local practice
Urban	local prevailing practice	Indep. Entity: Bank rate Gov't Dept. : Local practice
Ag. Infrastructure	local prevailing practice	same

\* Markup is defined in terms of a constant basis point spread over the cost of funds to the government.

\*\* International rates are defined as the floating rate lending terms of BOC, plus a fixed rate premium.

/1 To be achieved over the 8th Five Year Plan period.

/2 Market rate is defined as competitor's rate (ABC's for agriculture, BOC's for industry).

3/ Education and health.

Attachment II

China: Interest Rate Spreads on Floating Rate Commercial Borrowings

<u>China Sovereign Borrowings</u>	<u>Interest Rate Spread</u>	<u>Term</u>
Bank of China loan	.1875	1-5 years
	.3175	5-10 years
Bank of China bond	.166	10 years
 <u>China Commercial Borrowings</u>		
Beijing Shanghai Hotel	.625	10 years
Beijing Jinhua Bldg. Co.	.625	10 years
China Arts & Crafts	.275	1-2 years
	.35	3 years
	.50	5 years
New World Hotels	.625	10 years
CITIC (working capital facility)	.75	5 years
	.75	10 years

WORLD BANK / INTERNATIONAL FINANCE CORPORATION  
**OFFICE MEMORANDUM**

DATE May 21, 1986

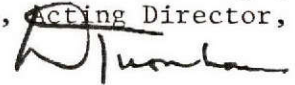
TO Mr. Ernest Stern, Senior Vice President, SVPOP  
through Mr. Gautam S. Kaji, Acting RVP, AENVP

FROM David Turnham, ~~Acting~~ Director, AEPDR

EXTENSION 61820

SUBJECT CHINA - Xinjiang Area Development Project  
International Waterways

ek  
ed  
5/26/86



Appraisal of the above project is scheduled for June. There is a potential international waterways question in connection with the project which does not, however, appear to require any action by the Bank or the Borrower. The following description is provided for information in accordance with para. 4 of OMS 2.32:

Within the project there are two areas, Zhaosu and Tacheng which relate to international waterways. The Zhaosu project area lies within the catchment of the Hasang, a small tributary of the Tekes River. The entire normal flow of the Hasang is already being abstracted for irrigation. For most of the year there is no flow from the Hasang into the Tekes River which originates in the USSR and eventually joins the much larger Ili River which flows from China into the USSR. The project works in the Zhaosu area consist of rehabilitating the existing irrigation system and making more efficient use of the available water. This will enable the system to serve a larger area. Similarly, in the Tacheng project area which involves the use of seven mountain streams, all the normal flows have already been diverted for irrigation. Consequently, these streams no longer flow into the Emin River which flows from China into the USSR. The project works in Tacheng area consist of improvements to the present canal system. These two project components, therefore, would not affect the quality and quantity of flows into the USSR, and since there are no relevant riparian agreements, no notification of riparians would be necessary under para. 9(a) of OMS 2.32.

Cleared with & cc: Mr. K. Ahmed (AEACH), Ms. Lichtenstein (LEGEP)

cc: Messrs. Smith and Ting (AEPA3)

NLichtenstein/tk

## OFFICE MEMORANDUM

Date: March 25, 1986

To: Mr. Ernest Stern, Senior Vice President, Operations  
(through Mr. Attila Karaosmanoglu, Vice President, AEN)

From: Gautam S. Kaji, Director, AEA

Ext: 72103

Subject: China--Three Gorges Project

Sound approach. we should do all we can to help create a sound basis for decision making, without prolonging the process unduly. If we get deeper into a

special role we will treat it "outside plan" too.

ES  
3/26


With respect to your recent query, attached please find a copy of my report to Mr. Karaosmanoglu on our recent discussions in China on the Three Gorges Project. In summary, while a considerable amount of technical and economic work has been carried out over the past 40 years by the Chinese with a variety of external help, we concluded that there remains a large number of unresolved technical and economic issues. In particular, the economic analysis has significant gaps and is largely based on administered prices, and what may be outdated costs. The Chinese have agreed that they need to carry out a more rigorous and comprehensive economic analysis, and fill in the technical gaps before they can establish this massive project as the least-cost option for meeting their power needs. We have proposed, and they have accepted, that they would retain consultants to carry out the detailed investment study in accordance with the terms of reference that we would help them prepare. In addition, the Chinese also accept the need to appoint a panel of experts in various specialised fields to help them oversee and review the work done by the consultants. We would, at this stage, make no special financing arrangements for the study and the panel of experts. The existing Technical Cooperation Credit has funds which can very appropriately be used for this purpose. Should the Chinese, on the basis of the findings of such a study, make a decision to proceed with this project, and if we also conclude that the project deserves Bank support, we could subsequently provide a special technical assistance credit to complete the preparatory work leading up to preparation of bid documents. At this stage, our involvement is solely to ensure that the Chinese have a professionally sound and substantively complete basis for making their own decision.

GSKaji/jh

## OFFICE MEMORANDUM

DATE March 25, 1986

TO Mr. A. Karaosmanoglu, AENVP

FROM Gautam Kaji, Director, AEADR 

EXTENSION 72103

SUBJECT CHINA - Three Gorges Project: Technical and Investment Study.  
Background

You will recall that during Mr. Stern's and your visit to China in October 1985, the issue of possible Bank involvement in the Three Gorges Project (TGP) was raised by the Finance Minister. You had agreed to consider such a request. As a follow-up thereof, a meeting at the working level took place in December between Minister Qian of the Ministry of Water Resources and Electric Power (MWREP) and Mr. Nayyar of the Energy Division. Minister Qian indicated that while the work on possibly the world's largest hydro power project had been continuing for the last forty years, investigations on the project had been intensified over the last five years and the Chinese engineers had now prepared a detailed feasibility study. In doing so the Chinese government had secured specialized assistance from a large number of countries including USA, Canada, Italy, Sweden, USSR etc. She added that the government would also like to seek Bank assistance for this project, specifically in evaluating the issues relating to resettlement and navigation.

The Minister was advised that while issues relating to resettlement and navigation were critical to the project, the Bank's comparative strength lay in assisting the government in undertaking an overall review of project feasibility; in fact our future involvement in this very large project as financiers would be predicated upon our satisfaction that the project was technically feasible and economically viable. The Minister indicated that she had not considered such a comprehensive Bank involvement at the feasibility stage and she would need to review the matter internally and seek guidance from the highest level within the Government. On February 3, we were advised that GOC would wish to seek Bank assistance in carrying out an overall feasibility study of the project and eventually take a leading role in raising the necessary resources.

During my recent visit to China (March 9-18), various aspects of our possible involvement in the Three Gorges Project were considered. In preparation for these discussions, a mission from the Energy Division led by Mr. Nayyar had discussions with the representatives of MWREP, Yangtze Planning Authority (responsible for designing the project) and visited the dam site. Some of the major issues reviewed and the recommended Bank action, is considered below.

Project Parameters

The proposed Three Gorges Project is located 40 km upstream of the existing Gezhouba project on the Yangtze river. The dam-site is in Hubei province with most of the proposed reservoir in Sichuan province. The Gezhouba project would form a reregulating reservoir for TGP. The Yangtze Planning Authority (YPA) is responsible for planning and designing all power projects and flood control measures on the Yangtze river. The main physical parameters of TGP as presently designed are as follows:

- (a) After detailed investigations of eight possible locations, the site and dam axis has been selected at Sandoping.
- (b) The dam height will be 165 meters; the operating level of the dam (150 or 160 m) is still being debated. The trade-offs are in terms of increased benefits for power generation, navigation and flood control against higher cost and an increase in the number of families needing resettlement. After considering various aspects MWREP believes that the balance of advantage will lie in selecting the operating level of 160 m.
- (c) The reservoir will have adequate storage capacity to control a 100 year flood. The power plant at the dam will have a generating capacity of about 15,000 MW and will on the average generate 75 terawatt hours (TWh) annually. It will have a complex system of navigation locks involving possibly a four stage lift.
- (d) It would necessitate resettlement of 420,000 (at elevation 160 m) individuals (projected population figure for 1994) of which approximately 40% are from rural areas, major relocation of many industrial works will be required.
- (e) The project will require preparatory work for three years, the first unit will be commissioned some eight years thereafter and the remaining units (29 x 500 MW) over the following seven years. The project is expected to be completed in eighteen years with power being generated from the eleventh year.
- (f) Power will be supplied to demand centres in 9 states in Central and East China over some 10,000 circuit-kilometers of extra-high voltage alternating and direct current transmission lines.

MWREP Estimates of Cost and Benefit

Chinese officials estimate the cost of the project at Yuan 17.2 billion (US\$ 5.5 billion), which includes resettlement costs of Yuan 4.4 billion; an average 10,000 Yuan per person. Transmission costs are estimated at another Yuan 5.5 billion (US\$ 1.7 billion). These costs are based on 1984 prices. According to the Canadian consultants currently assisting the YPA, the revised costs may be 30% higher than the Chinese estimate. Preliminary estimates in 1985 dollars indicate that the base-cost of the project (including resettlement and transmission) may be in the range of US\$ 10-12 billion.

Major benefits as perceived by MWREP are in terms of power generation, flood control and navigation. Primary benefit is power generation; which it estimates will cost less than US\$ 600-800 per KW and 1 cent per kWh. The second major benefit of the project is in terms of flood control. It would inure a downstream area of about 126,000 sq. km covering a population of about 175 million, and save on the maintenance of dykes which extend over 30,000 km. (According to YPA, damages from 1954 flood were well in excess of Yuan 20 billion). Thirdly, this project will have a positive impact on navigation for upto 600 km and permit 3000 ton barges to sail from Chungking right down to the sea (against present capacity of 300 to 1500 tons). There are several other secondary benefits as well. The major costs are in terms of a massive resettlement efforts this project will entail; a large proportion of investible resources which TGP will preempt and possible interruption to navigation during construction.

MWREP has argued that the development of TGP represents the least cost method of meeting the power demand of central and eastern China. Currently the generating capacity in central and eastern China is about 33,000 MW with an energy output of 173 TWh. By the year 2000 the demand is estimated to grow to over 500 TWh requiring a generating capacity of 100,000 MW. This assumes a growth in demand of about 7.3% per annum, which is broadly in conformity with our own projections contained in our Economic Report. Further, besides TGP, remaining hydro potential which can be developed to meet the requirements of central and eastern China is only about 3000 MW and in any event plans are afoot to develop the potential. The alternative to TGP is thermal generation which is clearly more expensive. Nonetheless given the magnitude of the demand, in addition to TGP, thermal generating capacity would need to be developed to the extent of 50,000 MW requiring additional movement of coal to the extent of 150 million tons.

In spite of extensive work done by the Chinese, there are a large number of unresolved technical and economic issues. It would need to be clearly established that a long gestation project of this nature represents the least cost option and an expenditure of US\$ 10 - 15 billion represents the optimal use of China's resources. In addition resettlement of over 400,000 people and

the attendant economic and socio-political cost would need to be carefully assessed and evaluated. Other environmental aspects particularly those related to sedimentation of the reservoir, landslides, impact on public health, aquatic life and downstream effects will need to be carefully assessed. Separately, the technical aspects present a major engineering challenge; detailed review and additional work would be needed on the design of the coffer dam (stage 2), river control during construction, soundness of dam design for higher levels of seismicity, planning and design of the transmission system, design and construction of navigation locks et.al.

For some of the considerations mentioned above, there is still considerable division within China on the desirability of this project. A number of questions have been raised in regard to the economic justification and the timing of the project and its impact in terms of environment, resettlement and possible interruption of navigation during construction. The Peoples' Congress in its last session directed that a detailed study be carried out on these and other aspects and the results presented to it, for consideration in its session of 1987. In the event this project is approved, it will be accorded a special status of a national project and will be financed outside the Five-Year Plan. It appears that projects of extraordinary national importance are implemented in this manner; the Daqing Petroleum and Industrial Complex was developed in such a way.

#### Recommended Bank Action

Despite preparatory work of over 40 years and extensive use of foreign consultants, there are technical gaps which need to be reviewed, updated and may need further work. The economic analysis is weak and inadequate. Work to the extent necessary has not been carried out on various environmental aspects. There is clearly a need for an Investment Study which, would bridge these gaps, collate and update widely dispersed data and evaluate the technical and economic viability of the project. Such a study is significant as it would be a critical input in the Chinese decision making process and subsequently form the basis for securing external assistance for funding this project. GOC has confirmed that it would like the Bank to assist it in carrying out such a study. Further, they would wish to complete the study by June, 1987.

In order to respond to this request we would propose the following approach:

- (1) The Bank would assist GOC in finalizing the terms of reference for the study and in selecting qualified consultants.
- (2) Given the magnitude and complexity of this project, we recommended that GOC separately appoint a panel of international experts, who, inter alia, will be specialists in environment, sedimentation,



rock and soil mechanics, navigation, river diversion, reservoir planning and optimization of dam height, power system planning, evaluation of benefits and costs etc,. We expect to use in-house expertise for economic evaluation. This group of experts, who we would help identify, would firm up the terms of reference for the investment study and subsequently supervise and review the findings of the consultants. We expect a substantial interface between the panel of experts and the consultants during the conduct of the study.

(3) The consultants and the panel of experts could be funded through the existing TCC credit. We estimate that the study would cost about US\$ 4 million; in addition the cost of the panel of experts is expected to be in the range of US\$ 500,000. The Ministry of Finance awaits our detailed letter before agreeing to the use of TCC funds.

(4) Given the need to complete the study within a year, we are in the process of identifying the necessary experts. This group could visit China in May/June 1986 for an indepth review of TGP. Terms of reference for the consultants will be finalised after this review.

(5) Substantial Bank staff input would be required, particularly for the economic evaluation and the general follow-up on this study; for FY87 we estimate our additional needs on account of TGP at about 150 staffweeks.

(6) Bilateral assistance from Canada, USA, Sweden, Italy, Norway etc, is available in significant magnitude. We have proposed that while the TCC funds finance the investment study; bilateral assistance can be used for financing specialized technical aspects.

## OFFICE MEMORANDUM

DATE December 20, 1985

TO Mr. E. Stern, SVPOP

FROM ~~/to~~ Jean-Loup Dherse, EISVP

EXTENSION 7-2747

SUBJECT CHINA: Bohai-Liaodong Bay Technical Assistance Project (\$35 million)

*Plan, action*

*file*

*I raised this issue some time ago and was told that we would not finance the direct exploration. Proceeding on that basis, and with this explanation, it's ok.*

*-es*

*12/23*

1. I understand that you requested further explanation of the merits of the proposed Bohai-Liaodong Bay Technical Assistance Project and how it relates to the Guidelines for Petroleum Lending (OMS 3.82).
2. China's offshore exploration policy is closely in line with the basic objectives governing the Bank's oil and gas lending. China has an excellent record of offering high priority offshore acreage to private industry, about 95% of which has been opened to the international oil companies; in the particular case of Bohai, with the exception of the Liaodong Bay (a relatively small area), there has been an active private oil company presence in exploration and production for almost a decade. The Government decided to retain a small area in the Bohai offshore for non joint-venture operations of the China National Offshore Oil Corporation (CNOOC) and its regional affiliates so that they could gain direct operating experience of offshore technology and develop the requisite level of technical skill in order to maintain continuity in offshore activity. The Chinese oil companies also need to develop this capability in order to become effective joint-venture partners with international oil companies and to properly monitor the ongoing and future petroleum activities in offshore China. The proposed project aims to help develop this capability through an integrated technical assistance approach (within the framework of the appraisal of the JZ-20-2 oil and condensate discovery in the Liaodong Bay) to Bohai Oil Corporation (BOC), one of CNOOC's regional subsidiaries, as opposed to the piecemeal technical assistance they have been getting in the past.
3. Although a priori it would appear that an alternative, and perhaps more effective, way of obtaining the requisite experience would be through a farm-out of the discovery to an international oil company, I believe that at this point urging BOC to follow this approach, after having already undertaken a substantial portion of the exploration risk by themselves, may not be in their best financial interest. The oil and condensate reservoirs encountered in the Liaodong Bay area are complex and their potential is not properly defined. Serious doubts exist about reservoir continuity and, therefore, the commerciality of individual discoveries. Any private oil company would, therefore, have to heavily discount apparent reserves and production potential in order to account adequately for the geological risks in making a farm-in offer. The chances of reaching a mutually satisfactory agreement would not be promising at this stage. On the other hand, they would substantially improve at the completion of the integrated appraisal program included in the proposed Bank project.

4. We have recently received assurances that CNOOC would offer the JZ-20-2 structure to the industry upon completion of the appraisal program as they did in the case of the Chengbey oil field in the Bohai's Gulf (which was taken up by a Japanese consortium of companies). We would expect a similar approach for the Liaodong Bay to bring in foreign oil companies with equity and operational experience. CNOOC has also agreed to consult with the Bank on their future operations in the Liaodong Bay area and their program for technology transfer, as well as limited-recourse project financing. It has been made clear to CNOOC that any Bank involvement in the development of the structure should not be considered automatic and would depend on the results of the appraisal program as well as the specific financial and participation arrangements for field development.

5. For the reasons outlined above, I favor departing from the letter of the guidelines (OMS 3.82), in particular, paragraph 34(a). I am satisfied that the spirit and the purpose of the guidelines are being complied with in the contemplated operation.

Distribution

Messrs. A. Karaosmanoglu (AENVP); G. Kaji (AEADR); D. Turnham (AEPDR);  
C. Koch-Weser (AEACH); P. Bourcier (EGYPP); M. Iskander (EGYD2);  
E.D. McCarthy, G. Yuksel, (Ms) J. Koch, A. Smit, J. Thomas,  
(Ms) S. Shum (EGYD1)

EISIC  
Regional Information Center

GYuksel:jd

December 20, 1985

007 AK

AK  
Be glad to discuss. But the 1985-87 numbers merely reflect exchange rate changes. The IDA-7 guidelines for 85-87, in my memo of August 21, 1985, were SDR 1290 million. I don't

Mr. E. Stern, Senior Vice President, Operations

Mr. Stern:

re: IDA Allocations for China

1. In reviewing the memorandum of December 13, 1985 prepared by PBD and CPD, which sets out, among other things, the IDA allocations for China, both as it relates to the 7th and the (hoped for) 8th Replenishments, I wanted to draw your attention to the following:

(i) As regards FY87, Table 5 on page 7 of the memorandum suggests an adjusted allocation for the years FY85-87 of \$1,280 million. Given the fact that we lent China \$442.3 million IDA in FY85 and expect to lend about \$450 million IDA in FY86, it would leave an amount of \$387.7 million for FY87. This significant drop in IDA for China in FY87 will be very unfortunate as the Chinese will undoubtedly take it amiss. They might be tempted to speculate that this reduction in IDA stems from their taking a more relaxed posture on this issue, and in particular, agreeing to increased IBRD borrowings during our visit. It will undoubtedly strengthen the hands of those within the Government (SPC included) who are still not convinced about enlarged borrowing from IBRD.

(ii) Looking a bit further, I am also struck by the fact that on the basis of our most likely predictions of an IDA8 Replenishment (SDR 10.5 billion) the proposed allocations for China for FY88-89 (Table 6, page 7) would imply an IDA allocation of \$427 million per year. As you will recall during your meetings with the Prime Minister, you had mentioned a figure of \$500/600 million from IDA8 and this was very clearly registered with them. I am not sure what IDA8 Replenishment figure you had in mind when you indicated this probable allocation, but it will nevertheless become an issue with the Chinese.

2. We are trying to firm up our FY87 lending program with the Chinese now and hope to discuss with them in March as agreed with you an enlarged program for the further years.

3. Could we please discuss?

*Attila Karaosmanoglu*  
Attila Karaosmanoglu

12/6

~~EK~~

① This is a bit confusing.

Does this say the proposed project meets the guidelines or is an exception being sought?

② Will we have GOC agreement that the areas will be marketed to joint ventures?

③ I'd like a note from Diverse, explicitly endorsing this project and saying it meets (or is consistent with) the guidelines.

1. Mess. Defferent.  
Work - Done up and

~~2/12~~

31 File

Ek 12/9

③

## OFFICE MEMORANDUM

DATE: December 3, 1985

TO: Mr. Ernest Stern, SVPOP

FROM: Attila Karaosmanoglu, AENVP *AK*

EXTENSION: 74503

SUBJECT: China: Bohai-Liaodong Bay Technical Assistance Project

I received the attached memorandum from Mr. Koch-Weser. The Bank will not normally consider financing exploration or appraisal activities of a national oil company alone unless:

- (a) the area has been offered widely on reasonable terms and conditions and yet no foreign investor has agreed to participate; and
- (b) an appropriate process has been designed to attract private participation in the subsequent appraisal and/or development of the field. (Petroleum Lending Guidelines, para 34).

However, there are in this case strong arguments (as presented in paras 4-6 of the attached memorandum) that would justify the Bank presence in the project at this stage.

The Bohai Bay area has been offered to international oil companies and the Japanese joint venture with the China National Offshore Oil Corporation (CNOOC) has had some success in finding oil in the Chenbei area. Separately, CNOOC has been working on a section of the Liaodong Bay (a northern part of the Bohai Bay) and found some gas, which led to the Bank's current involvement. As one of its important objectives, the proposed project would help design the process to attract private participation in the subsequent development of the field. For this reason, I believe that the proposed project falls within the framework of the Guidelines.

Because of the important role the Bank can play at this stage (paras. 6 and 7 of the attachment) and of the potential impact of this project on the future development of oil and gas resources in China, I recommend that the project be included in our FY86 lending program.

Mr. Dherse supports this recommendation.

Attachment

Cleared with and cc: Messrs. Bourcier, Daffern (EGY).  
cc: Messrs. Dherse (EIS), Rovani, McCarthy (EGY),  
Kirmani, Turnham (AEP), Kaji, Koch-Weser (AEA)


YKimura:hk *YK*

## OFFICE MEMORANDUM

**Date:** November 27, 1985

**To:** Mr. Attila Karaosmanoglu, AENVP

**Thru:** Mr. Gautam Kaji, AEADR

**From:** Caio Koch-Weser, AEACH 

**Extension:** 72565

**Subject:** China: Bohai-Liaodong Bay Technical Assistance Project

1. The Chinese Government has requested Bank financing for an offshore petroleum appraisal and development project in the Bohai gulf. The discovery was made by the Bohai Oil Corporation (BOC), a subsidiary of the China National Offshore Oil Corporation (CNOOC). The discovery well drilled in 1984 flowed gas and condensate, while the two more recent step-out wells have had oil as well as gas shows. BOC's initial proposal was for the financing of an integrated appraisal and development project. However, following Bank recommendations, BOC recognized that such an integrated approach with a large capital investment would be too risky and decided to proceed first with an appraisal of the discovery and with the study of alternative development plans. BOC and GOC have recently requested the Bank to consider financing this first phase as an FY86 project which would include:

- (a) drilling three to four appraisal wells to assess the commerciality of the discovery;
- (b) providing 3-D seismic services and related computer equipment to assist in delineating the field and designing its development;
- (c) evaluating alternative development and financing plans; and
- (d) designing a strategy for the future exploration of this area which appears potentially attractive.

2. The project is largely a technical assistance project of which the appraisal wells are an essential element. The total project cost is estimated at \$60 million and the proposed loan at \$35 million, of which about 24% would be for services and specialized materials/equipment for the wells, 17% for seismic services and related computer equipment and the rest for studies, training and other technical assistance. Nevertheless, the justification for the Bank's presence in the proposed project needs to be carefully examined in the context of the Bank's Petroleum Lending Guidelines, particularly with regard to the criteria for Bank support of national oil companies.

3. BOC was created in 1965 to explore for and develop hydrocarbons in the China offshore, long before CNOOC was created in 1982 to be the counterpart of foreign companies in all offshore ventures. In addition to its joint ventures in the southern Bohai gulf, BOC continues to explore on its own the northern part of the Bohai gulf including Liaodong Bay where the recent discovery was made. BOC's proposed exploration and appraisal program for delineating the discovery is well within its implementation capability and the exploration risk is limited. Moreover, it is unlikely that with the information available at this stage on reserve and reservoir conditions BOC

could farm out part of its interest on reasonable terms to a third party; and it is, therefore, advisable for BOC to proceed with the appraisal and bring the quality of the prospect to a level which would be sufficient to attract potential partners.

4. It should further be noted that the discovery structure (JZ-20-2) is located on a north-south trend extending some 160 km into the gulf which may prove to be a series of attractive prospects. At present only limited seismic surveys have been carried out to further define this trend. If further appraisal drilling confirms the presence of commercial hydrocarbons in the first structure, and if further surveys confirm the existence of additional structures, the task of exploring this area over a reasonable time period may be a considerable undertaking. In this regard, the possible benefits of some alternative strategies for further exploration/development, including project management arrangements and farming out to private companies, would have to be considered at an early stage.

5. Current Government policies call for the financing of offshore petroleum investments without direct budgetary support (although Government guarantees may be provided for loans). While exploration expenditures are largely borne by the international oil companies, China's offshore is now entering the development phase and BOC and CNOOC will require over the medium term substantial funding to cover their share of the development cost of commercial discoveries. It is, therefore, important that both of them be well prepared when they approach potential partners and the international capital market, particularly if both institutions want to rapidly be able to borrow on their own strength rather than depend on Government guarantees.

6. For both cases the Bank can play a valuable role:

- (a) by assisting BOC in developing an exploration/development strategy based on a realistic assessment of the first discovery and of the other potentially attractive areas and of the availability of potential partners; and
- (b) by assessing with BOC and financial advisers the feasibility of various financing schemes, including limited recourse financing, and assisting BOC and CNOOC in structuring its investment program so that it can mobilize financing from a variety of sources without requiring Government resources.

7. These two key elements should form the basis of a successful cooperation between the Bank and BOC and, more importantly, should help to establish a longer term relationship with CNOOC (perhaps as a first step, the development of offshore gas in the South China Sea by Atlantic Richfield for which CNOOC has already expressed interest in the Bank's participation in financing the pipeline). The proposed project, therefore, should enable the Bank to play an effective catalytic role in the mobilization of financial resources as well as an important institution building role in the structuring of projects which would minimize the debt burden of the Government.



8. Because of the importance of these objectives for the future of the Bank presence in the energy sector, we would recommend that the Bank participate in the financing of this project.

9. May I have your agreement.

Cleared with and cc: Messrs. Bourcier, McCarthy (EGY), Turnham (AEP)

cc: Messrs. Dherse (EIS), Rovani, El-Mekkawy (EGY), Salman (LEG),  
Kaji, Linn, Koch-Weser, Kimura, Pohl, Tidrick (AEA),  
Mses. Koch, Shum (EGY), Schaeffer (AEN).

JK/PB/YK:hk

Mr. A. Karaosmanoglu, AENVP

Ernest Stern, SVP, Operations

CHINA: On-Lending Rate Issue

December 14, 1984

AC  
~~FK~~  
file

As you know, I am profoundly skeptical of the argument that interest rates are not effective instruments of capital allocations. While it no doubt may be true that this is the situation in some countries, there is equally no doubt that this approach to capital allocation has created major problems for those countries. It seems to me therefore that we cannot take too complacent a view of the role of interest rates or the dilatorious effect of excessively low rates. The pricing of capital deserves the same attention from us as the pricing issues relating to commodities.

I agree with you, however, that China is in a period of transition and that price changes will come about only gradually. We must seek to expand our understanding with the Chinese Government about the need to raise interest rates and to do so as part of their price reform program. If you are satisfied that this understanding exists and can be strengthened, we can accept, for an interim period, rates of interest which might not be fully satisfactory. This, in essence, accepts your recommendation in para. 11.

Having reached an agreement on an interest rate which I assume will not be less than 8% (although your memo keeps referring to "around 8%"), the same rate should apply to all projects. It would make no sense to accept a different interest rate for the power, coal and fertilizer projects. Particularly in regard to coal, where there is agreement on pricing increases, the case for having the operating agency accept at the same time a more realistic price for capital is very strong.

cc: Mr. Clements ✓

ES:dpw

Mr. Stern

## China: Lending Rate Issue

I am not sure that the argument that interest rates are not very important in the Chinese context is particularly persuasive. The limited role of interest rates, in fact, is presumably one of the problems. In addition, while flexibility is obviously desirable and necessary, we do have a Bank policy on interest rates of which the Chinese have presumably been made aware.

I personally feel that policy reform must be pursued through specific projects as well as through our general dialogue. However, if we are going to rely heavily on the latter, we might at least have a clear understanding that the Government will give some attention to developing a clear lending rate policy (para 12.)

RC

12/13/84

## OFFICE MEMORANDUM

DATE December 10, 1984

TO Mr. Ernest Stern (SVPOP)

FROM Attila Karaosmanoglu (AENVP) *AK*

EXTENSION 74503

SUBJECT CHINA - Onlending Rate Issue

1. As I reported to you earlier, the second power project negotiations have been suspended due to the onlending rate issue (my memorandum of November 15). Two other projects scheduled for negotiations in January (coal and fertilizer) will most likely be held up also for this reason. Further, we must anticipate similar delays for projects in the pipeline -- especially energy and industry projects -- so long as the issue is not resolved. Thus, the FY85 and very likely future year lending programs for China would face serious problems unless the Bank can agree to a more flexible approach and longer-term horizon for securing its objectives in on-lending arrangements. This note sets out the background relating to the present situation and recommends a strategy to break the current deadlock.

Role of Interest Rates

2. Prior to 1979, capital charges were almost non-existent in China. Enterprises remitted all profits to the state and both investment and working capital were allocated through budgetary grants. In 1979, the Government began to provide some funds as bank loans rather than as budget grants. Equally important, it began experiments with a profit retention system. Enterprises were thus sensitized to capital charges and other costs.

3. Since then, the Government has gradually extended the role of capital charges in exerting financial discipline. Interest rates have been raised, the proportion of investment and working capital funded from loans has been increased, and in 1983 all enterprises were brought under a system substituting taxes for profit remittances. Progress has been uneven however. Loan financing is not yet universal and interest rates vary: 3-3.5% on local currency loans compared to nominal domestic inflation of 2-3% per year, and 6.5-8.5% on most foreign currency loans to state enterprises; but lower subsidized rates are also available. The effective cost of capital to enterprises is also variable. Profit incentive and financial discipline have been reduced by enterprise-specific tax rates and other means of administrative interventions. Under the partially-reformed system, therefore, interest rate is not an effective instrument of capital allocation. Investment decisions, by and large, are not based on profitability calculations. Interest rate is not even a significant instrument for motivating price adjustments. Important price adjustments are not likely to be introduced because of financial considerations.

4. Our assessment, however, is that the Government is generally moving in the right direction. The commitment to increasing reliance on market forces was recently underlined in the widely-publicized Central Committee document on economic reform. This document states that China must increase enterprise autonomy and "establish a rational price system and pay full attention to economic levers." It also states that China "should further improve the tax system and reform the financial and banking system". This statement of intent is of great political significance, but translating these general objectives into concrete policy measures will undoubtedly be an immensely difficult, complex and controversial process.

5. Our objectives with respect to price and interest rate reforms remain much as outlined in the China Status Report of January 23, 1984. There we stated that the key issue of our policy dialogue is price reform, including both restructuring of relative prices and reduction in the scope of administered pricing. Because of the complexity and political sensitivity of these reforms, however, our strategy is to rely mainly on our economic work and associated policy dialogue in pursuing this issue. As stated in the report, "specifically we plan to continue encouraging the Government, in investment financing, to shift further from grant allocations to loans, and to increase gradually the interest rates charged on these loans. Recognizing that movement towards higher interest rates and a more appropriate onlending system will be a gradual process, we propose to negotiate onlending rates in the context of each particular project (e.g. higher distortion in output pricing may require a more gradual movement in interest rates.)" Our strategy remains unchanged. Indeed, the developments mentioned above confirm that we should continue to pursue our policy dialogue in the broader context of system reform generally. I also remain convinced that on those broad issues we will be able to influence the direction of change more effectively through our policy dialogue, and specifically through our economic and sector work, rather than through project conditionality.

#### Onlending Rates

6. Regarding onlending rates for Bank loans specifically, the Government is in agreement with the Bank's principle that borrowers should pay full costs on the capital they use and is reexamining its onlending rate policies (not only for Bank loans but also for all external assistance). However, it is unwilling (and in respect of the Ministry of Finance, unable) to accept immediately rates which reflect the cost of international borrowing. This issue is particularly relevant to the three upcoming projects in energy and industry.

7. Negotiations for the second power project have been suspended because the Chinese were unwilling to accept an onlending rate above 8%. Their argument is that although the Government is committed to raising energy prices as part of overall price reform, this will take time. Meanwhile the project entity cannot bear the full IBRD interest rate and is unwilling to enter into commitments which would increase its future financial liability. They further argue that progress has been made in raising the cost of capital under this project because loans have replaced grants for transmission and distribution

projects. (The Chinese position is recorded in detail in my memorandum of November 15).

8. In the coal project, we have insisted and will obtain during negotiations a commitment to increase the price of coal from its present very low level to a level based on long run marginal cost within the coming five years, and the Government has already taken the first step in that direction. Here also, we have asked for an onlending rate equivalent to the IBRD rate and so reported to the Loan Committee, but the Chinese have maintained that they cannot accept more than 6%. Another break-down of negotiations would almost be certain if we maintain our position to onlend at the IBRD rate.

9. In the fertilizer project, the Bank has asked for onlending at standard IBRD rate plus 10% premium. The price of fertilizer is somewhat below the world price, and the Government is reluctant to accept the Bank's recommendation, proposing only a 7% onlending rate.

#### Recommendation

10. There are two possible approaches to the issue of onlending rates. One is to insist that all loans to revenue-earning sectors bear at least full IBRD rates. However, with this approach we could risk the entire lending program as well as the ongoing constructive dialogue we have on system reform. Moreover, onlending rates are not the critical issue in China as they apply to a very small segment of financial transactions. It is not at all clear whether insisting on on-lending rates which are significantly higher than the overall structure of interest rates in China will achieve much in terms of resource allocation, price reform, financial discipline or the reform of the financial system. A coal price increase, for which we have obtained a commitment of the Government, is much more important, for instance, than a higher onlending rate.

11. Our recommendation, therefore, is to adopt the alternative approach of pushing for higher onlending rates in every project, but to be willing to accept compromises, provided that some progress is being made in other aspects of financial reform. Specifically I recommend that the Region be given the freedom to negotiate whatever onlending rate around 8% it can obtain under each of the three projects (power, coal, and fertilizer) of the FY85 program with an understanding that, at each step, the Region makes sure that reasonable progress is being made in promoting the project entity's financial independence. Such a flexible approach would allow us to put continual pressure on the Government, while considering relevant issues of prices, taxes, subsidies, and onlending rates as a whole.

12. I should note also that negotiations on this issue are likely to be difficult. Even within the Government, a clear-cut onlending rate policy has not yet been drawn and the Ministry of Finance (MOF), which is generally most understanding of the Bank's policy guidelines, is constantly negotiating with

line ministries for more stringent financial discipline of project entities, including higher onlending rates and higher taxes. Our judgement, however, is that it has probably gone as far as it can on this issue.

cc: Messrs. Yenal (AEN); Kaji (o/r), Koch-Weser, Lim, (AEA)  
Kirmani, Turnham, Beach (AEP)  
Golan, Goldberg, Segura (IND); Vorkink (LEG)  
Mses. Haug (IND); Lichtenstein (LEG)

GTidrick/YKimura:cw  
IntRates-3

## OFFICE MEMORANDUM

DATE October 12, 1984

TO Files

FROM Mr. Vineet Nayyar, Acting Chief, EGYD1 *Vineet Nayyar*

EXTENSION 7-4085

SUBJECT CHINA: Minutes of the Meetings Held With the Chinese Delegation Led by the Minister of Petroleum Industry on September 14, 1984.

1. Minister of Petroleum Industry, Mr. Tang Ke and Secretary General of the State Council, Mr. Du Xingyuan, visited the Bank on September 14, 1984. The Minister of Petroleum met initially with Mr. Karoasmonoglu and Mr. Rovani and subsequently with Mr. Clausen and Mr. Dherse.

2. Mr. Tang Ke initiated discussion by expressing satisfaction at the level of cooperation which had been built up between the Bank and the petroleum sector in China. Over a short period of time, the World Bank had funded three projects and, while some problems were being encountered in procurement, the physical implementation of the projects was very satisfactory. Over and above the financial assistance which had been made available for these projects, his Government was especially grateful for the technical assistance which had been secured as a result of the Bank's participation.

3. The Minister then proceeded to give an overview of the petroleum sector. He indicated that when Mr. Clausen visited Beijing last year, some concern had been expressed at China's capability to sustain oil production at the level of 100 million tons per year and some of the Bank's experts had alluded to the possibility of an imminent decline in production. Since then, there had been a qualitative improvement in China's petroleum prospects. As a result of China's continuing exploratory efforts, additional reserves (oil-in-place) to the extent of 600 million tons had been established onshore; of this, 200 million tons were considered recoverable. Oil production in 1984 was likely to be of the order of 112 million tons; this was a significant increase over last year's production level of 106 million tons. Initially, the target of oil production established for 1990 was 120 million tons. However, in view of the oil reserves proven last year, target for oil production by the end of the decade had been raised to 150 million tons. In addition, by 1990 offshore oilfields would supplement production by at least 5 million tons. For natural gas, against the current annual production level of about 12 billion cubic meters, a target for onshore production by 1990 was fixed at about 20 billion cubic meters. Offshore, a significant gas discovery had already been made near the Hainan Island and the reserves were currently being estimated at about 100 billion cubic meters. Once the optimum end use pattern of this gas has been determined, the gas field would be developed which would add significantly to the annual production of gas within China.



4. However, massive capital investment would be required to sustain production from the existing oilfield and to discover and develop new oilfields in order to achieve the production targets established for 1990. This investment requirement would in part be funded by an internal mechanism where revenues from the production of oil in excess of a predetermined target, was earmarked for oil exploration. In addition, for exploring and developing its offshore areas, participation agreements had been entered into with a large number of foreign oil companies. Further, the Government of China was now in the process of inviting foreign oil companies to undertake exploration in some of its onshore basins. It is quite possible that some offerings be made by January 1985.

5. Internal resources and private equity capital notwithstanding, there was still a significant financial gap which needed to be bridged. It is in this context that the Minister wanted to determine the magnitude of World Bank assistance earmarked for China's petroleum program. Mr. Karaosmanoglu indicated that the Bank shared the Government's view that the highest priority should be afforded to its energy sector. It was for this reason that energy lending to China had been 25% of the Bank's overall lending. The Bank would continue to afford the same priority for the energy sector, but at this stage it would be difficult to put a precise figure on lending for the petroleum sector, which would depend on many factors including the overall IBRD lending agreed to with the Government.

6. The Minister indicated that it was his impression that the Bank was closing the door on lending for the oil sector. Mr. Rovani pointed out, that the Bank was currently in the process of reviewing its policy on oil and gas lending. Further, while it was quite possible that lending for oil may become somewhat restrictive in the future, Bank would continue to lend, as heretofore, for the gas sector and infrastructure related thereto. As China had a large petroleum sector, there should not be any difficulty in identifying and financing projects which conform to Bank's revised guidelines. For example, the Bank could help finance, inter-alia, government portion of the joint ventures with the foreign oil companies, the development of gas fields, oil and gas pipeline, service industry to support offshore exploration, training programs etc. However, for the Bank to identify appropriate projects for funding and in order to ensure that the lending continues at the present pace, it was necessary that the Government recommends, very early, a number of projects for Bank selection. This was agreed to.

7. Reverting to the issue of procurement, Mr. Rovani pointed out that while in the initial stages procurement was characterized by tardy decision making, most of the issues and procedural problems seem to have been resolved and the contracts under the first two petroleum projects were in the process of being awarded. However, it was important to learn from the experience of the previous two projects and ensure that similar problems do not recur for the Karamay Petroleum Project. Mr. Tang Ke agreed that the progress in regard to the procurement was less than satisfactory; it resulted from cumbersome bureaucratic methods within China and relative unfamiliarity with Bank procedures. Delay in procurement had resulted in China having to incur avoidable expenditure in terms of commitment fee, and he would very much wish to avoid similar waste of public resources in future.

8. In his meeting with Mr. Clausen, the Minister once again gave an overview of the oil prospects in China (para 3). He indicated that China was capable of not only sustaining the present level of oil production but also enhancing it significantly. However, to achieve the revised and somewhat ambitious targets in regard to oil production, China would require a massive inflow of capital resources. To achieve this, China had invited private oil companies to explore in its offshore areas and was now considering onshore basins for similar joint ventures. However, even after taking into account the resources which would become available from these ventures and the borrowings it would otherwise secure in the commercial market, there would still be a significant financing gap. Mr. Tang Ke, therefore, hoped that the Bank would not close the door on oil lending. Mr. Dherse clarified that it was not the Bank's intention to reduce the lending in the sector, but to use its limited resources for attracting additional capital in the form of commercial borrowings and private equity. Mr. Clausen endorsed China's policy of inviting private oil companies for oil exploration as it would result in an efficient transfer of both resources and technology. In that context welcomed its latest decision to invite international oil companies for exploration in its onshore areas. Mr. Tang Ke hoped that Mr. Clausen would use his good offices in securing from Bank's overall lending to China a larger share for the petroleum sector. In conclusion, Mr. Tang Ke stated that the financial assistance provided by the Bank would be very useful; however, what he valued more was the transfer of technology which the Bank had been instrumental in affecting and the technical assistance provided by the Bank staff.

Cleared with and cc. Mr. C. Koch-Weser, AEACH

cc. Mr. A.W. Clausen

Messrs. E. Stern (SVPOP); Jean-Loup Dherse (EISVP); A. Karaosmanoglu (AENVP); S. Kirmani, D. Turnham (AEPDR); G. Kaji (AEADR); Y. Kimura (AEACH); A. Vorkink (LEGEP); Y. Rovani, P. Bourcier, E. D. McCarthy (EGY).

VNayyar:njd

June 12, 1984

TO: Mr. Stern

Attila suggested that I send you a copy for your information. We will have the project ready to go, and will wait until they take a first step on adjusting the price (which we understand might well happen within the next 12 months) or give us a stronger statement.

To explain para. 2 of the letter: I had discussed a statement with them that would commit the government to achieving the objective (i.e., long-run marginal cost pricing or roughly doubling the present price) within the 7th plan period (1986-90). They didn't accept that and proposed "in the next few years" instead, as you have seen. When you reacted that we need a more specific timing of the first step, we proposed a statement that commits them to a first adjustment by the end of 1985.

  
Caio Koch-Weser

Beijing, June 7, 1984

Mr. Caio Koch-weser  
Chief, China Division  
The World Bank

Dear Mr. Koch-weser:

Thank you for your telex June 4, 1984 concerning the draft statement on coal price. As was explained to you and Mr. Turnham during your stay in Beijing last April, it is the Government's decision to raise the prices of energy, especially that of coal at an appropriate time as an essential part of China's economic reform. But when to do that must be considered in the context of the overall economic reform, and must not be dealt with as an isolated issue, otherwise it would cause unnecessary confusion. Premier Zhao Zhiyang, when meeting with the eight visiting Executive Directors on May 21, also explained to the Executive Directors China's position with regard to this issue; his explanation, I believe, won their sympathy and understanding.

The paragraph you proposed to be added at the end of the coal price statement, you must be aware, is actually a step backward compared with what you suggested last time when we met here. The Government, moreover, has not decided so far to raise the price of coal in 1985. We hope that the issue can be resolved in the light of mutual understanding and trust, and that the timing for price adjustment would be made more flexible. Accordingly, we recommend that the last paragraph of the draft statement be amended as:

Quote The Government plans to review the price of coal soon and to raise it over the next few years, hopefully within the Seventh Five Year Plan, in order to achieve and then maintain the objectives stated above. unquote.

We would appreciate it that you could make efforts as you have always done to explain to the management the Government's position so as to expedite the processing of the Project.

With best regards. I am,

Yours sincerely



(Wang Liangsheng)

Deputy Director,  
External Finance Department  
Ministry of Finance, PRC

## OFFICE MEMORANDUM

DATE March 23, 1984

TO Mr. E. Stern, Senior Vice President, SVPOP

FROM Attila Karaosmanoglu, Vice President, AENVP *AK*

EXTENSION 74503

SUBJECT CHINA - Internal Settlement Rate

1. The attached memorandum from Mr. Koch-Weser to Mr. Jaycox (dated March 22, 1984) addresses treatment of China's internal settlement rate (ISR) in Bank project documents. The memo proposes both an interim procedure and a preferred long-term solution. In considering this issue, you should be aware of several important points that have emerged in our recent discussions of the ISR with the Government and within the Bank.
2. First, our counterparts have done much to clarify application of the ISR but are not well placed to resolve this issue. They believe that the Bank's position will not be easily understood within the Government and have emphasized the need for more time to generate the necessary support internally for such an approach. A final solution will likely need the endorsement of China's senior officials.
3. Second, our procedure to date for dealing with the ISR was based on our initial understanding of its application (see attached, para. 2). An immediate change in our approach, to using the ISR as the only effective exchange rate, would draw attention to the ISR issue and could cause serious difficulties for the Government; it might even jeopardize the remainder of our FY84 lending program.
4. Third, the broader implications of a change in the Bank's approach should not be underestimated. The ISR has implications for all externally funded projects as well as joint ventures (see attached, para. 5). A change in the Bank's treatment of the ISR could affect the operations of other aid institutions and existing joint ventures, and cause considerable complications for negotiation of major new joint ventures.
5. Finally, I recognize that the interim proposal recommended by the staff after consideration of other alternatives is not optimum in terms of presenting projects to the Board, which is likely to raise probing questions about treatment of the remaining FY84 projects (see attached, para. 6). However, we are convinced that the Government will need time to digest the implications of a change in our approach and to generate acceptance for our proposed solution.
6. I therefore ask for your agreement to proceed as proposed in para. 7 of the attached memorandum.

Attachment

cc: Mr. Husain (OPSVP)

LMitchell:mac

*OK  
2)  
3/26**3-234*

## OFFICE MEMORANDUM

DATE March 22, 1984

TO Mr. E.V.K. Jaycox, Director, AEA

FROM Caio Koch-Weser, Chief, AEADF

EXTENSION 72565

SUBJECT CHINA - Internal Settlement RateBackground

1. During preparation of the first Economic Report, the Bank was informed that in connection with its moves to decentralize foreign trade management, China had introduced an Internal Settlement Rate (ISR) because of the differentials between Chinese and world prices. The ISR, which was set at \$1 = Y2.8 in January 1981 (the official exchange rate was then \$1 = Y1.5), would avoid creating incentives for imports and disincentives for exporters (see Economic Report Main Text, para. 5.35). At that time, it appeared that the ISR had a rather narrow application and had no relevance for Bank projects.

2. By late 1983, it had become clear that the ISR was applied more broadly than we had initially believed. The ISR did in fact apply to Bank (and other externally financed) projects. The effect of applying the ISR appeared to be twofold: i.e., it resulted in (i) a charge on the use of foreign exchange, and (ii) essentially a contribution from the Government if locally procured goods are financed through foreign loans. Based on this initial understanding, application of the ISR has been reflected in Bank projects recently presented to the Board. In the Power and Railways Projects (Board meeting on March 27), the effect of the ISR is shown as a line item on the project cost table as a charge on the use of foreign capital, because any Chinese agency wishing to use foreign exchange must purchase it at the ISR from the Bank of China, and imported asset values must reflect that rate. To be consistent with this approach, documents for projects involving local cost financing or local cost disbursement would need to show that the difference between the official rate and the ISR (Y 0.8 per dollar) was an additional contribution by the Government because part of the project is being funded from abroad. This contribution would reduce the need for other sources of local financing.

Outcome of Recent Discussions

3. Over the past few months, the Government has been very open in explaining the ISR to us. We have learnt that the ISR is the de facto rate of exchange for Chinese yuan to the U.S. dollar for all Chinese entities that use or receive foreign exchange, including capital flows and equipment imports under Bank Group projects. The official rate of exchange, now about Y2.0:\$1, is the conversion rate used for "foreign exchange certificate" yuan, which must be used by tourists and foreign traders and investors, and for remittances. In effect, the Government is operating two different currency and accounting systems--one for Chinese entities, denominated in regular yuan (the ISR) and one for foreign entities, denominated in "foreign

exchange certificate" yuan. The latter are convertible into regular yuan at a rate of 1:1.4; i.e. \$1 = "Y"2.0 = Y 2.8. For Chinese agencies using Bank/IDA funds, all costing, accounting, financing and disbursement and repayment obligations in fact take place at the ISR, though we have not to date shown this in our project analysis and reports to the Board, because we have only recently become fully aware of how this system works.

4. With a better understanding of the system, we now believe that the ISR should be treated as the effective exchange rate. However, there is little conceptual understanding in China of why the ISR and not the official rate should be used for our projects. It will be difficult for us to convince the Government of the reasons for this change. There seems to be considerable internal debate about the wisdom and rationale of the ISR and various monetary and trade authorities appear internally divided.<sup>/1</sup> This situation is further complicated by bilateral trade complaints--by U.S. groups in particular--based on interpretations of the ISR as a system of taxes on imports and of subsidies to Chinese exporters. Although the presentation that we had adopted as an interim solution is prima facie a little easier for the Government to accept, disgruntled trade groups may seize on this treatment of the ISR as proof of their claims of a trade subsidy. China's long-term interests may thus not be well served by this approach. National pride and inadequate understanding of economic theories within China make it politically difficult to discuss treating the ISR as an effective devaluation.

5. Officials in the Ministry of Finance argued strongly that we be sensitive to the difficulties they face. They urged us not to make changes now, certainly not for projects that had already been fully appraised. We should also recognize that the Government would need time to explain internally our switch to the ISR, and that this would not be a good time for such a change. It would probably have implications for other multilateral or bilateral aid programs and might also affect major joint venture negotiations. In addition, the Government does not want to do anything to rock the boat during forthcoming trade talks with the US. (However, we have explained that using the ISR as the effective rate of exchange is consistent with testimony used to refute charges of trade subsidies; as such it is in China's best interests.) Lastly, we have pointed out that conduct of our project dialogue using the effective (ISR) rate rather than an official rate is much more in keeping with our general effort to encourage sound price analysis and price reform. However, in view of the Government's difficulties, we propose an interim solution for projects already appraised.

#### Treatment of Remaining FY84 Projects

6. Four projects will be presented to the Board in the balance of this fiscal year. Two involve only foreign exchange financing (Karamay Petroleum and China Investment Bank II) and could be presented using the approach used

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<sup>/1</sup> Incidentally, the Government objected to the IMF considering that China has a dual exchange rate. While we have kept IMF staff informed of our findings, we have not yet consulted them on our preferred long-term solution of using the ISR as the effective exchange rate. However, we believe that the IMF would generally support this view.

for the Lubuge Project (see para. 2). A third project (Rural Health) involves a small amount of local cost financing, and "charge/contribution" treatment of the ISR would only result in a small contribution by the Government showing in our project documents. The fourth project (Rural Credit) was appraised using the official exchange rate, with IDA financing 35% of project cost and the Agricultural Bank of China (ABC) 35%, with subborrowers contributing 30%. Use of the "charge/ contribution" formulation of the ISR will result in the amount of yuan being onlent to ABC increasing by 40%, with the increase being presented as a contribution from the Government. The amount of the IDA credit would remain at \$50 million, but the combined contributions of IDA and the Government would amount to 49%, thus reducing financing required of ABC as stated in the documents presented to the Loan Committee. On project grounds we have no objection to this change in the financing plan.

Summary of Recommended Actions

7. We propose to inform the Government that after a transitional period, the ISR <sup>1/</sup> would have to be used as the effective exchange rate in Bank project documents. We would proceed with Board presentation of the CIB II and Karamay Petroleum projects using the "charge on use of foreign capital" formulation. The documents for the Rural Health and Rural Credit projects would show a "contribution from the Government". We would inform the Government that if questioned by the Board, we would explain China's application of the ISR and make known our intention to use only the ISR as the exchange rate for projects now being appraised.

cleared with and cc: Mr. Turnham (AEP)  
cc: Messrs. Karaosmanoglu (AENVP), Kirmani (AEPDR)

JRBumgarner:mac

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<sup>1/</sup> If the Government were to abolish the ISR and establish a unified exchange system, we would, of course, use that rate.





# Record Removal Notice



<b>File Title</b> China - General - Loan Committee Project File		<b>Barcode No.</b>  1058384		
<b>Document Date</b> 11/22/1983	<b>Document Type</b> Memorandum			
<b>Correspondents / Participants</b> To: Atilla Karaosmanoglu From: S. S. Kirmani				
<b>Subject / Title</b> China - Results of the First ICB's Civil Works Bids				
<b>Exception(s)</b> Information Provided by Member Countries or Third Parties in Confidence Deliberative Information				
<b>Additional Comments</b>		The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.		
		<table border="1"><tr><td><b>Withdrawn by</b> Bertha F. Wilson</td><td><b>Date</b> October 11, 2023</td></tr></table>	<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023
<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023			

## OFFICE MEMORANDUM

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9/14/83

DATE September 9, 1983

TO Mr. Ernest Stern, Senior Vice President, Operations

FROM Attila Karaosmanoglu, Vice President, AENVP *AK*

EXTENSION: 74503

SUBJECT: CHINA - Use of IDA Special Fund

1. By Mr. Adams' memorandum of July 27 to Ms. Pratt, the Region proposed allocating \$60 million in Special Fund resources to the Rural Credit project. You rejected this proposal on the grounds that in this project IDA would be financing only local expenditures.

2. We would now like to propose the Rubber Development project instead for use of the Special Fund resources. The Loan Committee has approved negotiations (now set for October 11) on the basis of a \$100 million IDA Credit. Of this total, about \$39 million are for non-ICB local costs for rubber plantings and windbreak establishment. Most of the balance (\$57.3 million) of the credit is allocated to ICB-procured equipment and fertilizers. There is a small unallocated balance of \$3.7 million.

3. To use the Special Fund resources we propose a pro-rata allocation (40:60) of Credit and Special Fund resources to local and foreign expenditures. In establishing the list of items to be financed from each source, we have taken account of both China's interest in access to the most cost-efficient sources of supply, (particularly in the case of vehicles and machinery), and the interest of Special Fund donors that they not be allocated items for which their suppliers are likely the lowest bidders in any event. An approximate breakdown of this allocation is shown in the attachment.

4. The only problem is that the introduction of Special Fund financing at this stage, after the approved documents have been sent to China and the Government is far advanced in its preparations, will need careful explanation to the Government, especially if we are to avoid further delay to this project (land clearing is set to begin this fall).

5. May we have your permission to proceed, please.

cc: Messrs. Jaycox (AEA), Kirmani, Turnham (AEP),  
Koch-Weser (AEA), Smith (AEP),  
Vorkink (LEG), Miller (LOA)

Attachment  
DBerk/JRBumgarner:mac

CHINA, RUBBER DEVELOPMENT PROJECT

Proposed Allocation of  
IDA/Special Fund Resources

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	<u>IDA</u>	<u>Special Fund</u>
	(\$ Millions)	
	(estimated local cost financing in parenthesis)	
Fertilizers		22.4
Sawmills		2.7
Timber Complexes		10.8
Plantations & Windbreaks <u>1/</u>	(15.6)	(23.4)
Unallocated	3.0	.7
 Vehicles & Machinery	 18.9	
Technical Assistance	1.3	
Training and Research Equipment	1.2	
	40.0	60.0

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1/ Force account construction against which reimbursement would be made at 30% of expenditures.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION  
OFFICE MEMORANDUM

RC/EK/file

DATE: September 14, 1983

TO: Files

FROM: Horst M. Scheffold, Loan Officer, LC1DC

EXTENSION: 72039

SUBJECT: DOMINICAN REPUBLIC - Port and Power Engineering Project  
Comments from Loan Committee

During the period of the Loan Committee's review, August 31 to September 2, 1983, the following observations were received from the Acting Senior Vice President, Operations (through Mr. Clements):

- a) the acting SVPO considers local cost financing (para. 6 of transmittal memorandum) would be acceptable to the extent that it involved expenditure on local consultants which would be financed in the case of foreign consultants;
- b) he stated that the proposed condition of disbursement (para. 8 of transmittal memorandum) should be made a condition of effectiveness;
- c) discussion of the institutional aspects of the Dominican Power Company (CDE) should be strengthened in the President's Report and a description of its financial conditions should be added;
- d) he stated that prior to Board presentation of the proposed Haina Coal Port and Power projects, a paper should be presented to the SVPOP reviewing the economic situation, the creditworthiness and the prospective lending program of the Dominican Republic.

In addition to the above, the Acting Senior Vice President made suggestions regarding the presentation of the President's Report.

Mr. van der Tak, reviewing the documents for OPSVP, made the following comments (through Mr. Raizen):

- a) noted that it was now Bank policy to apply standard country terms for engineering loans, which for the Dominican Republic would allow a repayment period of 17 years rather than the proposed 15 years;
- b) questioned whether the provision for physical and price contingencies was adequate;
- c) commented that the discussion of the investment programs for both, the port and power sectors (para. 25 of the President's Report), should be revised to provide a better explanation of the economic/financial viability of these programs, and in particular of the aspects for which engineering is being financed by the Bank loan should be provided;

d) asked for clarification of the role of the Dominican Ports Authority (APD) in relation to the coal port facilities and why it should not be the beneficiary of the proposed loan insofar as these facilities are concerned; also, the interrelationship between CDE and APD with respect to the coal port facilities should be discussed in more detail in the President's Report;

e) questioned the need for retroactive financing since a PPF is available; and

f) noted some apparent anomalies with regard to (i) the attribution of CDE and Government funds for financing local cost components of the projet and (ii) the basis proposed for disbursing the Bank loan to cover part of the project's local costs.

Mr. van der Tak also offered suggestions for the improvement of the President's Report.

cc: Messrs/Mme. Stern, SVPOP (4)  
Qureshi, FIN (2)  
Husain, VPOPS  
Shihata, VPGC  
Dherse, VPEGY  
Pouliquen, OPS  
Rotberg, VPTRE  
Rajagopalan, PAS  
Molares, LEG  
Mole, LOA  
Rovani, EGY  
Clements, SVPOP  
Raizen, OPSVP

Messrs/Mme. Ardito Barletta  
Steckhan, LC1DR  
van der Meer, LCPDR  
Jennings, LCP  
Meo, LC1DR  
Newman, LCP  
Martinez, LCP  
Engelmann, LCP  
Scheffold, LC1DC  
Wilson, LC1DC  
Koenig, LC1DC

## C. FICE MEMORANDUM

~~HA-ER~~  
- country  
file

TO: LIC

FROM: Andrew N. Vorkink *ANV*

SUBJECT: CHINA - Default on External Debt

DATE: January 13, 1983

A meeting was held on January 12 among Messrs. Stern, Kopp, Horsley, Jaycox, Scott, Goldberg and Vorkink to discuss Mr. Scott's draft memorandum to Mr. Clausen on the above topic.

The following were decided as initial steps for dealing with the current situation.

1. Mr. Koch-Weser, now in Beijing, should raise the subject with Chinese authorities and give them a copy of O.M.S. 1.28. In such discussions he should:
  - a) request an explanation of the Chinese position on the U.S. lawsuit on the bonds as to why they did not appear and what the Government now intends to do about the judgment; and
  - b) explain our policy, including that we have been and are applying it to other countries and that how we apply it to China depends upon their position on such matters; while we are not taking a stand on the merits of the bondholders' claims, an outright repudiation of all prior debts would give us difficulties.
2. Mr. Stern would send a copy of the memo to Mr. Clausen with a note that we are raising this issue with the Chinese.
3. Additional steps would await the results of Mr. Koch-Weser's discussions, including if necessary an appropriate period for the Chinese to consider their response.

cc: Messrs. Scott, Goldberg, Hassan  
Ms. Lichtenstein  
Messrs. Stern, Karaosmanoglu, Jaycox, Bumgarner

ANVorkink:fh

## OFFICE MEMORANDUM

*file - China'*

TO: Ms. Jane Pratt, SVPOP

DATE: December 3, 1981

FROM: Caio Koch-Weser, *CKW* Chief AEADFSUBJECT: CHINA - IDA/IBRD Lending Program for FY82/83

1. As we discussed over the phone, and with reference to Mr. Jaycox' memorandum to Mr. Stern of November 24, I am sending you two sets of documents which record the agreement reached in late March of this year between Mr. Stern and Mr. Husain to allocate US\$400 million of IDA resources to China during IDA VI, even if the Chinese Government borrowed not more than the same amount from IBRD, thereby accepting that the program blend for that period might turn out to be as soft as 50/50. The first set are internal memoranda and briefing notes addressed to Mr. Stern, or to Mr. McNamara or Mr. Clausen through Mr. Stern. The second set contains two letters written by Mr. Jaycox to Finance Minister Wang Bingqian, recording that the above decision was immediately communicated to the Chinese authorities and, since then, has been the basis for our lending program discussions with the Government. I would like to emphasize that we have always pointed out to the Government that China would have to borrow a minimum of US\$400 million from IBRD during IDA VI, and that we would hope that China would plan for a substantially larger total borrowing from the Bank Group than US\$800 million.

CKW:caa

cc: Mr. Jaycox (AEADR)

1981 ANNUAL MEETING BRIEFING PAPERMatters to be Raised by Mr. Clausen

1. In welcoming the Chinese delegation, Mr. Clausen may wish to express the Bank's appreciation for the Government's contribution towards the successful completion of the first Economic Report and approval of the University Development Project.

Political Developments

2. In July 1981 an important Communist Party meeting installed Hu Yaobang, a protege of Deng Xiaoping, as Chairman of the Party and made other leadership changes. It also approved a definitive statement on the historical role of Mao Zedong. A period of political stability is now expected. The leadership has turned its attention to long-term economic policies, and a sixth five-year plan is currently being prepared for 1981-5. The pressure of this work and 1982 budget preparation account for the absence of the Minister of Finance from the Annual Meetings. Mr. Clausen might wish to ask about the timing and likely directions of the plan.

Recent Economic Policies

3. After the Cultural Revolution (1966-76), the leadership initiated reforms aimed at providing lower-level units with more freedom of decision making, stronger incentives and better signals. However, they represent comparatively minor changes in a system that remains highly regulated and very inefficient. The leadership also gave improved living standards higher priority as a development objective. The new policies increased production and consumption sharply but also led to large unplanned budget deficits, coupled with strong inflationary pressure. This led in early 1981 to a switch in emphasis from medium-term structural adjustment to short-term stabilization. Price controls were stiffened; some recentralization of economic decision making was introduced; and capital construction expenditures were to be slashed by 40% from 1980 to 1981. However, efforts are being made to continue investment programs in priority sectors, most notably energy.

Key Economic Issues

4. The Government's drive to improve living standards will in the coming decade be subject to a tight set of interlocking constraints: agricultural land, domestic energy production, trained manpower, and foreign exchange and financial resources for new investments. In certain respects, however, prospects are more promising: population growth is slow; better planning and system reform could substantially increase efficiency; and access to foreign markets, technology and capital is much improved.

5. In agriculture, even relatively modest output growth will depend on effective research, regional specialization, improved management of water and other resources, training of labor, and tighter linkages between production and income. In energy, the outlook for domestic production is for only modest



growth rates of total primary energy production (2% per year) and electricity generation (4.3% per year) in 1980-85. Prospects for economic growth thus depend critically on reducing energy use, especially in heavy industry. To accomplish this will require planning by subsectors, reform of energy allocation procedures, and changes in energy prices. Industrial export performance will also largely determine the prospects for growth. Their rapid expansion has high priority and is contingent on updating industrial technology, improved designs for consumer and capital goods, stronger incentives for innovation and economic efficiency, and institutional changes that enable Chinese manufacturers to compete in world markets.

#### External Borrowing

6. China's need for imports of all kinds will be great, requiring the Government to decide how much to borrow. It has hitherto been very conservative about foreign borrowing. However, the relatively small external debt and the projections of the economic mission for the balance of payments and debt service capacity indicate that China is creditworthy for considerable additional borrowing. Given the limited availability of IDA and other concessionary aid, the Government should be urged first to draw down uncommitted bilateral official credit (\$2.6 billion), and second to accept more of the export credits, with interest averaging 7.5% per annum, offered to China (outline agreements for about \$14.5 billion). Mr. Clausen may wish to bring up the role that external borrowing can play in the implementation of the new plan.

7. During the last year China has drawn about \$1 billion from the IMF without drawing the upper credit tranches. Now, however, it is reportedly considering borrowing several billion dollars; the matter will be further discussed at the Annual Meetings. The IMF Managing Director will make a private visit to China in October.

8. The Government and the Bank have agreed that, for the IDA VI period, the lending program would be \$400 million of IDA VI funds and \$400 million of IBRD funds, for a total of \$800 million (including the FY81 University Development Project). The Government attaches great importance to this particular blend, probably to preserve its position for IDA VII and vis-a-vis other large blend countries. In fact, unlike other countries, it would rather maintain this blend than increase the total amount of lending by accepting a harder one. We continue to urge the Government to be flexible on this issue. China's vast population and low income per capita makes it eligible for large amounts of IDA after it has exhausted its creditworthiness. We have agreed with the Government to a work program that would allow us to commit about \$5.2 billion IBRD and IDA funds in the IDA VII period (FY84-86).

Work Program

9. The Bank's introductory economic report was circulated widely within China - including the State Council - and very well received at all levels. The Chinese officials found it objective, friendly, and also useful. They were impressed by its wide scope, its scale, and the speed with which it had been produced. They were particularly interested in the comparisons with other countries, the analysis of current problems and policy issues, and the illustrative projections which they found helpful in making their own projections for the new plan. The report will clearly take some time to digest both in China and in the Bank.

10. The findings of the economic mission indicate that the Bank should assist the Government in its efforts to (i) improve sector planning and investment criteria, and managerial and financial performance of institutions, in reforming the economic system; (ii) achieve better utilization of existing productive capacity and human resources, and quick production increases, required for adjustment of the economy; (iii) remove critical constraints to longer term development, e.g. in energy, agriculture, and education; and (iv) obtain an appropriate level of external concessionary funds, from the Bank and other sources.

11. We have agreed with the Government that the following sectors will receive priority: education, agriculture, energy, industry, and transportation. Seven firm and two standby projects are now being worked on for FY82/83.

Issues likely to be Raised by the Delegation

12. Taiwan Data. The Chinese delegation may take this opportunity to raise again the Bank's treatment of data on Taiwan. The Government's position is that Taiwan Province, as a part of China and with the legal status of a local administrative unit, ought not to appear in any statistical table on a par with China. The reinclusion of Taiwan statistics in the 1981 Annual Report is interpreted by the Chinese as the Bank treating Taiwan like an independent entity and is therefore unacceptable to the Chinese Government. Although the Chinese Executive Directors chose not to oppose the form "Taiwan, China" in the Annual Report, they do not regard this as a precedent for other Bank documents, preferring either exclusion of separate data on Taiwan or inclusion of such data under the heading "Other", with a footnote explaining that the figures are for China's Taiwan Province.

13. General Capital Increase. A supplementary note on this subject will be prepared on Mr. Thahane's return from China and after consideration of this matter by the Board on September 17.

# OFFICE MEMORANDUM

see p. 4

T, 2

DATE: June 18, 1981

TO: Mr. Robert S. McNamara  
(through Mr. Ernest Stern, SVPOP)  
FROM: S. Shahid Husain, AENVP  
SUBJECT: CHINA - Status of the Bank-China Relationship

1. The distribution to the Executive Directors of the introductory economic report and documents on the first project provides an occasion to review the status of the Bank-China relationship--what has been achieved over the past year and the prospects for the coming years. This memorandum provides that review and forms the background to the statement I intend to make at the presentation of the project scheduled for June 23.

## Evolution of the Relationship

2. Following your mission in April 1980, and the change in China's representation in the Bank in May, my July mission opened the way for our most important activities of the past year: the introductory economic mission and work on an initial operations program. At the end of 1980, debate intensified among the Chinese leaders on the need for further measures to stabilize the economy, notably by further reducing planned levels of investment. This debate led to decisions to cancel, or at least defer substantially, a number of important projects and cast some uncertainty over our own operations. Thus, other sources of external capital such as private banks and firms in Japan and the U.S. found their important projects delayed and their credit lines unutilized, while we were unable during a March operational mission to make much progress in defining activities for future work.

3. This period of uncertainty for Bank Group operations has now ended. In May, I led a mission to discuss the introductory economic report with the Government. The mission members were able to reach agreement with the Government on a program of lending for FY82 and FY83, and on associated studies and preparatory missions. Government agencies also made proposals on projects for FY84 and FY85.

## The Chinese Side of the Relationship

4. The relationship with the Bank is taken seriously at very high levels in the Chinese leadership. This is evidenced not only by your meeting with Deng Xiaoping and my own with Zhao Ziyang (now Prime Minister), but by our continuing access to Vice Premiers in the economic field and the wide distribution--including the State Council--of the economic report. The Government was quick to make institutional arrangements for handling the relationship with the Bank. A high-level Steering Group has been set up with seven core agencies as members. There is now a World Bank Division in the Ministry of Finance. A Loan Projects Office has been set up under the auspices of the State Foreign Investment Control Commission, to coordinate project activities and develop standard procedures with the aid of three panels on project design, equipment procurement and civil works contracting. The Executive Director's office is playing an important role, participating in the economic mission and in the continuing dialogue between the Government and the Bank. The Government's efforts contributed to the rapid processing of the first project for Board presentation.

5. It will be a considerable time before these groups are fully effective in furthering our policy dialogue with the Government and for day-to-day operations. It is proving difficult to find staff with the necessary language skills and technical/professional backgrounds. The Government is aware of these problems, however.

#### Achievements to Date

6. Economic Work. The green cover draft of the introductory economic report, including all the annexes, was sent to the Government for review at the end of March. It was very rapidly translated into Chinese and circulated to all the relevant ministries and agencies, including the State Planning Commission, the Ministry of Finance, and the State Statistical Bureau, as well as to the State Council. It appears to have been very closely studied (as evidenced by the large number of detailed corrections made to statistical tables, discussions of institutional procedures, etc.).

7. Discussion of the report took place in early May. The State Planning Commission and Ministry of Finance led the discussion for the Chinese side, though separate discussions were also arranged with the relevant ministry or agency for each annex. The discussions began at the working level and moved upwards. The final meetings were with the Minister of Finance and Vice Premier Gu Mu. The atmosphere at the meetings was most cordial.

8. In substance, the report was very well received at all levels. The Chinese officials found it objective, friendly, and also useful. They were impressed by its wide scope and by its scale, as well as by the speed with which it had been produced. They were particularly interested not only in the comparisons with other countries, but also in its analysis of current problems and policy issues, and in its illustrative projections for the future. They found the latter helpful in making their own projections for the Sixth Five-Year Plan (1981-85), which they hope to complete by the end of 1981 or early 1982.

9. The authorities in general chose not to discuss the text of the report paragraph-by-paragraph (apart from the specific factual corrections mentioned earlier, and politically sensitive points of history, ancient and modern). Instead, where they disagreed with the report on important issues, they presented an alternative point of view for general discussion, leaving us free to make whatever amendments we felt were appropriate.

10. The main disagreement they had concerned the conclusion that China was likely to become a substantial importer of oil by the end of the 1980s. They were confident that oil production could be maintained at about its present level of 100 million tons per year (though they were unable to provide further information to support this view, apart from reports of recent discoveries) and that opportunities for very large energy savings exist. China does not intend to become an oil importer, although the Government accepts that this is a possibility if appropriate measures are not taken soon to accelerate energy development and conservation. The

report has been revised to show substantial oil imports as a possibility only if energy conservation is less than highly successful, and the possibility of a positive trade balance in oil even at the end of the decade has been included in the sensitivity analysis.

11. Operations. The initial operations program discussed in July 1980 contained six projects in education, agriculture, transport, and power. As a result of the changes in government priorities, not all of these have been retained in the program agreed in May 1981 (Attachment II). Our joint efforts have enabled the first project, the \$100 million loan and \$100 million credit for University Development, to be processed relatively quickly. The ports and first agriculture projects have also been advanced, with appraisal missions scheduled for July and this fall, respectively. In addition, EDI's program has got off to a good, quick start with a project planning seminar for senior officials being held in Washington in May and another in Shanghai in June.

#### Next Steps

12. During the coming months, our program will focus on the following main items:

- (i) initiating further economic and sector work in FY82;
- (ii) initiating and establishing a program of collaborative research on economic development with Chinese institutions;
- (iii) continuing or initiating work on the agreed program of projects for lending in FY82 and FY83;
- (iv) securing Government agreement to a set of projects for lending in FY84 and 85 to ensure their timely preparation;
- (v) preparation of the first CPP on China for Senior Management Review before the end of 1981; and
- (vi) an intensive program of EDI courses in China in a variety of fields.

13. Economic and Sector Work. The Government proposes to translate the grey cover introductory economic report so that it will have a wider audience in China. After it has had an opportunity to review this final version, we intend to secure the Government's agreement to early publication of the report by the Bank; the report has a large potential audience in the business and academic communities, and probably also to some extent among the general public, and its publication seems likely to benefit the Bank.

14. The time needed for the report to be widely circulated and assimilated in China suggests that its effect will continue to be felt for some time to come. The Bank also has to absorb its messages and act on its

recommendations and implications. Nonetheless, we have proposed a program of further economic work in FY82 to the Government, but with flexible timing. In the introductory report, we could only begin to address certain issues, and our understanding of some important matters is still rudimentary or lacking. On the macroeconomic side, we have proposed work on China's medium-term prospects, which will need to be examined in the context of the Sixth Plan, and on how to further the process of system reform. We will discuss the schedule for this work with the Government in July.

15. In addition, we believe it would be mutually advantageous to enter into a program of collaborative research with Chinese institutions. We have made arrangements for the coordination of such a program on the Bank side. We have also written to the Academy of Social Sciences, which has expressed interest in collaboration.

16. The bulk of our FY82 economic and sector work (see Attachment I) will be the program of sector work agreed in broad lines in May. However, the Government is still not fully cognizant of the role of sector work in Bank operations. We also need to assure that our lending takes place in the context of a satisfactory dialogue on overall economic and sector policies. The agreed work program, which is large, is likely to extend into FY83.

#### Operations

17. FY82/83 Program. Our meetings in May confirmed the agreement reached earlier that for the remainder of IDA VI, the Bank would allocate to China, and China would borrow, \$400 million of IDA VI funds and \$400 million of IBRD funds, for a total of \$800 million (including financing for the FY81 University Development Project).

18. You are aware of the importance the Government attaches to this particular blend; in fact, unlike other countries, it would rather maintain this blend than increase the total amount of lending by accepting a harder blend. Although we have urged the Government to be flexible on this issue, we should not press it in the near future to take additional IBRD funds. The Government also wishes to have a 50:50 blend for each individual project during this period. This is unacceptable, and we have urged instead that funds be allocated flexibly, aiming at IDA-only and IBRD-only projects to the extent possible. The Government stated that it would have to give further consideration to this issue, and we intend to pursue the matter further in future. \*

19. In accordance with both the Government's priorities of adjustment and reform of the economy and the findings of the economic mission, we agreed that the following sectors would receive priority in our work: agriculture, light industry, energy conservation and production, transport (particularly ports), and higher, adult and technical education. After FY83, health lending will also be considered. Within these sectors, priority will be given to measures that improve efficiency and to projects aimed at increasing the productivity of existing capacity.

20. We agreed to continue or initiate work in the near future on a lending program of eight projects for FY82/83 (see Attachment II). With the addition of standbys, we intend to aim at two firm projects for \$225 million with one (still rather uncertain) standby in FY82, and six projects for \$375 million with 3 standbys in FY83.
21. EDI will offer five courses during FY82, focusing on both macro-economic topics and project analysis.
22. Another Regional activity that will help to rapidly familiarize a limited number of Chinese officials with Bank project work is a study tour of selected projects in the Philippines, Pakistan and possibly Thailand. This tour is being arranged for the late summer.
23. FY84-86 Programs. We have further agreed with the Government that for planning purposes, we should aim at a work program that would allow us to commit about \$5.2 billion in the IDA VII period (FY84-86). The Government has requested a blend of at least 50:50 IDA:IBRD for IDA VII, but is aware that this issue cannot be settled in the near future. In May, we reviewed a long list of project proposals for FY84 and FY85 with the Government; some had been suggested by the core agencies and others independently by sector ministries. The list is tentative at this stage: the Government plans to review the projects further and confirm their priority before work on them begins. Their review is expected to be completed in the next few months. Even if the full lending program referred to above should not materialize because of IDA resource constraints, the program is likely to substantially increase between FY83 and FY84, and it would require a much increased effort by both China and the Bank to prepare such a program. Delays in making decisions during FY82 could well undermine achievement of the lending objectives for FY84 and FY85.
24. Country Program Paper. We shall shortly start preparing the first CPP on China. This will build on the introductory economic report and on the agreements reached and expected on projects for the early years of the period covered. However, the timing is too tight to take account of the new five-year plan. The CPP will be reviewed with the President in late November. We shall discuss the program with the Chinese authorities as appropriate in an attempt to ensure that it broadly fits in with their priorities.
25. We have agreed with the Government on a semi-annual review of the program with the State Planning Commission, the Ministry of Finance, the State Capital Construction Commission and the line ministries. The first such review will take place after the CPP review, and we have proposed a date before the end of the year.

### Conclusions

26. The Bank can look back with some satisfaction on its first year of dealings with the People's Republic of China. The main achievement has been the beginning of a dialogue marked by great friendliness on the government

side and a willingness to make special arrangements for doing business with the Bank. We have come to know leading actors in the economic field, and they in turn have begun to understand the Bank. Our efforts in writing and processing the economic report, including its very positive reception by the Government, were highly successful. We have brought our first project to the Board and agreed on a program that can provide a modest buildup of lending in FY82 and FY83.

27. It is still necessary to emphasize that our relationship with China is a new one, and that the level of activity and the quality of our dialogue may fluctuate as they have done in the past year. The availability of much fewer IDA funds than we expect could restrict our operations and greatly impede development of the relationship. The Government has no medium-term plan and its economic management is somewhat weak. Also, it may not yet completely be certain on how to proceed in many areas. Proposals for Bank economic and sector work beyond FY82, and lending activities in the outer years of our operational programs in particular, are therefore highly tentative.

Attachments (2)

cc: Messrs. Hasan, (AEN)  
Kirmani, Wyss (AEP)  
Jaycox, Koch-Weser, Lim (AEA)  
AEADF staff

DBerk:mac



Sector Work to be Completed or Initiated in FY82

<u>Sector</u>	<u>Topic</u>	<u>Description</u>	<u>Relation to Operations</u>
<u>Agriculture</u>	Agricultural Credit	Financing of agricultural investment and possible Bank assistance (to be studied at same time as financial intermediaries in industry)	Agricultural Credit component in North China Plains (FY82); possible Agricultural Credit (FY84/5)
	Irrigation/ Drainage	Review of irrigation/drainage problems, initially in North China Plains	North China Plains I (FY82) and II (FY84/5)
<u>Industry</u>	Financial Inter-mediation	Process of allocation of investment resources, especially role of banking system, institutional arrangements, project evaluation, priority subsectors	Industrial Credit (FY83 and 84/5)
<u>Energy</u>	Energy Conservation	Energy efficiency in specific subsectors (initially in heavy industry)	Energy Conservation (FY84/5)
	Coal	Limited study leading to project identification, and later to larger study of links between coal/transport/power	Coal I (FY84 S) and Coal (FY84/5)
<u>Transport</u>	Highways/Inland waterways	Study of transport in limited geographical areas	FY84/5 projects
<u>Education</u>	Post-secondary non-degree manpower	Requirements for polytechnics	FY84/5 project
<u>Health</u>	Sector study	Rural health services and health manpower training	FY84/5 project
<u>Construction</u>	Sector study	China's ability to participate in ICB for civil works in Bank projects in China and abroad	All projects with civil works component

Operations Program, FY81-84S

<u>Fiscal Year</u>	<u>Project</u>	<u>Description</u>
81	University Development	Expansion and improved quality of science and engineering teaching and research at 26 universities, including improved management
82	North China Plains	Reclamation of land for grain and cash crops, and water master planning
	Three Ports Development	Container and coal berths at Tianjin, Shanghai and Huangpu, estuarial studies and master planning
83 S	Petroleum I	Daqing secondary recovery
	Heilongjiang Grain	Development of state farms in northeast China for grains and soybeans
	Agricultural Training and Research	
	Industrial Credit	Pilot project with DFC (to be created) for one or two activities (textiles/light industry/energy conservation/exports) in one area (possibly Shanghai or Tianjin)
	Energy Conservation Center/ Industrial Management Training <u>1/</u>	
	Petroleum II	Development of 3 new onshore fields
84 S	Coal I	Possibly Luan/Jincheng mines in Shanxi province in north central China
S	Power I	Possibly Lubuge Hydropower (Yunnan province in south China) or Shanxi-Beijing/Tianjin transmission line
S	Education II	Adult education/TV university

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1/ May eventually be combined with other project(s).

## OFFICE MEMORANDUM

CONFIDENTIAL

TO: Mr. Robert S. McNamara  
(through Mr. E. Stern)

DATE: April 24, 1981

FROM: Edward V.K. Jaycox (Acting RVP, AEN)

DECLASSIFIED

SUBJECT: CHINA - Your Meeting with Vice Minister of Finance Li Peng,  
Monday, April 27, at 4:15 p.m.

NOV 30 2022

WBG ARCHIVES

1. Vice Minister Li Peng, Alternate Governor of the Bank, is leading a large delegation to negotiate the Bank's first loan and credit (University Development Project) to China. (He will also head the Chinese delegation to the Development Committee meeting in Gabon.) You met Mr. Li a year ago in Beijing and again at the Annual Meetings. He has asked for a meeting because this will be the last opportunity for a visiting Chinese delegation to meet with you before your departure from the Bank. We do not expect the Chinese side to raise any particular issues with you, but Mr. Li will probably ask for your assessment of the IDA situation, the expansion of future Bank lending, and the likely outcome of the Gabon meeting. The following suggests a number of points you may wish to raise. The attached Country Brief (which was prepared for Mr. Clausen) summarizes China's development record, present readjustment policies, key economic issues for the 1980s, the Government's objectives, and the Bank's dialogue and operations to date.
2. The Government's Present Economic Policies. You may wish to inquire about the Government's present policies of sharp, short-term stabilization, its longer-term development priorities, and its plans for making use of available external resources. - The Sixth Five-Year Plan, due last year, will not be formulated until the end of 1981, at the earliest. The present substantial cuts in investment are not being made in the context of an overall medium-term investment program; therefore, their costs in terms of future capacity constraints on production growth in particular sectors could be very great. But with the current emphasis on short-term stabilization, little consideration seems to be given to alternative longer-term strategies.
3. The Bank's Economic Report on China. You may wish to point to the excellent cooperation between the Government and the Bank's first economic mission, and to the considerable interest of the Bank's member governments in seeing the Economic Report after it has been reviewed with Government. - A Bank mission, led by Mr. Husain, will review the report and its six sector annexes (agriculture, industry, energy, transport, education, and population, health and nutrition) with the Government in early May. Board distribution is tentatively planned for end-May.
4. Size and Blend of Bank Lending Program. You may wish to mention again that the volume and blend of future Bank lending to China hinge on the elaboration of China's longer-term borrowing plans and also depend on the agreements to be reached between governments on the Bank's future financial plans. As to the remainder of IDA VI, you may wish to confirm that the Bank has agreed to a blend of \$400 million IDA and \$400 million or more IBRD.

5. China's low income per capita (\$256 in 1979) makes it eligible for large amounts of IDA lending. But the country's relatively small external debt and the alternative projections of the economic mission for the balance of payments and debt service capacity also indicate that China is creditworthy for substantial amounts of IBRD lending in the coming years. The Government's present policies of economic retrenchment have led to an increased reluctance to borrow large amounts on conventional (and IBRD) terms; the strong request for a 50/50 IDA/IBRD blend for its borrowing from the Bank Group during IDA VI and IDA VII; the anticipation of a slower build-up of Bank operations to lower borrowing levels than indicated last July; and the request for smaller individual project and loan size in the early years. In the immediate future, the Bank cannot expect to persuade the Government to request larger amounts of IBRD lending, thus hardening the IDA/IBRD blend. Rather, the Bank will initially have to develop a broad dialogue with the Government on how the country can best make use of available external resources to achieve its objectives of modernization and adjustment of the economy.

6. University Development Project. You may wish to point to the major efforts by the Government and the Bank to conclude a first project agreement within about a year of China's change of representation in the Bank. The Chinese leadership is anxious to see the project presented to the Board before your departure from the Bank and wishes to indicate its willingness and ability to move quickly in developing China's relations with the Bank. In this period of economic retrenchment, the Chinese authorities are concerned about world-wide perceptions of their trustworthiness in business deals, and about their ability to follow through on commitments. Therefore, their "performance" in concluding an early project agreement with the Bank is important to them. For these reasons, they have decided to move ahead on this project, although their entire investment program remains in a state of flux. We are planning to present the project to the Board on June 23.

7. The Bank has agreed to a 50/50 IDA/IBRD blend for this first operation, consisting of a \$100 million loan and a \$100 million credit. The total project cost is \$300 million. The project would strengthen higher education and research in the fields of science and engineering. It would provide civil works, furniture, equipment, specialist services, fellowships, and other related inputs to: (a) increase the number of graduates and the volume of research work at 26 leading universities; (b) raise the quality of graduates and research work at these universities; and (c) strengthen management at universities and the Ministry of Education.

8. Bank Country Assistance Strategy. You may wish to point to the difficult economic issues the Government will have to face in the 1980s in agriculture, industry, energy, and education (see attached Country Brief); the Bank would be willing to cooperate with the Government in these areas. Mr. Husain's forthcoming mission would expect to reach agreement with the Chinese authorities on the subsectors and types of lending that should receive initial priority in the Bank's work and on a program of economic and sector work for the coming year, which would lead to the development of a pipeline of lending operations.

9. The tight set of interlocking constraints on development that China faces in the 1980s and the priorities set by the Government for its investment program indicate that the Bank's technical and financial assistance should focus on energy, industry, agriculture, education and transportation. In energy, the Government has expressed interest in involving the Bank in enhanced oil recovery in existing fields and on-shore petroleum exploration and development, coal mining, and power generation. In the industrial sector, the Bank might assist in energy conservation, training, selective rehabilitation of large enterprises, and financial intermediation to support many small investments. In agriculture, the Bank could support irrigation, cash-crop development, training and research, and credit. In education, the Government has expressed interest in continued Bank involvement in university development, and in its assistance in developing vocational and technical training, adult education, and teacher training. Finally, in transport, the Bank expects to finance port improvement programs and might assist in developing highways and railways.

10. Due to the absence of a systematic, longer-term planning framework in most of these sectors, work on projects will, in many cases, have to be preceded by careful sectoral and inter-sectoral studies. We are therefore planning an extensive program of economic and sector work for the coming years.

Attachment

CKW:dce

*for Dr. Q. in* *See p. 4 and annex table*

CHINA

COUNTRY PROFILE (1980) /a

Population (million)	977	Exports (GNFS)/GNP (%)	7
Growth rate (%)	1.3	Exports per capita (\$)	18
Labor force gr. rate (%)	2.0	Primary excluding food	5
GNP per capita (US\$)	256 /b	Manufactures	8
Growth rate (3 year average) (%)	7	Net petroleum imports p.c.(\$)	-
Investment/GNP (%)	29	Current account balance/GNP (%)	-0.5
Savings/GNP (%)	28	Debt service/GNP (%)	0
Poverty incidence (%):		Debt service ratio (%)	less than 3
Rural	n.a.	Net transfer/GNP (%)	
Urban	n.a.	Total medium & long term	0
Fertility	2.8	Bank	0
Adult literacy (%)	66	Bank opns. 1978-80 averages:	
Life expectancy (years)	64	Commitments/GNP (%)	0
		Number of projects per year	0
		Debt outstanding and disbursed (\$m)	3,400

/a Because data are more recent and because of differences in concepts and definitions, the country data are not directly comparable with those shown in Table 1.

/b for 1979.

Source: Country Data

Development Record

1. China has an extremely varied climate and terrain, huge energy resources, a vast, largely self-sufficient and diversified production base, and a highly literate, disciplined population. Over the past three decades, development efforts have been aimed at two main objectives: elimination of the worst aspects of poverty; and industrialization, with an emphasis on heavy industry. Chinese development strategy has been constrained by an extreme shortage of cultivable land and a high degree of international isolation.

2. Efforts directed at alleviating poverty began with an initial phase of redistribution, followed by agricultural development programs and widespread provision of social services, based mainly on local resources and initiative. Despite slow growth of agricultural production in relation to population, the results have been very impressive. At the same time, rapid industrialization of the economy resulted from a massive infusion of centrally mobilized capital, with little concern for cost-effectiveness, and using technology largely dating from Soviet designs of the 1950s. Growth of per capita GNP was well above the average for low-income countries (2.7% per year in 1957-59; per capita GDP of \$256 in 1979). However, consumption has grown significantly slower than income, owing to an unusually high savings rate (over 40% in 1957-79). Nonetheless, China's most remarkable achievement has been to make low-income groups far better off in terms of basic needs than their counterparts in most other poor countries. Over the past decade, the country has also been phenomenally successful in reducing its population growth.

3. After the Cultural Revolution (1966-1976), the new leadership initiated a set of reforms, aimed at providing lower-level units with more freedom of decision-making, stronger incentives and better signals. Although these reforms are well focused on basic weaknesses of China's socialist economic system and have improved cost consciousness of enterprises and communes and the range and quality of consumer goods and services, they represent comparatively minor changes in a system that remains highly regulated and very inefficient.
4. The new leadership also gave increased living standards higher priority as a development objective. It took steps to raise the share of consumption in aggregate demand and the share of consumer goods in aggregate production. It planned to reduce the share of investment in budget expenditures, and to spend more on housing, education, health, agriculture and light industry. Urban wages and agricultural procurement prices were raised substantially. Agricultural production, light industrial output, and real consumption per capita rose sharply from 1978 to 1980.
5. The new policies were less successful in other respects. The Government seriously miscalculated their effects on the budget and on the balance between aggregate demand and supply, partly because it failed to achieve the planned reductions in investment. There were large unplanned budget deficits in 1979 and 1980, coupled with strong inflationary pressure that was only partly suppressed by the price control system.
6. This led in early 1981 to a switch in emphasis from medium-term adjustment to sharp, short-term stabilization. Price controls were stiffened; some re-centralization of economic decision-making was introduced; and capital construction expenditures were to be slashed by 40% from 1980 to 1981, resulting in the abandonment of a large number of major projects, including those financed from foreign sources. However, efforts are being made to continue investment programs in priority sectors, easing critical constraints on further expansion of domestic production, most notably energy.

#### Key Economic Issues

7. The Government's drive to improve living standards will in the coming decade be subject to a tight set of interlocking constraints: agricultural land, domestic energy production, trained manpower, and foreign exchange and financial resources for new investments. In certain respects, however, prospects are more promising: population growth is slow; better planning and system reform could substantially increase efficiency; and access to foreign markets, technology and capital is much improved.
8. In agriculture, further output growth is limited by land scarcity and by the fact that the easier advances in intensive cultivation have already been made. The foodgrain balance will thus remain precarious. Even relatively modest output growth (2.3% per year for foodgrains, 3% for total agricultural output) will depend on vigorous and skilful implementation of policies of agricultural research, greater specialization of output mix in line with local comparative advantage, improved management of water and other resources, training of labor, and tightening of linkages for production teams between production and income. As in the past, however, rapid growth of industrial output of commune and brigade enterprises is likely to boost rural income growth.

9. The outlook for domestic energy production has recently deteriorated, with oil output peaking in 1979 (106 million tons) and likely to fall to about 90 million tons in 1985. With only modest growth rates projected for total primary energy production (2% per year) and electricity generation (4.3% per year) in 1980-85, prospects for economic growth depend critically on reducing energy use per unit of industrial output. The bulk of the large potential for energy saving is in heavy industry, which accounts for about 60% of commercial energy use. To accomplish this will require thorough advance planning by major subsectors, reform of energy allocation procedures, and changes in energy prices.

10. The performance of the industrial sector -- in economizing on energy, materials and capital, in earning foreign exchange, and in technological innovation -- will largely determine the extent to which the main constraints on economic growth can be eased. Expansion of manufactured exports must have high priority, based on the abundance of skilled low-wage labor and the enormous potential for economies of scale. But such rapid export growth is contingent on updating of industrial technology, improvements in the design of both consumer and capital goods, stronger incentives for innovation and economic efficiency, and various institutional changes enabling Chinese manufacturers to compete in world markets. Serious shortages of skilled and managerial manpower, due to the upheaval of ten years of Cultural Revolution, plague the industrial sector (and other sectors of the economy) and will take years to remedy.

11. The need for imports will be great -- imports of oil for fuel and raw materials, food to increase consumption, and capital goods to contribute to modernization. Faced with these needs, the Government must decide how much to borrow. In the longer term, two key determinants of the optimal level of China's foreign borrowing, namely the rate of growth of manufactured exports and the efficiency with which capital is used, are both dependent on reform of the economic system and improvement of economic management. But in the present situation of adjustment, borrowing decisions in a country that has large unused lines of foreign credit and small debt service commitments should also take account of the social and political utility of additional present consumption, benefits from fuller use of installed capacity, and the dampening effects of increased imports on domestic inflation.

#### Government Objectives

12. The virtual absence of medium-term planning since 1958 has aggravated the inefficiencies of the Chinese economic system. Apart from political interference, longer term planning efforts have been impaired by technical weaknesses in annual planning and project appraisal, a poor data base, and an unsatisfactory balance of responsibilities between central and local government.

13. The Sixth Five-Year Plan, due last year, will not be formulated until the end of 1981, at the earliest. The present substantial cuts in investment are not being made in the context of an overall medium-term investment program; therefore, their costs in terms of future capacity constraints on production growth in particular sectors could be very great. But with the current emphasis on short-term stabilization, little consideration seems to be given to alternative longer-term strategies.



14. In the absence of a long-term, economy-wide plan and, indeed, an adequate technical planning capacity, the Government has so far only indicated broad sectoral and sub-sectoral development priorities -- to be addressed within the constraints of its curtailed investment program: energy production and conservation; light industry; agriculture, with emphasis on new land development, irrigation, research and training; education, particularly higher and technical education; and transport, especially port development.

#### Bank Response and Dialogue

15. The formulation of a detailed, longer-term strategy of Bank assistance to China hinges on the elaboration of China's Five-Year Plan. It is also constrained by the Government's recent shift in emphasis from medium-term adjustment toward short-term stabilization of the economy.

16. The relationship between China and the Bank developed rapidly after the change of representation of China in the Bank, in May 1980. A first operational mission in July 1980 agreed with the Government on two parallel lines of action: (i) preparation of a major introductory economic report on the country's past development performance, economic system and future prospects, which -- together with the Sixth Five-Year Plan -- would serve as a foundation for formulating a program of cooperation in the first half of 1981; and (ii) work on an initial operations program of six projects (university education, irrigation, ports development, railways, hydro-power and thermal power) so that lending could commence soon.

17. A large economic mission spent over two months in China in late 1980; its report, including six sector studies, will be reviewed with the Government in May and sent to the Executive Directors soon thereafter. A number of project missions have worked with various sector ministries on the initial operations program. But the program has been affected by the recent drastic cut in the Government's investment program. The size of the most advanced operation, the University Development Project, has been reduced substantially. In its revised form, the loan is still to be approved by the Board in late FY81 or early FY82. The agriculture and ports projects are proceeding on schedule; the two power projects will probably proceed at a later time; and the railways project has been dropped.

18. China's low income per capita makes it eligible for large amounts of IDA lending. But the country's relatively small external debt and the alternative projections of the economic mission for the balance of payments and debt service capacity also indicate that China is creditworthy for substantial amounts of IBRD lending in the coming years. The Government's present policies of economic retrenchment have led to an increased reluctance to borrow large amounts on conventional (and IBRD) terms; the strong request for a 50/50 IDA/IBRD blend for its borrowing from the Bank Group during IDA VI and IDA VII (the Bank has agreed to a blend of \$400 million IDA and \$400 million or more IBRD for the remainder of IDA VI); the anticipation of a slower build-up of Bank operations to lower borrowing levels than indicated last July; and the request for smaller individual project and loan size in the early years (probably in the range of \$80-100 million per loan rather than \$170-200 million as assumed earlier). In the immediate future,

the Bank cannot expect to persuade the Government to request larger amounts of IBRD lending, thus hardening the IDA/IBRD blend. Rather, the Bank will initially have to develop a broad dialogue with the Government on how the country can best make use of available external resources to achieve its objectives of modernization and adjustment of the economy.

19. The findings of the economic mission indicate that the Bank should pursue the following basic objectives in its economic and lending work. The Bank should assist the Government in its efforts to (i) improve sector planning and investment criteria, and managerial and financial performance of institutions, in the course of the reform of the economic system; (ii) achieve better utilization of existing productive capacity and human resources, and quick production increases, required for the adjustment of the economy; (iii) remove critical constraints to longer term development, e.g. in energy, agriculture, education and transportation; and (iv) obtain an appropriate level of external concessionary funds, both from the Bank's own resources and from other sources, e.g. through cofinancing.

20. These objectives have not yet been translated into a detailed work program for the next years. After review of the economic report with the Government, the Bank plans in May to reach agreement with the Chinese authorities on the subsectors and types of lending which should receive initial priority in the Bank's work and on a program of economic and sector work for the coming year which would lead to the development of a pipeline of lending operations.

21. The tight set of interlocking constraints on development that China faces in the 1980s and the priorities set by the Government for its investment program indicate that the Bank's technical and financial assistance will focus on energy, industry, agriculture, education and transportation. In energy, the Government has expressed interest in involving the Bank in enhanced oil recovery in existing fields and on-shore petroleum exploration and development, coal mining, and power generation. In the industrial sector, the Bank might assist in energy conservation, training, selective large enterprise rehabilitation, and financial intermediation to support a large number of small investments. In agriculture, the Bank could support irrigation, cash-crop development, training and research, and credit. In the field of education, the Government has expressed interest in continued Bank involvement in university development, and in its assistance in developing vocational and technical training, adult education, and the training of teachers. Finally, in transport, the Bank expects to continue its financing of port improvement programs, and might assist in developing high-ways and railways.

22. Due to the absence of a systematic, longer-term planning framework in most of these sectors, work on projects will, in many cases, have to be preceded by careful sectoral and inter-sectoral studies. The Bank is therefore planning an extensive program of economic and sector work for the coming years.

Table II A (i) - LENDING VOLUME - CHINA (INCLUDING SECTOR CONTRIBUTION)

(\$ million)

China	Annual		Five-Year Totals		1979 GNP per capita	1979 Popu- lation (mln)	Lending per capita FY82/83 Annual Average (US\$)
	FY82	FY83	FY79-83	FY81-85			
IBRD	150	450	600	n.a.	\$256	970.920	IBRD 0.31 IDA 0.21
IDA	150	250	400	n.a.			
Total	300	700	1,000	4,250			
Constant FY80 \$	263	577	840	3,274			
<u>Sector</u>							
Agriculture and Rural Development	80	100	180				
Industry		100	100				
Population, Health and Nutrition	-	-	-				
Education	50	100	150				
Oil, Gas & Coal	-	200	200				
Power	-	100	100				
Transportation	170	100	270				
Total	300	700	1,000	4,250			
<u>Number of Operations</u>							
Agriculture and Rural Development	1	1	2				
Industry	0	1	1				
Population, Health and Nutrition	0	0	0				
Education	1	1	2				
Oil, Gas & Coal	0	2	2				
Power	0	1	1				
Transportation	1	1	2				
Total	3	7	10	28			

1,5

OFFICE MEMORANDUM

Confidential

TO: Messrs. S. Shahid Husain and Edward V.K. Jaycox DATE: April 8, 1981

DECLASSIFIED

FROM: Caio Koch-Weser *CKW*

NOV 30 2022

SUBJECT: CHINA: Education Project

WBG ARCHIVES

1. At a meeting today (April 8), the Vice-Minister of Education informed Mr. ter Weele that he had just returned from a meeting with Vice-Premier Deng Xiaoping where a decision was made on the education loan. Deng Xiaoping had asked that his personal greetings be conveyed to Mr. McNamara; he had emphasized the importance of beginning the relationship with the World Bank on a positive note and he had pointed to the symbolic nature of the first loan which should be agreed quickly. The Government had therefore decided to support the entire project, i.e. as originally conceived. The Vice-Minister added that, based on that decision he would like the Bank to process a loan of \$250 million, with a blend of 50/50 (i.e. an IDA amount of \$125 million) as rapidly as possible.

2. It is Mr. ter Weele's assessment that the Government made an enormous effort in the last few days to arrive at a quick decision (which had to be taken at the highest level) and to prevent a reduction of the size of the project despite the present general investment cutting exercise. He therefore did not raise the issue that the Bank had not agreed to a 50/50 blend beyond \$100 million IDA, and strongly recommends that senior management approve the higher amount.

3. Although one can argue that the Bank has already gone quite far in agreeing to a 50/50 blend for IDA VI and the first project, that this is only the last step in a well-orchestrated Chinese strategy to achieve a \$250 million loan with a 50/50 blend (which the Region had originally proposed), that an allocation of \$125 million IDA would eat heavily into the \$400 million IDA VI amount for China, and that there might be adverse Board reactions, I would consider the difference of \$25 million not to be very significant compared to the advantage of leaving the original project intact.

4. I would therefore propose that you seek Mr. Stern's agreement as soon as possible, so that I can inform Mr. ter Weele and the Government (if there is to be no increase in the IDA amount, Mr. ter Weele would of course have to try to quickly work out and agree on how to cut the project by 20%.) I would further propose that we go to the Loan Committee next week. Mr. Kimura's mission has left for China this morning in order to prepare the negotiations on April 27.

*Mr. Stern*

cc: Messrs. Kirmani and Wyss

CKW/hk

*I suppose this recommendation and will appreciate your approval to proceed on this basis \$125 million IDA.*

I,6

## OFFICE MEMORANDUM

TO: Mr. E. Stern, SVPOP

DATE: April 7, 1981

FROM: S. Shahid Husain, AENVP

DECLASSIFIED CONFIDENTIALSUBJECT: CHINA: Status of Bank Work Program

NOV 30 2022

WBG ARCHIVES

1. Important changes have taken place over the past few months in the direction of China's present policies of adjustment of the economy; they have affected the Government's attitude toward borrowing from the Bank Group and our Initial Operations Program, and they will shape the size and content of our lending program for the coming years. On our side, we have now completed the Bank wide review of the introductory economic report on China and I plan to review the report with the Government in early May; also we are preparing for negotiations of the first loan to China in late April. In the following, I will briefly report to you on (i) the changed economic environment in China, (ii) the Government's present position on future borrowing from the Bank, particularly the IDA/IBRD blend issue, (iii) the status of our initial operations, and (iv) action to be taken over the next few months.

The Present Economic Environment

2. The discussions with senior government officials held recently by a Bank mission (led by Mr. Jaycox) confirmed that China has entered a period of marked economic retrenchment. The policies introduced in 1979 to adjust the economy <sup>1/</sup> have been expanded and strengthened and the period of readjustment is now expected to last for at least another three years. The measures were prompted by the State Council's conclusion during the second half of 1980 that investment activity still remained at a much higher level than planned, that there would be another sizeable budget deficit in 1980, that inflation was eroding the increases in purchasing power of the population granted in recent years, that the country's energy balance and oil export prospects, contrary to earlier projections, looked rather grim, and that the execution of a number of major investment projects (e.g., the large Baoshan steel complex near Shanghai) encountered serious difficulties and huge cost overruns due to poor planning. Apparently towards the end of the year, Vice Premier Chen Yun (architect of China's readjustment efforts in the early sixties after the Great Leap), supported by Yao Yilin (Head of State Planning Commission) was able to convince China's leadership that a limited period of sharp readjustment measures ("short pain is better than long pain") was required.

3. The process culminated in Yao Yilin's speech in late February to the Standing Committee of the Fifth National People's Congress on the readjustment of the 1981 national economic plan; among others, appropriations for capital construction will be reduced from Y55 billion to Y30 billion and defense expenditures cut in order to balance the overall state (but not central) budget; Y5 billion in state treasury bonds will be sold by allocation to state and collective enterprises and local governments; and some recentralization of economic decision-making will take place. To the extent possible, development programs in the priority sectors of energy, transport, education

<sup>1/</sup> Aimed mainly at giving higher priority to consumption at the expense of investment, and to agriculture and light industry at the expense of heavy industry.

and science, agriculture and light industry are to be continued, i.e. are to suffer less severe cutbacks. A large number of ambitious investment projects, undertaken in many cases with foreign investors and suppliers, have been postponed or abandoned, leading to the cancellation of a series of major contracts with foreign companies and difficult compensation negotiations, particularly with Japanese suppliers. It appears that many of these projects had been poorly selected and designed and, quite apart from the present financial constraints, should not have been undertaken in the first place.

4. For the next few years the Government expects lower growth rates than experienced in the past few years. Imports are to expand more slowly, the current account deficit is to be kept at a modest level and external borrowing is to be limited. Elaboration of the Sixth Five Year Plan (1981-85) will be completed by the end of 1981 at the earliest.

5. In the absence of a longer term planning framework and a better information base, it is difficult to judge the economic justification of the drastic measures taken and their implications for longer term growth and consumption levels. Politically and ideologically, of course, the present course of action might have been inevitable, but in its discussions with the State Planning Commission the mission found little evidence of an appreciation of the costs of the new course in terms of growth foregone and postponed reforms of the system, i.e., the need to balance longer term requirements of development and shorter term needs of readjustment. There seems to be little consideration of alternative strategies, e.g. greater reliance on imports to satisfy demand and foreign borrowing to finance investment. Indeed, present policies appear to be conservative and may represent an over-reaction to recent economic difficulties. For example, planners seem to be excessively concerned about the country's future debt servicing capacity (their concern heightened by the sudden realization last year that the country might well become a net energy importer by the mid-80's). Finally, the criteria to be used in cutting investment programs in the different sectors appear not to be entirely clear yet, with ministries trying to revive certain projects. But the political determination to readjust is strong -- to balance, to progress only slowly and to dampen expectations in the process. It presents a formidable challenge for the Bank's and the IMF's future economic dialogue with the authorities.

#### Borrowing from the Bank: The IDA Issue

6. The Government's present conservative policies and its more pessimistic assessment of the country's future creditworthiness position translate into an increased reluctance to borrow large amounts on commercial terms, a strong stance taken on the issue of an appropriate IDA/IBRD blend of its borrowing from the Bank Group over the next five years, the anticipation of a slower build-up of Bank operations to lower total borrowing levels than indicated last July (unless a very favorable blend can be obtained), and the request for considerably smaller individual project and loan/credit size in the early years. In the meetings held with the recent Bank mission, Finance Minister Wang Bingqian and other senior officials pointed to the Government's early request for a 50/50 blend of IDA/IBRD resources in the lending program for the next five years, to the fact that India and other IDA recipients had

received a substantially better blend than the one indicated for China in the Board paper of December 18, 1980 and that the blends contained in the Board paper for IDA VI (25% IDA) and IDA VII (1/3 IDA) were unacceptable in the light of China's low income levels and limited future debt servicing capacity.

7. Moreover, despite our statements to the contrary, the various ministries of "non-productive" and/or non-foreign exchange earning sectors that are engaged with the Bank in preparing initial lending operations -- i.e., particularly the Ministry of Education but also the Ministry of Agriculture -- had assumed that "their" borrowing from the Bank would be entirely IDA-financed because they would lack the capacity to service and repay IBRD loans (which the Government would simply pass on to them, if not literally at least for accounting purposes); their constituencies (e.g., university presidents and students) would strongly react to borrowing any significant amount on IBRD terms. It became clear that, as in the case of many other Bank borrowers, the concept of "productive" versus "non-productive" sectors is deeply engrained in Chinese thinking.

8. The mission explained at length what Mr. McNamara and I had explained earlier, i.e., IDA VI had been negotiated without reference to China, the uncertain prospects for both IDA VI and VII, the fact that IDA VII allocations to all recipients would have to be reviewed at the appropriate time, the sensitivity of the blend for the first operation, and the possibility that, once the size of the lending program and its overall blend would have been agreed upon, the Government in consultation with the Bank, could allocate IDA and IBRD funds quite flexibly on a project-by-project basis. It also explained that China's creditworthiness for borrowing from IBRD would be an important factor and that such borrowing was also concessionary and highly advantageous.

9. The dialogue with the Chinese on the extent and nature of Bank assistance is by no means concluded. It will be a continuing affair. Yet, it is clear that there is great internal controversy within the Chinese Government on the size and direction of the investment program, the extent of foreign financing and the terms on which such financing should be accepted. In the near term, the Chinese are fairly clear about certain aspects of their relationship with the Bank. First, they attached great value to our country economic and sector work and are looking forward to the discussions on the economic report. Second, the size of the Bank Group assistance program will be determined by the IDA funds we are able to allocate. And lastly, projects will be substantially smaller than we had originally expected. As far as FY82 and FY83 are concerned, the maximum Bank/IDA lending I would envisage is \$1 billion of which \$400 million would be IDA. As to our first operation, the Education project was ready with a total project cost of \$350 million and Bank Group financing of \$250 million, including \$100 million of IDA. The Chinese have now indicated that they want a substantially smaller project with Bank Group financing of about \$50 million of which half would be IDA. Our mission is now in Beijing discussing with the Chinese the revision of the initial project. We still expect to take it to the Board in the current fiscal year and Loan Committee clearance would be sought in the middle of April.

Future Work Program

10. Work on future projects continues. The most advanced are the Port project and the Agriculture project. The Government has also indicated keen interest in Bank assistance for petroleum production. We shall discuss this further during my visit to China. While the China work program remains intact, the projects will be smaller - for FY82-83, we are now expecting the average size of loans to be in the range of \$80-120 million, as compared to \$170-200 million expected earlier this year. The lending buildup is likely to be as follows:

	<u>FY82</u>	<u>FY83</u>	<u>FY84</u>	<u>FY85</u>	<u>FY86</u>
Bank	150	450	n.a.	n.a.	n.a.
<u>IDA</u>	<u>150</u>	<u>250</u>	n.a.	n.a.	n.a.
Total No. of Projects	3	6	8	10	10
Average Size of Loans	100	115	n.a.	n.a.	n.a.

11. Clearly, the Chinese want Bank assistance and they want it on most favorable terms. At least for now they attach value to our economic work and dialogue. There is substantial basis for proceeding with our work program as we had initially planned. The relationship continues to be excellent and continues to improve. However, for some time to come, there will be considerable uncertainty as to the extent of Bank Group assistance to China. Under this circumstance, my own suggestion would be that we do not go with a separate budget paper to the Board on China. The China budget should be integrated in the overall Bank budget. I would also hope that we can avoid a full-fledged Board discussion on lending to China. The issues have been substantially highlighted in the earlier discussion.

cc: Messrs. Jaycox  
Kirmani  
Hasan  
Wyss

CKoch-Weser/SSHusain:mt



II, 2  
- 1

June 8, 1981

Mr. Wang Bingqian  
Minister of Finance  
Ministry of Finance  
Beijing  
People's Republic of China

Dear Mr. Wang:

On behalf of the Bank's management and the staff who participated in the recent mission, I would like to thank you, Mr. Li Peng, Mr. Gan Ziyu and the officials of your Ministry and the other agencies for the cooperation extended to us. We are, in particular, grateful for the great effort undertaken by your Government in reviewing the Economic Report and processing the education credit in the very limited time available. Both sets of documents have been distributed to our Board of Executive Directors this week.

In our final meeting with Mr. Li Peng and Mr. Gan Ziyu, I proposed that, in addition to the Aide Memoire which we left with your Ministry before we departed, I would write you a letter which would record the agreements reached with regard to the planned program of cooperation. Let me then, first, briefly deal with the size and terms of the lending program for the next years and the sectoral priorities for that program; second, outline the work program, comprising the projects to be prepared for lending in the Bank's fiscal years 1982/83, the project proposals to be pursued for lending in FY84/85, and the supporting economic and sector studies to be undertaken; and, third, propose an initial schedule of work and some procedures we might follow in the future in developing and reviewing our program of cooperation.

#### Size and Sector Priorities of Lending Program

Our meetings confirmed the agreement reached earlier that for the remainder of IDA VI (FY82/83) the Bank would allocate to China and China would borrow US\$400 million of IDA VI funds and \$400 million of IBRD resources, resulting in a total lending program of US\$800 million (including the University Development Project). The Bank is aware of your request for an at least 50/50 IDA/IBRD blend for IDA VII, but it is understood by both sides that this issue cannot be settled in the near future. However, it was also agreed that for planning purposes of both the Government and Bank we should aim at a work program which would allow us to commit about US\$5.2 billion in FY84-86; this would be considered a "rolling" plan and would be reviewed periodically.

In accordance with your Government's priorities of adjustment and reform of the economy and the findings of the economic mission, we agreed that the following sectors would receive priority in our cooperation: agriculture; industry; energy; transport; and education. After FY83, lending to the health sector is to be considered as an additional area of activity.

Finally, as Mr. Husain stated in his meeting with you, we hope that your Government in its foreign borrowing decisions will take a broad view of the productivity of foreign capital in determining the application of such resources, that you will determine debt servicing capacity at the level of the entire economy and not of an individual project, and that you will concentrate on the aggregate terms of China's foreign borrowing and not just on the terms of individual operations. In the case of the Bank's lending program, we urge that the agreed overall IDA/IBRD blend not be reflected in every single operation but that IDA and IBRD funds be allocated flexibly on a project-by-project basis, aiming to the extent possible at "IDA only" and "IBRD only" operations as we do in other "blend" countries. We understand that you will have to give further consideration to this issue.

#### Work Program

While our discussions emphasized the need for flexibility in our program of cooperation, particularly during China's present period of economic adjustment, it was also recognized that a substantial lead time is required for the deployment of Government and Bank staff resources to prepare projects and supporting studies. This is especially important in view of the fact that a substantial increase in operations is expected for FY84/85. The identification of a pipeline of project proposals for the coming four years during our recent discussions takes account of that requirement. Let me (i) outline the proposed program of cooperation on general economic studies to provide the analytical basis for our future operations generally; (ii) deal with the projects (and necessary supporting studies) on which we reached firm agreement to work for possible lending in FY82/83; and (iii) summarize the proposed program of studies and project work which will lead to lending operations in FY84/85. The attached Aide Memoire table summarizes the program. It has been slightly revised from the version we left with the Government last month to take account of subsequent changes in the proposed timing of the next missions.

Economic Studies. We discussed briefly the need for further study of general economic issues as the basis for determining the size, composition and terms of Bank group lending to China. I emphasized the importance of such studies especially to justify China's claim for IDA resources during the IDA VII replenishment period. In this connection it will be important for us to have a better understanding of China's macroeconomic prospects, especially its investment requirements, budgetary prospects and foreign capital needs, over the next 5-10 years. As you are aware, a very limited start was made in the introductory economic report in assessing China's macroeconomic prospects over the 1980's. We hope that in the next twelve months, we will have an opportunity to study these issues in greater depth. The appropriate timing for the study will depend on the timetable for the preparation of the Government's Sixth Five-Year Plan; the Bank's study of macroeconomic prospects would naturally be conducted in close cooperation with the State Planning Commission and the Ministry of Finance.

You mentioned during your meeting with Mr. Husain that the Government would welcome the Bank's analysis of China's development problems from the Bank's perspectives of experience in other countries. The Bank would indeed regard this as a high priority for its economic work and would organize such studies so that they can be helpful to the Government. We have suggested that an area for study in the coming year be system reform. For such a study, the Bank could recruit experts in socialist planning as well as others familiar with other developing countries. During our discussion, we agreed that the Ministry of Finance would consult with the relevant agencies and let us know how you wish us to proceed.

One of the most effective ways of sharing the Bank's development experience in other countries with Chinese economists would be to collaborate with Chinese research institutions on studies of economic issues of mutual interest. During his visit to China last December, Mr. Chenery, our Vice President in charge of economic research, met with the Academy of Social Sciences and agreed in principle to begin a program of collaborative research. We hope some progress can be made in this area during the next few months through an exchange of visits, with the objective of initiating collaborative research sometime in 1982.

FY82/83 Lending Program. We agreed to continue or initiate work in the near future on a lending program of eight projects (including the FY81 University Development Project); further, the Bank was presented with proposals by the State Economic Commission for an energy conservation center and for industrial management training. We would also work on three standby projects (i.e., projects for which the Bank could lend in FY83 if one or more of the regular projects have to be postponed or dropped).

In agriculture, we confirmed that preparation of the North China Plains Project would continue and that the design of the project would be slightly revised. A preappraisal mission is presently in China to assist in this redesign work, and the appraisal mission is planned for early fall so that the project can be negotiated and presented to our Board before the end of FY82. We were informed that your Government intends to borrow US\$60 million for this project. We agreed to initiate work on two other projects: Heilongjiang Grain Base, and Agricultural Training and Research; loan amounts of \$80 million and \$60 million, respectively, have been proposed by the Government. It was also agreed that a study of the agricultural credit system (Agriculture Bank) be undertaken in conjunction with the work on industrial financial intermediation as preparatory work for a possible agriculture credit project.

In industry, we agreed to begin work as soon as possible on an Industrial Credit Project which could lead to a pilot lending operation of \$35 million in FY83. It was proposed that a preparatory study should be undertaken in FY82, identifying the subsectors to be served by such an operation (e.g., light industry in Shanghai), analyzing the process of allocation of investment resources and particularly the role of the banking

system, and exploring the necessary institutional arrangements and appropriate methods of project evaluation for such lending. We will write a letter shortly to the agencies concerned elaborating on our proposal in preparation for the first mission (see below). In addition, following our discussions with the State Economic Commission, we agreed to consider early assistance to the establishment of the planned energy conservation center and management training program, possibly as a separate, small FY83 project, but more likely in conjunction with one of the other early lending operations.

In the energy sector, it was agreed to start work immediately in petroleum on an enhanced secondary recovery project in Daqing (to which a lending amount of \$150 million would be allocated), and on a project to develop three new onshore fields (\$50 million). We have now learned that the agreed mission has to be postponed by about two months in order to allow for necessary preparation on the part of the Ministry of Petroleum. Further, we proposed that work be initiated on a first coal project, possibly the Luan or Jincheng mine in Shanxi, as a standby operation. Preparation of the project need to be preceded by a limited study of the coal sector. Finally, we also proposed treating the Lubuge Hydropower Project and/or the Shanxi I Transmission Line as another standby project for which the Bank could lend in FY83.

In transportation, we confirmed that appraisal of the Three Ports Development Project would take place in July so that this loan (with an amount of \$165 million) can be negotiated and approved in FY82.

Finally, in education, we proposed that work be initiated on a second education project, with emphasis on TV University for adult education, as a standby operation for possible lending in FY83.

FY84/85 Lending Program. The project proposals listed in the Aide Memoire table for FY84/85 are based on suggestions made by the State Planning Commission and the Ministry of Finance but include also further project ideas put to us by the sector ministries in our round of meetings with them. The findings of the economic mission indicate that many of these projects would have to be preceded by careful studies; some of them would be major undertakings, involving a number of sectors and ministries. Those studies, which we discussed with the sector ministries and commissions concerned, as well as the State Planning Commission and the Ministry of Finance, are listed also in the Aide Memoire. We would like to emphasize again that the purpose of the studies would be to provide the general framework and set the priorities needed for the identification of the respective projects.

We understand that your Government is presently conducting a further review of this program for the years after FY83 and that the beginning of our collaboration on these projects should await the outcome of those deliberations. We have taken account of that in our revised work schedule proposal (see below).

In the agriculture sector, a number of project ideas were raised with us by the sector agencies. We proposed to include the following under the FY84/85 program: (i) a second irrigation/drainage project in the North China Plains, to be preceded by a study of irrigation and water planning in that area, focussing on the problems and potential of the Huang He Basin; (ii) an aquaculture project, mainly the development of freshwater fish-ponds; (iii) a forestry project; (iv) a multi-purpose water storage and irrigation project on the Luan River in Hebei; (v) an agricultural credit project; and (vi) a rubber development project in Hainan.

In industry, the following projects were suggested: (i) an energy conservation project, focussing primarily on energy efficiency in subsectors and preceded by a study of the Government energy conservation program to identify projects for Bank assistance; (ii) a second and larger industrial credit project; and (iii) a project to modernize heavy industry, focussing on a specific industry such as machine tools or iron and steel, possibly with an export orientation.

In the energy sector, we proposed a further project in petroleum, either secondary recovery, onshore development or exploration. Further, a second coal mining project was proposed. Finally, we confirmed that work on the Shuiko Hydropower Project would continue and that we would again include the Shuoxian Thermal Project in our program, pending the outcome of the current negotiations with US companies. We discussed again the need for a major study of the complex linkages between coal mining and processing, coal transport and power generation which future investment decisions will have to take into consideration. We were informed that such a study, while desirable, required further inter-agency consultation.

In the transport sectors, we considered the following projects for FY84/85: (i) a highways project; (ii) an inland waterways project; (iii) a second ports project; and (iv) a rural roads project. We suggested undertaking studies in the inland waterways and highways subsector with a view to define and prepare the above listed projects. We have also recommended including a Port Development Study in the First Port Project to be appraised in July 1981, which would assist in preparing a second port project. The studies of waterways and roads would be focused on river basins and regions selected by Government. In order to identify the above projects and the studies needed for their preparation, Messrs. Carnemark and Yenny would be able to visit in late August 1981.

In education, we agreed to work on a second university development project and a vocational/technical training project. A study on manpower analysis for post-secondary non-degree education is proposed for FY82 to determine the need and profile of education at the polytechnic level.

In health, we considered a project to strengthen rural health services and health manpower training, preceded by a health sector study to be undertaken in FY82.

June 8, 1981

Finally, we proposed a construction industry review study, with the long-term objective of supporting the development of China's contracting companies to bid for, win, and execute contracts under international competitive bidding in China and abroad.

Let me also point again to our suggestion concerning the establishment of a technical services fund financed by an IDA credit, to provide for international technical expertise on those occasions when such assistance is required for the preparation of major projects. As I suggested, we will write a letter elaborating on this concept.

#### Schedule of Work

Both sides agreed that work on the firmly identified projects for FY82/83 should proceed immediately. With regard to the schedule of work on the program for the years after FY83, we understand that you will respond to this letter once you have completed your current consultations with the relevant agencies. We will then agree with you on the schedule for missions. Our tentative proposals for missions over the coming months are given in the attached Aide Memoire. In most instances we propose that work on major studies begin with a small "reconnaissance mission" for which only limited preparation should be required on the part of the Government.

With regard to the FY82/83 program, we propose the following missions:

- (i) North China Plains Project -- appraisal, probably in September, depending the results of the current preappraisal mission;
- (ii) Heilongjiang Grain Base Project -- identification mission of Mr. Smith in July/August;
- (iii) Agricultural Training and Research Project -- identification mission by Messrs. ter Weele and Farner in July followed by preappraisal in October;
- (iv) Industrial (and Agricultural) Credit Project -- reconnaissance mission on financial intermediation study by Messrs. Lim and Gould (Chief of the Division responsible for the project) in July, followed by a mission in November 1981;
- (v) Daqing Secondary Recovery Project and Three Onshore Fields Development Project -- identification mission in August/September;
- (vi) Three Ports Development Project -- appraisal mission will come in July;
- (vii) Energy Conservation Center and Management Training Project -- mission by Messrs. ter Weele and Farner in July could discuss the management training aspects and a later mission on the proposed energy conservation study could discuss the conservation center;
- (viii) Coal Mining Project (standby) -- coal sector and project identification mission in September;
- (ix) Lubuge Hydropower Project and/or Shanxi I Transmission Line Project (standby) -- identification mission by Mr. Beach in September; and
- (x) TV University Project (standby) -- identification mission by Messrs. ter Weele and Farner in July (see above); mission would also assist the Government with initial implementation of University Development Project.

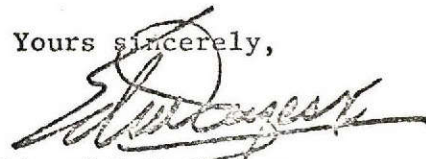
June 8, 1981

With regard to the proposed general economic studies, Mr. Lim will discuss the schedule with you during his visit in July in connection with the Industrial Credit Project. In addition, Mr. Chenery has written to the Academy of Social Sciences, with a copy to the Ministry of Finance, proposing a reconnaissance mission in July to explore possibilities for collaborative research with Chinese research institutions.

Finally, both sides agreed that we would conduct a comprehensive review of the work program semi-annually with the State Planning Commission and the Ministry of Finance. I propose that we plan for the first such meeting to take place in November 1981.

I am looking forward to receiving your comments and suggestions.

Yours sincerely,



Edward V.K. Jaycox  
Director

East Asia and Pacific Regional Office

Attachment:

cc: Messrs. Wang Liansheng, Chen Hui

AIDE MEMOIREWork Program FY82-85

	<u>Projects FY82/83</u>	<u>Projects FY84/85</u>	<u>Studies FY82</u>	<u>Next Missions</u>
Agriculture	<ol style="list-style-type: none"> <li>1. North China Plains</li> <li>2. Heilongjiang Grain Base</li> <li>3. Training and Research</li> </ol>	<ol style="list-style-type: none"> <li>1. North China Plains II</li> <li>2. Aquaculture</li> <li>3. Forestry</li> <li>4. Hebei Multipurpose</li> <li>5. Agricultural Credit</li> <li>6. Hainan Rubber Development</li> </ol>	<ol style="list-style-type: none"> <li>1. Agriculture Credit System</li> <li>2. Irrigation and Water Resources in North China Plains Planning Study</li> </ol>	<ol style="list-style-type: none"> <li>1. Agricultural Credit Study; July 1981 (jointly with Industrial Financial Intermediation Study)</li> <li>2. Heilongjiang Project; August 1981</li> <li>3. Training and Research Project; July 1981</li> <li>4. North China Plains Project; May/June 1981</li> </ol>
Industry	<ol style="list-style-type: none"> <li>1. Industrial Credit (possibly also component for commune industries)</li> <li>2. Energy Conservation Center and Management Training</li> </ol>	<ol style="list-style-type: none"> <li>1. Energy Conservation</li> <li>2. Industrial Credit II</li> <li>3. Remodeling of Heavy Industry</li> </ol>	<ol style="list-style-type: none"> <li>1. Financial Intermediation/Light and Textile Industry</li> <li>2. Energy Conservation</li> </ol>	<ol style="list-style-type: none"> <li>1. Financial Intermediation Study; July 1981</li> <li>2. Energy Conservation Study; Fall 1981</li> <li>3. Management Training; July 1981</li> </ol>
Energy - Petroleum	<ol style="list-style-type: none"> <li>1. Daqing Secondary</li> <li>2. Three New Onshore Fields Development</li> </ol>	<ol style="list-style-type: none"> <li>1. Secondary Recovery/or Onshore Field Development II/or Exploration</li> </ol>		<ol style="list-style-type: none"> <li>1. Daqing Secondary Recovery, and Onshore Fields Development; August 1981</li> </ol>
Coal	<ol style="list-style-type: none"> <li>1. Coal Mining I (Standby)</li> </ol>	<ol style="list-style-type: none"> <li>1. Coal Mining II</li> </ol>	<ol style="list-style-type: none"> <li>1. Coal/Power/Transport Development (to be defined during Coal Sector/Project Identification Work)</li> </ol>	<ol style="list-style-type: none"> <li>1. Coal Sector/Project Identification; September 1981</li> </ol>



	<u>Projects FY82/83</u>	<u>Projects FY84/85</u>	<u>Studies FY82</u>	<u>Next Missions</u>
Power	1. Lubuge Hydropower and/or Shanxi I (500 KV) Transmission line (Standby)	1. Shuoxian Thermal 2. Shuiko Hydropower	1. Interconnection of grids	1. Lubuge Project; Shuiko Project; and High-Voltage Transmission Project; September 1981
Transport	1. Three-Ports Development	1. Highways Development 2. Inlands Waterways 3. Ports Development II 4. Rural Roads	1. Studies in the inland waterways, highways and port subsectors related to project definition and preparation to be defined by late August identification mission	1. Three Ports Development Project (Appraisal Mission) July 1981 2. Project Identification Mission (inland waterways, roads, Ports II); late August 1981
Education	1. TV University (Standby)	1. University Development II 2. Vocational/Technical Training	1. Manpower Planning	1. Project Identification (combined with Agricultural Training Project, and Industry Management Project); July 1981
Health		1. Rural Health Services and Health Manpower Training Project	1. Health Services Sector Study	1. Health Services Sector Study; November 1981
Construction Industry			1. Sector Review-Potential for Contractors' Participation in ICB	1. Sector Review (First Mission in Combination with Three Ports Development Project Appraisal Mission); June/July 1981

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Spare

April 17, 1981

His Excellency  
Wang Bingqian  
Minister of Finance  
Ministry of Finance  
Beijing, China

Dear Mr. Minister:

I would like to thank you and the officials of your Ministry for the hospitality and cooperation extended to my associates and me during our recent visit to China.

In our final meeting with Vice Minister Li Peng and Vice Chairman Gan Ziyu, I proposed that -- in view of the fact that agreement on a work program for the coming year could not be reached at that point in time -- I would return to China in May to continue the discussions and reach such an agreement after Mr. Husain had reviewed the Economic Report with your Government and held more general discussions on the scope, priorities and strategy for our future cooperation. I had also proposed that in preparation for Mr. Husain's and my visit in May, I would write you a letter, recording the understandings reached in my round of meetings with the various sector commissions and ministries with regard to priority areas, necessary studies and possible projects for a proposed program of cooperation for the coming years. Let me then, first, summarize the agreements reached in the meantime between China and the Bank on the size and terms of the lending program for the next two years which will now enable us to define a work program; second, outline the proposed elements of a program of cooperation as they emerged from our discussions with the sector agencies in March; and, third, propose a program for our meetings in May.

#### Size of Lending Program

The question of the relative shares of IDA and IBRD resources in the Bank's lending program during the remainder of IDA VI and in its first loan to China could not be resolved during my visit. However, after reporting your Government's position to our senior management, we were able to quickly reach agreement with your authorities that (i) the Bank would allocate to China and China would borrow US\$400 million of IDA VI funds and a minimum of US\$400 million of IBRD resources during FY82/83, resulting in a total lending program of US\$800 million or more; and (ii) the University Development Project loan would be reduced to US\$200 million, consisting of a US\$100 million IDA credit and a US\$100 million IBRD loan.

Although the Bank is well aware of your request for an at least 50/50 IDA/IBRD blend for IDA VII (and of your position that the blend should receive priority over the amount of lending tentatively indicated in the Board paper of December 1980), it is understood by both sides that this issue cannot be settled in the near future. Further, we have taken note of your position that in the early years of our cooperation mainly medium and smaller size projects rather than large operations should be undertaken. I am confident that these agreements provide us with the necessary indication of the approximate volume of Bank lending in the coming years, so that we can now determine the scope and content of our work program -- the sectors and subsectors to be covered, the types of lending to be pursued, the rough number of operations to be planned, and the supporting studies to be undertaken.

#### Content of Lending Program

In my letter of January 19, 1981, I suggested five general objectives for the Bank's cooperation with China which we should bear in mind in determining the content of a program of operations. You indicated to us in March that your Government wished to give these objectives further study in the light of China's more immediate needs of adjustment and reform, and its longer term development goals. I would hope that we can hear your Government's reactions and suggestions on this point during Mr. Husain's and my visit in May, so that we can base our dialogue on a clear understanding of the general objectives of our cooperation.

Pending completion of the Sixth Five-Year Plan as the future framework for formulating our longer term strategy of cooperation, your Ministry and the State Planning Commission indicated to us five priority sectors for initial operations: energy, industry, agriculture, education and transportation. We then held meetings with the various commissions and ministries of these sectors, and also with the Ministry of Health. These discussions identified in every sector various areas for possible Bank involvement, a number of project ideas to be further pursued, and a series of specific economic and technical studies which would be required to support the development of a pipeline of projects.

Energy. Against the background of the high priority given by your Government to the development of China's energy resources, our meetings with the Ministries of Petroleum, Coal and Electric Power identified a series of major studies and projects for possible cooperation. In petroleum, Bank assistance was considered for (i) secondary recovery programs in existing on-shore fields such as Daqing; (ii) on-shore oil exploration efforts; and (iii) the development of new on-shore fields. It was tentatively concluded that identification and preparation of such projects could be undertaken in the near future and would not have to be preceded by broader subsectoral studies. We offered to send a small team of experts to initiate work with the Ministry within the next two months.

In the case of coal development, I suggested that we first cooperate on (i) a subsector study of coal mining and processing requirements, leading to the identification of projects to be processed in the next two to three years, and (ii) a major study of the complex linkages between coal mining and processing, coal transport and power generation which future investment decisions will have to take into consideration. Whereas the latter study would be a major undertaking requiring a more lengthy process of defining its scope and terms-of-reference, I indicated that the former could be carried out by a smaller Bank reconnaissance mission around September 1981, followed by a full technical mission towards the end of the year. The latter mission would also be prepared to define with the Government the scope and terms-of-reference of the study under (ii). As to early projects, the Ministry of Coal suggested that the Bank might assist in the development of the Lu An coal mine in South-East Shanxi, with an annual capacity of 16 million tons.

In electric power, we were informed in our meetings with the State Planning Commission and the Ministry of Electric Power that (i) the Shuikou Hydropower Project had been postponed until 1985, but that the Bank should continue its preparation work with the Ministry of Electric Power; (ii) the Bank might be asked to pursue work on the Shuoxian Thermal Power Project, pending the outcome of current negotiations between the Ministry of Coal and three US companies on the development of the associated coal mine; (iii) the Lubuge Hydropower Project in Yunnan, which is under construction, could be the first Bank-financed project in the power sector (its high head plant requires turbines which are at present not built in China); and (iv) the Shanxi I transmission line was also a candidate for early Bank support and could be combined with (iii) into one project. As to major technical studies, we discussed the work required on the interconnection of China's regional power grids.

Industry. Our meetings with the State Economic Commission and the State Machine Building Commission identified the following areas for possible project cooperation: (i) energy conservation; (ii) upgrading of light industry by supporting a large number of smaller, high priority investments through credit lines; (iii) selective rehabilitation of heavy industries; and (iv) training and R&D. We discussed the need for major, careful studies in industry on (i) energy conservation and (ii) the financial sector (focussing on the financial inter-mediation role to be performed by the People's Bank and the Construction Bank), before we could embark on lending operations in these areas. Such work could be initiated in the near future; the Bank would be able to send a financial sector mission (with a subteam focussing also on the financing of agriculture and the Agriculture Bank; see below), in November 1981, preceded by a small reconnaissance mission in July.

Agriculture. We were informed by the Government that work on the North China Plains Project was to be continued but that the project design was being

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revised; in particular, the number of counties to be covered had been expanded. We have now proposed that the Bank send a small mission in late May to assist in this redesign work (and possibly get acquainted with the proposed Heilongjiang project), and that an appraisal mission visit China in late summer or early fall.

In the meeting with the State Agricultural Commission and the Ministries of Agriculture and State Farms, Bank project assistance in the following priority areas was proposed: (i) development of Heilongjiang grain base; (ii) training through upgrading of key agricultural colleges; (iii) research; and (iv) credit to finance agricultural production, rural industries and the services sector (e.g., transport) at the commune level. I suggested that the Bank together with the respective agencies would have to carry out a number of studies before selecting projects in training, research and credit. Work on the agricultural credit system could be carried out in conjunction with the proposed financial sector work on industry (see above). Finally, we proposed a study to define planning and investment criteria for future development programs in irrigation and drainage.

Transport. The recent Ports Project mission has been able to make substantial progress in working with the various port authorities and the Ministry of Communications toward appraisal in July. In my meeting with that ministry, the possibility of (i) a second ports development project, and (ii) a high-priority, quick pay-off highways project was raised. We discussed the need for a series of studies on the future development of the transport system, possibly by undertaking first a regional intermodal study for about two representative provinces. We also referred to the future investment requirements of the railways subsector as the backbone of the transport system, and specifically to the need for (i) a major coal transport study (see above); and (ii) a study on the main options for developing locomotion of railways. Unfortunately, I was unable to meet with the Ministry of Railways on the latter subjects.

Education. The Ministry of Education indicated to us the following priority areas for future Bank assistance: (i) further development of university education (through a second Bank project); (ii) technical, vocational education; (iii) adult higher education; and (iv) training of teachers. We agreed that a number of studies would be required in these areas, probably in part to be included under the first university development project.

Health. The Ministry of Health expressed its interest in Bank support for (i) the improvement of the rural health care system in a pilot project of thirty counties, and (ii) the development of water supply and sanitation. We agreed that, particularly in health services, such future financial assistance would have to be preceded by a program of careful studies, which could be initiated in FY82.

I realize, of course, that these proposals for a work program of studies and

His Excellency  
Wang Bingqian

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April 17, 1981

future projects require careful analysis by the State Planning Commission, State Capital Construction Commission and the Ministry of Finance as to their relative priorities in the context of the respective sectors, the Government's curtailed investment program, and China's present policies of adjustment, reform and longer term development. Their priorities also require scrutiny in the framework of the general objectives of cooperation between China and the Bank and the planned volume of Bank lending to China in the coming years. But in view of the lead-time required for an adequate preparation of the proposed projects and major studies (including the time needed by the Bank to develop its work program and deploy scarce staff resources), I recommend -- as we discussed in March -- that we agree in May on a "rolling" work program, with considerable detail for the next twelve months, which would be periodically reviewed and adjusted flexibly as your plans develop and our cooperation progresses. Reaching agreement on such a work program will hopefully be facilitated by the fact that Mr. Husain and his associates will first review the Bank's economic report with your Government, including the reports on the various sectors and focussing on the major policy issues which our experts have identified.

#### Program for Mission

Finally, regarding the program for our visit in May, I am aware of the schedule worked out by Messrs. Koch-Weser and Lim with Vice Minister Li Peng and other officials, namely that Messrs. Hasan and Lim and their colleagues would begin the review of the various sector reports with the respective agencies on April 30, that Mr. Husain would then lead the formal review meetings on our side in the week of May 4 and conduct general discussions with you and other senior members of the Government on the objectives, scope and priorities of the Bank's program of cooperation and the levels and terms of future Bank lending to China, in the light of China's longer term need for external resources and the overall financial plans of the Bank. These discussions would provide the framework for my ensuing meetings on the work program from May 8-13.

I would like to propose that my associates (Messrs. Wyss, Koch-Weser and Lim) and I first meet on Saturday, May 8, with your Ministry, the State Planning Commission, State Capital Construction Commission and possibly other members of the Steering Group to learn about your proposals and to agree on the priorities, sector composition and main elements of the future work program. After this initial exchange, we would then meet again with the main sector commissions and ministries on Monday and Tuesday (May 11 and 12), to follow up on our March discussions and agree for each sector to be covered on the initial studies to be undertaken, project proposals to be further pursued, and an initial schedule of work (including Bank missions). Finally, I suggest that I meet with you and again with the senior officials of the Steering Group on Wednesday (May 13) to resolve any outstanding issues and reach final agreement on the program of cooperation.

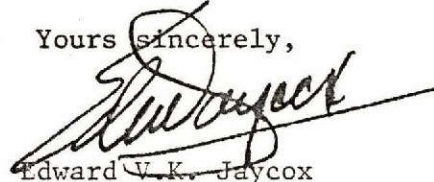
His Excellency  
Wang Bingqian

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April 17, 1981

I hope that these proposals meet with your approval and that you will find the process helpful.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "Edward V.K. Jaycox", written over a horizontal line.

Edward V.K. Jaycox  
Director

Country Programs Department  
East Asia and Pacific Regional Office



# Record Removal Notice



<b>File Title</b> China - General - Loan Committee Project File		<b>Barcode No.</b>  1058384		
<b>Document Date</b> 9/28/1981	<b>Document Type</b> Memorandum			
<b>Correspondents / Participants</b> To: Roland Wood, ADM From: Heribert Golsong, VPG				
<b>Subject / Title</b> Depiction of the Sino-India Border on World Bank Maps				
<b>Exception(s)</b> Corporate Administrative Matters				
<b>Additional Comments</b>		The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.		
		<table border="1"><tr><td><b>Withdrawn by</b> Bertha F. Wilson</td><td><b>Date</b> October 11, 2023</td></tr></table>	<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023
<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023			



## OFFICE MEMORANDUM

TO: Mr. E. Stern, SVPOP

DECLASSIFIED DATE April 7, 1981

FROM: S. Shahid Husain, AENVP

NOV 30 2022

CONFIDENTIALSUBJECT: CHINA: Status of Bank Work Program **WBG ARCHIVES**

1. Important changes have taken place over the past few months in the direction of China's present policies of adjustment of the economy; they have affected the Government's attitude toward borrowing from the Bank Group and our Initial Operations Program, and they will shape the size and content of our lending program for the coming years. On our side, we have now completed the Bank wide review of the introductory economic report on China and I plan to review the report with the Government in early May; also we are preparing for negotiations of the first loan to China in late April. In the following, I will briefly report to you on (i) the changed economic environment in China, (ii) the Government's present position on future borrowing from the Bank, particularly the IDA/IBRD blend issue, (iii) the status of our initial operations, and (iv) action to be taken over the next few months.

The Present Economic Environment

2. The discussions with senior government officials held recently by a Bank mission (led by Mr. Jaycox) confirmed that China has entered a period of marked economic retrenchment. The policies introduced in 1979 to adjust the economy <sup>1/</sup> have been expanded and strengthened and the period of readjustment is now expected to last for at least another three years. The measures were prompted by the State Council's conclusion during the second half of 1980 that investment activity still remained at a much higher level than planned, that there would be another sizeable budget deficit in 1980, that inflation was eroding the increases in purchasing power of the population granted in recent years, that the country's energy balance and oil export prospects, contrary to earlier projections, looked rather grim, and that the execution of a number of major investment projects (e.g., the large Baoshan steel complex near Shanghai) encountered serious difficulties and huge cost overruns due to poor planning. Apparently towards the end of the year, Vice Premier Chen Yun (architect of China's readjustment efforts in the early sixties after the Great Leap), supported by Yao Yilin (Head of State Planning Commission) was able to convince China's leadership that a limited period of sharp readjustment measures ("short pain is better than long pain") was required.

3. The process culminated in Yao Yilin's speech in late February to the Standing Committee of the Fifth National People's Congress on the readjustment of the 1981 national economic plan; among others, appropriations for capital construction will be reduced from Y55 billion to Y30 billion and defense expenditures cut in order to balance the overall state (but not central) budget; Y5 billion in state treasury bonds will be sold by allocation to state and collective enterprises and local governments; and some recentralization of economic decision-making will take place. To the extent possible, development programs in the priority sectors of energy, transport, education

<sup>1/</sup> Aimed mainly at giving higher priority to consumption at the expense of investment, and to agriculture and light industry at the expense of heavy industry.

and science, agriculture and light industry are to be continued, i.e. are to suffer less severe cutbacks. A large number of ambitious investment projects, undertaken in many cases with foreign investors and suppliers, have been postponed or abandoned, leading to the cancellation of a series of major contracts with foreign companies and difficult compensation negotiations, particularly with Japanese suppliers. It appears that many of these projects had been poorly selected and designed and, quite apart from the present financial constraints, should not have been undertaken in the first place.

4. For the next few years the Government expects lower growth rates than experienced in the past few years. Imports are to expand more slowly, the current account deficit is to be kept at a modest level and external borrowing is to be limited. Elaboration of the Sixth Five Year Plan (1981-85) will be completed by the end of 1981 at the earliest.

5. In the absence of a longer term planning framework and a better information base, it is difficult to judge the economic justification of the drastic measures taken and their implications for longer term growth and consumption levels. Politically and ideologically, of course, the present course of action might have been inevitable, but in its discussions with the State Planning Commission the mission found little evidence of an appreciation of the costs of the new course in terms of growth foregone and postponed reforms of the system, i.e., the need to balance longer term requirements of development and shorter term needs of readjustment. There seems to be little consideration of alternative strategies, e.g. greater reliance on imports to satisfy demand and foreign borrowing to finance investment. Indeed, present policies appear to be conservative and may represent an over-reaction to recent economic difficulties. For example, planners seem to be excessively concerned about the country's future debt servicing capacity (their concern heightened by the sudden realization last year that the country might well become a net energy importer by the mid-80's). Finally, the criteria to be used in cutting investment programs in the different sectors appear not to be entirely clear yet, with ministries trying to revive certain projects. But the political determination to readjust is strong -- to balance, to progress only slowly and to dampen expectations in the process. It presents a formidable challenge for the Bank's and the IMF's future economic dialogue with the authorities.

#### Borrowing from the Bank: The IDA Issue

6. The Government's present conservative policies and its more pessimistic assessment of the country's future creditworthiness position translate into an increased reluctance to borrow large amounts on commercial terms, a strong stance taken on the issue of an appropriate IDA/IBRD blend of its borrowing from the Bank Group over the next five years, the anticipation of a slower build-up of Bank operations to lower total borrowing levels than indicated last July (unless a very favorable blend can be obtained), and the request for considerably smaller individual project and loan/credit size in the early years. In the meetings held with the recent Bank mission, Finance Minister Wang Bingqian and other senior officials pointed to the Government's early request for a 50/50 blend of IDA/IBRD resources in the lending program for the next five years, to the fact that India and other IDA recipients had

received a substantially better blend than the one indicated for China in the Board paper of December 18, 1980 and that the blends contained in the Board paper for IDA VI (25% IDA) and IDA VII (1/3 IDA) were unacceptable in the light of China's low income levels and limited future debt servicing capacity.

7. Moreover, despite our statements to the contrary, the various ministries of "non-productive" and/or non-foreign exchange earning sectors that are engaged with the Bank in preparing initial lending operations -- i.e., particularly the Ministry of Education but also the Ministry of Agriculture -- had assumed that "their" borrowing from the Bank would be entirely IDA-financed because they would lack the capacity to service and repay IBRD loans (which the Government would simply pass on to them, if not literally at least for accounting purposes); their constituencies (e.g., university presidents and students) would strongly react to borrowing any significant amount on IBRD terms. It became clear that, as in the case of many other Bank borrowers, the concept of "productive" versus "non-productive" sectors is deeply engrained in Chinese thinking.

8. The mission explained at length what Mr. McNamara and I had explained earlier, i.e., IDA VI had been negotiated without reference to China, the uncertain prospects for both IDA VI and VII, the fact that IDA VII allocations to all recipients would have to be reviewed at the appropriate time, the sensitivity of the blend for the first operation, and the possibility that, once the size of the lending program and its overall blend would have been agreed upon, the Government in consultation with the Bank, could allocate IDA and IBRD funds quite flexibly on a project-by-project basis. It also explained that China's creditworthiness for borrowing from IBRD would be an important factor and that such borrowing was also concessionary and highly advantageous.

9. The dialogue with the Chinese on the extent and nature of Bank assistance is by no means concluded. It will be a continuing affair. Yet, it is clear that there is great internal controversy within the Chinese Government on the size and direction of the investment program, the extent of foreign financing and the terms on which such financing should be accepted. In the near term, the Chinese are fairly clear about certain aspects of their relationship with the Bank. First, they attached great value to our country economic and sector work and are looking forward to the discussions on the economic report. Second, the size of the Bank Group assistance program will be determined by the IDA funds we are able to allocate. And lastly, projects will be substantially smaller than we had originally expected. As far as FY82 and FY83 are concerned, the maximum Bank/IDA lending I would envisage is \$1 billion of which \$400 million would be IDA. As to our first operation, the Education project was ready with a total project cost of \$350 million and Bank Group financing of \$250 million, including \$100 million of IDA. The Chinese have now indicated that they want a substantially smaller project with Bank Group financing of about \$50 million of which half would be IDA. Our mission is now in Beijing discussing with the Chinese the revision of the initial project. We still expect to take it to the Board in the current fiscal year and Loan Committee clearance would be sought in the middle of April.

Future Work Program

10. Work on future projects continues. The most advanced are the Port project and the Agriculture project. The Government has also indicated keen interest in Bank assistance for petroleum production. We shall discuss this further during my visit to China. While the China work program remains intact, the projects will be smaller - for FY82-83, we are now expecting the average size of loans to be in the range of \$80-120 million, as compared to \$170-200 million expected earlier this year. The lending buildup is likely to be as follows:

	<u>FY82</u>	<u>FY83</u>	<u>FY84</u>	<u>FY85</u>	<u>FY86</u>
Bank	150	450	n.a.	n.a.	n.a.
IDA	150	250	n.a.	n.a.	n.a.
Total No. of Projects	3	6	8	10	10
Average Size of Loans	100	115	n.a.	n.a.	n.a.

11. Clearly, the Chinese want Bank assistance and they want it on most favorable terms. At least for now they attach value to our economic work and dialogue. There is substantial basis for proceeding with our work program as we had initially planned. The relationship continues to be excellent and continues to improve. However, for some time to come, there will be considerable uncertainty as to the extent of Bank Group assistance to China. Under this circumstance, my own suggestion would be that we do not go with a separate budget paper to the Board on China. The China budget should be integrated in the overall Bank budget. I would also hope that we can avoid a full-fledged Board discussion on lending to China. The issues have been substantially highlighted in the earlier discussion.

cc: Messrs. Jaycox  
Kirmani  
Hasan  
Wyss

CKoch-Weser/SSHusain:mt

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Flu

# OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara  
Through: Mr. E. Stern  
FROM: S.S. Husain *HS*  
SUBJECT: CHINA: Lending Program

DATE November 10, 1980

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1. Messrs. Hasan (who is leading the economic mission) and Koch-Weser, who have just returned from China, have reported on the ongoing work of the economic mission, the status of our initial operations program, and in particular the position the Government has taken on the composition and volume of future Bank lending to China.
2. So far, the economic mission has received excellent cooperation from Government agencies at all levels; discussions are candid and access to information is good. However, it is of some concern to the mission that general uncertainty still surrounds the country's longer term planning efforts. Work on the sixth Five-Year Plan is not expected to be finalized until mid-next year. In the meantime, the Government is planning to eliminate the national budget deficit by 1982 and is taking a very cautious approach with regard to external borrowing. The capital construction budget has been cut substantially, imports are being reduced, and this year's current account deficit is expected to be considerably smaller than last year's. Officials stated that China will probably make only limited use of foreign borrowing in coming years because of serious Government concern about the country's future repayment capacity. Some concern is being expressed as to the country's export prospects through the mid-eighties, particularly with regard to petroleum and coal. Oil production is not expected to increase in coming years, possibly resulting in declining exports. Coal exports might increase more slowly than assumed earlier. We expect the economic mission to shed further light on these issues.
3. Work on the initial operations program of six projects is progressing well. The education project will be appraised during the next four weeks. Preparation missions for the ports project, the hydroelectric power project and the agriculture project have either returned or are in the field. We expect to be able to present the education project to the Board before the end of the fiscal year.
4. As to China's future borrowing from the Bank, Finance Minister Wang Bingqian asked the mission to convey the following government position to you on a confidential basis:

First, China considered the Bank's long-term financial and technical assistance to be of great importance to its modernization program; the Government welcomed the Bank's tentative projection of a lending volume of several billion dollars some years from now and it considered the Bank to be the main source of future external borrowing. Long-term, low-interest bilateral Government loans would come second whereas the high-interest commercial credit facilities of \$20 billion would only be drawn upon as a last resort.

Second, IDA funds would have to account for at least 50% of future Bank lending to China. If such a ratio could not be achieved at high lending levels, a lower total lending amount would be preferable.

Third, in view of the fact that the country's long-term plan had not yet been finalized, it would be of no concern to him if Bank lending to China over the next two years did not reach high levels; his Government took a long-term perspective of its relationship with the Bank.

Fourth, he would propose that of the six initial projects, the education and agriculture projects be IDA-financed because projects in these sectors "had no capacity to repay on their own." The transport and power projects could receive IBRD funds because those ministries had the capacity to repay.

5. I take this as an initial position of the Chinese Government and detailed conversations should follow when we have the economic report and the CPP. However, the objective facts and the Chinese Government's initial position might merit a softer blend than in the draft paper to the Board, particularly for the IDA 6 period. For IDA 6 I would propose 1/3 IDA and 2/3 Bank.

WORLD BANK INTERNATIONAL

# OFFICE MEMORANDUM

FLU

TO: Robert S. McNamara, through Mr. W. Baum, Acting Senior Vice President Operations  
DATE: January 9, 1981

FROM: S. Shahid Husain *SH*

SUBJECT: CHINA - Recent Developments

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1. The Economic Mission has completed its fieldwork and returned from China. In recent weeks important changes have taken place in Chinese economic policy. I believe it appropriate to review for you the broad conclusions of the Economic Mission, the changes presently occurring in China and their likely implications for the Bank's role and program. (For your reference a copy of the final statement of the Economic Mission is attached.)

### Findings of the Economic Mission

2. A core team and five sector teams undertook fieldwork and discussions with Government from mid-October to mid-December. The teams received excellent cooperation from their Chinese counterparts, travelled widely, and were allowed reasonably good access to data (the quality and availability of which had, however, suffered during the Cultural Revolution). As expected, the Mission was more successful in analyzing China's past development performance and in understanding how the Chinese system works, than in assessing the future development plans of the Government. The absence of data, trust and initiative within the bureaucracy is part of the problem, but more importantly the Government's own assessment of the economic situation and its future plans are much more in flux than we observed in July.

3. An IMF mission was in the field during part of the Bank's Mission to carry out a routine Article IV consultation and to discuss China's request for a loan from the Trust Fund and a 12 months' stand by arrangement in the first credit tranche, equivalent to SDR 450 million. Management's recommendation is expected to go before the Fund's board in mid-February.

4. The Economic Mission has confirmed that China's economic achievements during the last 30 years are impressive - a relatively high growth rate, a highly developed industrial structure for a poor country, relatively egalitarian distribution of incomes, and marked progress in meeting basic needs. On average, however, living standards are low; there are shortages of cloth and urban housing; the income disparity between urban and rural areas has grown; and over the past 20 years in some regions absolute incomes have probably fallen.

5. GNP per capita is estimated to be in the range of \$260 to \$270 at the official exchange rate. The GNP growth rate in 1957-1979 averaged about 8.5% p.a., which is less than commonly believed but still higher than in India (6% p.a.). The average per capita growth rate in the same period is estimated at 2.5-2.7% p.a., compared to India's 1.7% p.a. The growth of gross

agricultural output in 1952-79 was 2.4% p.a., as compared with 2.5% in India. The accumulation rate (investment as a ratio of national income) in constant prices has gone up from 15% to 33% during 1957-1979. (About 25-30% of accumulation represents a massive build-up in inventories.) Consumption growth per capita in 1957-79 was about 2% p.a., compared with the average of 1.3-1.4% for low income countries. Most of the growth in consumption in 1977 was in non-food items, and the growth in rural consumption was substantially below that in urban areas. Overall, China has done better than most low income countries, but less well than is generally believed.

6. Energy, oil and coal investments in recent years have lagged badly. We believe oil output will drop between 1980 and 1990; coal output may increase by 3-5% p.a. during 1980-85, while electricity output may increase by 5-6% p.a. over the period, but even this is unlikely to meet unfilled demands (as reflected in severe rationing to industries) and will require substantial new investments. Energy production and its efficient use have emerged as a major issue for China.

7. Agriculture is relatively highly developed. The cultivated area per capita is certainly small and even in total may have decreased over the past 20 years; fertilizer use is high; yields are respectable; the commune structure is potentially conducive to rural development, for providing credits, inputs; marketing and agricultural extension, but the system has not been allowed to work well. The lack of financial support for agriculture and insufficient material incentives are problems that new policies are now meant to address. Investments in water conservation, agricultural research and agricultural credit have also been neglected.

8. Light industry will have to be emphasized to provide employment opportunities, especially in rural areas. Transport, while not a serious constraint at present levels of production and energy use, will soon become a bottleneck.

9. China compares well with other countries in some but not all areas of education. Primary enrollment is universal, but many teachers are unqualified, as in all other developing countries. The secondary education enrollment ratio is 45% compared to India's 28%, but the share of technical education is extremely low, with less than 10% in vocational schools and only 1% in agricultural schools. In higher education, the effects of the Cultural Revolution were disastrous, and skilled and managerial manpower shortages will be a major development problem for years to come.

10. The solution to the problem of low income in rural areas lies partly in reducing the pressures of population on land. The success of population control policies and the sharp drop in the fertility rate over the last few years are encouraging. We believe that the target for limiting the population to 1,200 million by the year 2000, implying an annual growth rate of 1% p.a. for the next 20 years, is feasible.

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11. The allocation of scarce funds for agriculture, light industry and education, while also giving high priority to energy and transport investment, will be a real test of the Government's willingness to cut down on new construction in heavy industry and the very sizable annual increment in inventories. At the same time modernization and improved efficiency in the heavy industry sector will be important to future performance, since its weight in GNP is high, and it consumes 60% of total energy and more than 60% of capital construction funds. Further, there are substantial linkages of heavy industry to other sectors of the economy through petrochemicals, fertilizers, and construction materials. The preliminary judgment of the mission is that the modernization of industry does not need massive imports of equipment, but rather a selective use of foreign exchange to balance, to adjust, to modernize and to expand.

12. China's clearly defined priorities are increasing the efficiency of investment, restructuring output to meet the needs of consumption, and reducing waste and making better use of existing plants. The mission found strengthened planning and management reform to be critically needed. To a much greater extent than expected, we concluded that the statistical system had to be not only revitalized but also reformed; that little systems planning and evaluation of investment were conducted - even less than in many so-called market economies; that there is little analysis of benefits and costs at any level; that a long-term perspective is lacking (preparation of the Sixth Five Year Plan has been delayed further); that system reform without some price reforms may be impossible; and that many of the institutions (especially financial intermediaries) needed to operate a decentralized economy are weak or nonexistent.

#### Recent Changes in Economic Policy

13. At the time of the mission's wrap-up discussions in early December, it became clear that a major debate was taking place in the State Council, reviewing the initial results of the economic readjustment measures introduced in 1979. This debate culminated in a major policy editorial in the People's Daily, which was highly critical of the degree of progress made. Further adjustment of the economy is given priority over reform of the system, and the adjustment period will be extended beyond the three years envisaged originally.

14. The editorial was particularly critical of overextension in capital construction and unbalanced development, and of the failure to analyze economic results and the feasibility of investment proposals, particularly in projects involving large imports. It stressed the need for better control of investments of localities and enterprises and greater scrutiny of imports. Officials have also voiced serious concern that greater than expected budget deficits in 1979 and 1980 may result in inflationary pressures, which in turn might lead to social tensions (because of the population's extreme fear of inflation, originating from the Kuomintang days). There is also

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worry about uncertain export prospects, partly because of a likely decline in oil production. (Contracted oil deliveries to Japan will be cut back sharply this year and halved in 1982.) And there is concern about future debt service capacity. On these points the example of Poland is frequently invoked. In the absence of an adequate planning framework, these criticisms and fears are leading to an increasingly conservative economic policy. In August, the Government believed that the budget deficit would be eliminated not later than 1982 (mainly by cutting capital construction and defense expenditures). There may now be doubts that this can be achieved. A large number of investment projects are being dropped or postponed and the Government is cancelling contracts signed with foreign investors. It has expressed its intention of closing hundreds of uneconomic factories and reviewing hundreds of ongoing projects to determine which should be deferred or curtailed.

15. The economic pressures are reflected in political developments. Leaders associated with the ambitious investment program of 1977 and 1978, including efforts to secure large commitments of financing from abroad and who encouraged massive new plant and equipment orders since the downfall of the Gang of Four are being criticized. Earlier last year Yu Qiuli was replaced by Yao Yilin as head of the State Planning Commission; Vice Premier Gu Mu, a key figure in pressing for a rapid development of Bank-China relations and a key contact for us in his responsibilities for the Capital Construction Commission, the Foreign Investment Commission and the Import-Export Control Commission, has just been relieved of his Chairmanship of the Capital Construction Commission. It was Gu Mu who was the main architect of China's economic agreements with Japan, including large financial commitments in return for raw material and oil supply contracts. Gu Mu also played an important role in arranging for Japan's financing of the Baoshan Steel Complex, which has suffered huge cost overruns and is now the subject of intense criticism. (A second stage has just been postponed.)

16. The fierce debate in China over the direction and pace of the country's development seems to be resolving itself in favor of financial conservatism and a determination to move more slowly with the investment program while studying projects more carefully. Those who are confronted with choosing short-term adjustment priorities and determining longer term goals have only a vague notion of how to undertake these tasks, as the Economic Mission discovered; they are vulnerable to the pressures of the moment and are thus likely to overreact. It is clear that the Government will issue only a one year plan during 1981 and that preparation of the Five Year Plan will take much longer than expected. This protracted appraisal is not necessarily bad; it could result in a healthier atmosphere for China's long-term development and provide a better setting for investment planning and analysis.

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The Bank's Role

17. During the seven months since the change of China's representation in the Bank, the relationship between the Chinese Government and the Bank has developed rapidly and on a broad front. More than a dozen missions have been to China; they have worked with most of the commissions and ministries in the economic area, established contacts with many economic bureaus and research institutions, and visited about 17 provincial governments and a large number of localities, communes, enterprises and projects. At this stage, the Bank's general dialogue with the senior officials of our main counterpart ministries (Ministry of Finance, Ministry of Foreign Affairs) and commissions (State Capital Construction Commission, State Planning Commission) is characterized by openness and a spirit of shared objectives and close cooperation. As is to be expected, the various relationships are still not sufficiently institutionalized. Expectations with regard to the early benefits of cooperation have become more realistic as both sides became increasingly aware of each other's strengths and limitations. The Government appears cautious yet deeply interested in the assistance we can offer in terms of economic, sectoral and project work, especially as this relates to improved planning and project evaluation.

18. Recent events in China have affected the Government's attitude with regard to the development and content of the Bank's lending program in the coming years. They now seem to have realized that we can lend for smaller, less capital-intensive projects which fit their present needs better. The Government has requested that we help with their current financial constraints by, for example, lending through intermediaries for projects to renovate and improve the efficiency of existing industrial capacity, and for the completion of selected high-priority projects that would not otherwise be affordable and that have a quick productive potential. We will be exploring their thoughts on this type of lending in more detail during the next few months.

19. The recent changes in economic policy might also have implications for our Initial Operations Program. As you will recall, we had agreed last July that, as an exception and pending completion of the economic report, we would begin work on preparing and appraising an initial group of six projects for lending during FY82 and 83. Of the six, the Education Project (for tertiary level science and engineering) has been appraised. It should be ready for Board consideration this fiscal year. The Government indicated that some of the other five projects under consideration might require further careful study with regard to their economic justification and financial feasibility in light of the constraints imposed by the present readjustment policies. We will work with the Government on these issues.

20. The implications of all these factors for our program are not clear yet. During the wrap-up discussions, government officials indicated their interest in an intensive program of sector work to be carried out by the Bank. We may find that we are asked to play a much stronger role than expected in sector work and technical assistance, and that the depth and closeness of our country dialogue will mature more quickly than expected.

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21. On the other hand, the build-up of the lending program may be slower than anticipated. We are proceeding with our work program as outlined earlier to you. In particular, we are planning initial lending program and economic report discussions with the Government in March and final economic consultations in May, so that the economic report can be distributed to the Board in June before presentation of the first project.

cc: Jaycox, Kirmani, Hasan, Wyss, Koch-Weser

• Attachment

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Country Brief141  
fileCHINAProspects for the 1980s

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27. China's development strategy in the coming decade will be largely determined by a number of interlocking constraints. Agricultural incomes (the principal source for the poor) are limited by land scarcity by the fact that the easiest advances in intensive cultivation have already been made, by limited opportunities for international trade, and by out-of-date technology. Foreign exchange earnings have been constrained for many years by China's high degree of economic and political isolation from much of the rest of the world. Recent improvements in foreign exchange earnings from export of oil and coal have now been reversed by production declines and soaring domestic consumption. Skilled manpower shortages, particularly scientific and managerial staff, have developed as a result of years of neglect of technical and higher education and the extreme disruption of the Cultural Revolution<sup>t</sup>. These have now emerged as important brakes on further growth.

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28. Tension between development objectives of growth and poverty reduction has contributed to sharp policy oscillations for years. Industrialization has been rapid, largely as the result of an unusually high rate of domestically financed investment. Resultant growth of per capita GNP (2.7% per year in 1957-79; per capita GDP \$256, 1979) is well above the average for low-income countries. However, because the domestic saving rate has been so high, because investment has been less efficient than in other countries, and because agricultural growth has been constrained, the growth of per capita consumption has until recently been relatively slow.

As a result, and to meet raised expectations after a decade of political turmoil and considerable economic deprivation for some, Government is seeking to reduce the savings rate in order to boost living standards.

3. These efforts have been hampered by China's own economic system. It is seriously inefficient in converting inputs into outputs, and in matching supply with demand. Myriad problems have been created by the virtual absence of medium-term planning since 1958, by technical weaknesses in annual planning and project appraisal, by an unsatisfactory and shifting balance of responsibilities between central and local authorities and by prolonged inattention to prices.

4. On the other hand, there have been real improvements in the last four years (per capita consumption shot up at the rate of 10% in 1978-79) as the result of policy changes <sup>to</sup> emphasize consumption and better incomes. The prospects are not all bleak. The phenomenally successful effort since the last 1960s to reduce the birth rate has markedly improved future prospects for productive investment and higher incomes; better planning and system reform could substantially increase efficiency, and access to foreign markets, technology and capital is potentially much improved. The challenge is to harness this promise to ease the constraints on growth, while at the same time further reducing rural poverty.

#### The Current "Readjustment" Problem

5. With the change in the leadership group, after the Cultural Revolution the Government initiated a large capital investment program, including many foreign financed industrial projects. It also took steps to raise the share of consumption in aggregate demand and the share of consumer

goods in aggregate production. It planned to spend more on housing, education, health, agriculture and light industry. In 1979, Government realized it had committed itself to an overly ambitious capital construction program. Serious material shortages were occurring and budget deficits were judged likely. <sup>ordered.</sup> Cutbacks in civil construction and a number of large projects were ~~judged likely.~~ ~~Cutbacks in civil construction and a number of large projects were ordered.~~ Measures to improve consumption were largely unchanged, ~~and their objectives in important respects~~ but the Government miscalculated their effects on the budget and on the balance between aggregate supply and demand, partly because it also failed to achieve the planned reduction in capital investment. As a result, there were large unplanned budget deficits in 1979 and 1980, coupled with strong inflationary pressure that was only partly suppressed by the price control system. In late 1980, Government judged that it had to strengthen its short-term stabilization efforts, broadly labeled as "readjustment". Price controls were stiffened, capital expenditures were slashed, expansion of domestic production - most notably energy and agricultural raw materials for industry - was encouraged. Large projects, particularly those funded from foreign sources have been (even more) curtailed or dropped; exchange controls have been <sup>g</sup>strengthened and external borrowing policies made even more conservative.

6. The merits of these financial measures are difficult to judge in the absence of any medium-term plan and in a country that has very large unused lines of foreign credit and small debt service commitments. There seems to be little appreciation of the costs of retrenchment in terms of growth foregone and the postponed reforms to the system, nor does there

seem to be active consideration of alternative strategies, for example, greater reliance on imports to satisfy demand and foreign borrowing to finance badly needed new investment. Without it, the country's export position and energy balance will almost surely deteriorate over the next few years; technological changes in industry, agriculture and energy require new investments to be a main engine of future growth, which in turn, will be necessary for employment creation, and for equity. The severe financial constraints may result in China still being in a low income, low productivity trap later this decade. Nonetheless, China assesses current financial pressures as so severe as to require sharp and prolonged investment cutbacks, and in relation to the Bank Group, to mandate a highly concessional IDA/Bank blend.

#### Implications for the Bank's Program

7. Only a few weeks after the initial invitation by the Chinese Ambassador, Mr. McNamara and a group of senior Bank staff visited China in April 1980 and started discussions aimed at China's active membership in the Bank. China assumed its seat in the Bank on May 15, 1981<sup>0</sup> and elected its own Executive Director to a specially created twenty-first seat on the Board. A first operational mission by high level Bank staff in July 1980<sup>D</sup> agreed on an initial economic work program for the first report on China, and an initial list of six projects (in education, agriculture, transportation and energy development) to be prepared so that lending could commence soon after completion of economic work.



8. A large economic mission spent over two months in China in late 1980<sup>9</sup> and have produced a first economic overview of the problems and prospects of the Chinese economy including separate annexes on the education, industrial<sup>y</sup> agricultural<sup>e</sup>, human resources, transportation and energy sectors and a statistical volume. The conclusions of these reports will be reviewed with Chinese authorities in May<sup>1981</sup> and circulated to the Executive Directors soon thereafter.

9. Government's "readjustment" concerns have also caused second thoughts about the size and selection of projects being prepared for initial lending operations. For the near term and for the first projects, the Chinese are preoccupied with overall future IDA/Bank blend even though they know that no substantial resolution of the issue can take place now. Because of this, and the budget slashes taking a toll on China's investment program, initial project work will probably continue to proceed slowly. Of the initial six projects, the first three continue to be University Development, (planned for Board consideration in June 1981), Irrigation and Drainage, and Port Improvement (both scheduled for FY82). The other three projects, in energy development and transportation, will probably proceed only at a later time.

10. For the longer term, our key counterparts have reiterated their objective of sound relationship with the Bank Group and have said that they are not deeply concerned if the initial program does not build up rapidly. Access to IDA financing will remain a long-term issue. China sees itself as a poor country and hence, the need for a fundamental reallocation of IDA resources to reflect the needs of all the Bank's poor member countries, including China.

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Our knowledge of China is still inadequate in relation to that needed for an effective dialogue on alternative development strategies and policies to achieve them. A good start has been made, by the economic mission, however, and we are aiming toward a credible dialogue, in particular, on improved sector planning and investment criteria, managerial and financial performance, and better utilization of existing capacity and human resources. Project investments will help to remove critical constraints in energy, industrial and agricultural production growth, technical manpower, education and transportation, and will begin the transfer of a higher level of external concessionary resources to China. This will help to ease the conflicts in transition from "readjustment" to reform and to improve the longer-term growth prospects. While agreement on the details is yet inconclusive, the economic and sector work program will include work in each of the key sectors of energy, industry, agriculture, transport, education, and health and sanitation. This will improve our understanding and data base in these sectors and will give opportunity for closer work with China's planners in their preparation of the Sixth Five Year Plan. Project identification and preparation work will concentrate on energy development, (possibly including petroleum exploration and enhanced recovery programs), financial intermediation to help with both agricultural and industrial credit, selective industrial ~~and~~ rehabilitation and energy conservation, agricultural<sup>al</sup> research and training, technical manpower and teacher training, and selective transport infrastructure improvement.

LENDING TO CHINA

Introduction

1. Judgment of China's eligibility for Bank and IDA borrowing and formulation of a lending program have to be based on staff analysis of the country's development performance and prospects and a comprehensive policy dialogue with the Government. The Bank's first economic mission is presently in the field; this paper should not prejudge its conclusions, which are expected to be presented to the Government by end-March 1981. The first CPP on China is planned to be reviewed before the end of the fiscal year. Therefore, in the following, only a highly tentative assessment is made of China's eligibility for Bank and IDA borrowing. Based on this assessment, a possible progression of lending is presented for FY82-86. The overall amounts of lending and particularly the proportions of IDA/IBRD financing have to be considered as indicating only rough orders of magnitude.
2. The paper first reviews China's past development performance; second, it deals with the country's capital needs and creditworthiness; and finally, it presents an indicative program of lending.

Development Performance

3. Country Size and Per Capita Income. Among developing countries, China is by far the largest in terms of both population and GNP. It had a population of 952 million and GNP of \$219 billion in 1978, compared to India's population of 644 million and GNP of almost \$113 billion. China's official figure for GNP per capita in 1978 is \$230, though other estimates are as high as \$400 (the official estimate is based on official exchange rate conversion and probably understates the income's real purchasing power). Thus China's per capita income probably places it among the group of low-income countries with per capita incomes below \$360 in 1978, which for IDA-6 have been allocated 90% of total available funds, and certainly well below the upper limit of IDA eligibility of \$625 (at 1978 prices). The per capita income of major IDA borrowers ranged from \$90 (for Bangladesh) to \$400 (for Egypt) in 1978.
4. Economic and Social Performance. A firm assessment of China's economic and social performance cannot be made until a full analysis has been completed by the economic mission. Over a 30-year perspective, there is little doubt that China's performance by these two criteria is much better than that of India, Indonesia, Pakistan and Bangladesh - the only countries with which a meaningful comparison can be made. Growth has averaged about 5% a year. Income distribution improved significantly between 1950 and 1958 (as a result of land reform and other institutional changes) and has remained roughly unchanged despite rapid growth, although urban-rural income disparity may have widened somewhat in the 1970s. Access to social services is also more equitably distributed than in any of the countries mentioned above. An active population planning program has reduced the population growth rate from over 2% in 1970 to the current rate of 1.2%. Over the past year, even stronger incentives have been introduced in an effort to reduce the growth rate to 0.5% by 1985. During the 1970s, growth in China has been somewhat slower than in the past because of the political disruptions of the Cultural Revolution.

Nonetheless, China's performance in the 1970s probably still compares favorably with that of larger low-income countries, though perhaps not with that of the market economies of East Asia.

5. Mobilization of Resources and Efficient Use of Capital. China's performance by this criterion has been uneven. The country seems to share with most socialist countries a remarkable ability to mobilize resources for development but an apparent inability to use them efficiently (during most of the 1970s, an investment rate of 30% resulted in a growth rate of less than 5%). The latter, however, is attributable partly to the country's economic isolation since 1960, though inadequate planning and management have been contributing factors. Between the late 1950s and the late 1970s practically all the resources used for development were domestic.

Capital Needs and Creditworthiness

6. Current Account Deficit. Little can be said with any degree of certainty about China's future current account position. The future volume of trade is likely to be much larger than in the past and past balance of payments trends provide little guidance to future development. The main objective of imports during the 1960s and 1970s was to relieve domestic supply shortages, especially in food grains and industrial supplies. Since about the mid-1970s, the Government has begun to use external trade as a development instrument, and the volume of trade has expanded. Since 1976, borrowing from abroad was allowed, in order to finance imports required for the country's modernization program. The most recent trade statistics are given below:

	1976	1977	1978	1979	Annual average growth 1976-79 (%)
	-----(\$ billions)-----				
Exports	7.3	7.7	10.1	13.7	24
Imports	<u>5.4</u>	<u>7.3</u>	<u>11.3</u>	<u>15.8</u>	43
Total balance	1.8	0.4	-1.2	-2.1	

7. In the short and medium term, the country's import demands are likely to grow considerably faster than its export capacity, and China is likely to incur a large and growing trade deficit as it moves towards a more open economic structure. The transition to a level of imports appropriate for the size of the economy implies a rapid growth of imports for some years, and the amount of "pent-up" demand is very large, especially to modernize plants using the more efficient equipment or more advanced technology available from abroad. For the longer term, the transition to a more open economy implies rapid growth of exports as well as imports.

8. The rapid growth rate of exports and imports of the recent past can probably not be sustained for any length of time. In the following, some alternative projections of future growth rates are presented, though at this point, these are of necessity purely arithmetical exercises. As a "worst possible outcome" projection, exports in current prices might grow by 15% a year over the next six years, while imports grow by 25% a year, i.e. at substantially lower rates than those experienced over the past four years. Under these assumptions,

China's trade deficit would rise to \$29 billion by 1985, while total deficits for 1980-85 would amount to \$85 billion. Clearly such a level of deficits would be very difficult to manage. On the other hand, under a "best possible outcome" projection (both exports and imports growing by 20% a year in nominal terms), the trade deficit would rise to \$6 billion by 1985, while accumulated deficits over 1980-85 would total \$25 billion. However, it appears unlikely that the high rates of export growth assumed under this scenario can be achieved. Finally, a "most likely outcome" projection would assume that exports grow by 15% a year while imports grow by 20% a year. This implies that the trade deficit would rise to \$15 billion by 1985 and accumulated deficits for the next 6 years total \$50 billion.

9. In 1978, China enjoyed a service account surplus of \$1.2 billion, comprising \$0.5 billion of tourist income and a slightly larger amount of remittances from abroad. Net service income could amount to about \$2 billion a year during the 1980s. Accordingly, under the "most likely scenario," the current account deficit in the mid-1980s in current prices could be around \$13 billion a year, while cumulative deficits over 1980-85 would be about \$38 billion. The accumulated current account deficits of this scenario appear to be manageable if China can obtain longer term and concessionary financing. During his meeting with Mr. McNamara in April, Vice-Premier Gu Mu had stated that in the future, the country's current account deficit might reach \$10 billion per year.

10. Debt Service Capacity. China will be embarking on its modernization program with a relatively small external debt, but its debt service capacity and balance of payments prospects remain to be analyzed. However, it appears that in the early years of the modernization program, the country can afford to contract a fair amount of conventional loans. Estimates by US and Japanese sources indicate that, before 1974, China's external debt consisted almost entirely of short-term supplier credits. Since then, medium-term debt has been used to finance plant imports. By the end of 1978, total short- and medium-term debt was estimated at \$1.6 billion, about 16% of export value in that year. Because of the short-term and commercial nature of these debts, debt service payments have been quite significant at about 10% of exports in recent years, or even more in terms of hard currency exports.

11. In 1978, the Government began a major effort to seek external credit for financing its modernization program. By February 1980, a total commitment of \$26 billion had been obtained, of which \$16 billion were Exim Bank credits carrying interest rates between 7.25% and 7.50% and about \$10 billion were commercial bank credits carrying interest rates about 0.5% above LIBOR (currently 14.75%). During the Government's reassessment of the development program in 1979, doubts were apparently raised as to the economic justification and feasibility of the projects to be financed by these external credits. Most of the projects were in heavy industry. The Government has since reordered its priorities. Doubts were apparently also raised about the country's ability to service such an amount of external debt. As a result, only a very small amount of the debt commitment has been drawn upon. Instead, the Government attempted to obtain longer term concessionary credits.

12. Level of International Reserves. China apparently has a low level of international reserves. No official estimates of China's international reserves have ever been given, but available information indicates a total of \$2.7 billion in gold and foreign exchange./1

13. In conclusion, China at present has no external debt problem. So far, the country also seems to have no difficulty in obtaining a large amount of funds on Exim Bank and commercial bank terms. However, because of the huge backlog of import requirements and the Government's intention to accelerate the pace of modernization, the country faces very large foreign capital requirements over the coming years. Clearly China will have to obtain longer term and concessionary financing if debt service payments are to be kept at a reasonable level. There are virtually no historical data on which to judge China's ability to obtain and use external development assistance.

14. Economic Management. China will probably soon need to obtain and manage a sizeable foreign debt in order to implement its modernization program. In the circumstances, the crucial factor in an assessment of China's creditworthiness must be the country's economic management. Despite the country's achievements, the present Chinese leadership is very critical of development management in the past, especially since the mid-1960s, and they are frank about the inefficiencies of the Chinese economic system, which has remained largely unchanged since the late 1950s. The Chinese feel that these inefficiencies arise from excessive centralized control and planning, inadequate use of prices as an instrument and insulation of production from demand, isolation from foreign technology, and an excessive concentration on heavy industry.

15. The Government is presently introducing a series of economic management reforms. Steps are being taken to delegate significant production and investment decisions to industrial and agricultural units, to create a free market for some consumer and producer goods, and to introduce new monetary incentives for productivity. Many industrial enterprises are being transformed from direct state-managed units to substantially independent entities, with full accountability of managers for their performance. An expansion of financial and technological links with the outside world is seen as an integral part of the effort to modernize and restructure the economy, to improve consumption standards, and to deepen the technological base of the economy.

16. There are fundamental risks in the new course the Government is following, and an evaluation of the new policies and programs will only be possible after some time. In addition, China's near-isolation in recent years makes it difficult to assess the economy's ability to adjust to unexpected adverse external circumstances and internal factors, though in the past, the country has coped well, for instance, with the sudden withdrawal of Soviet assistance, and with political turmoil or experimentation with radical social and economic policies.

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/1 With gold valued at SDR 35 per fine ounce.

17. Availability of Projects and Implementation Capability. China's annual investment program amounts to more than \$75 billion. The country seems to have the capacity to absorb large amounts of lending and has a large number of projects at various stages of preparation for which it is seeking external financing. Because of the size of the Chinese economy, most of these are very large projects by Bank standards. Earlier this year, the Chinese presented to Bank mission members an initial list of 19 projects (with a total cost of \$10.6 billion and a foreign exchange component of \$6.0 billion) for possible Bank financing over the next five years. The size of the hydro and thermal power projects is indicated by their estimated cost, which ranged from \$670 million to \$2,370 million, with a foreign exchange cost of \$400 million to \$1,400 million. The estimated cost of most transport projects ranged from \$200 million to \$445 million, with a foreign exchange cost of between \$100 million and \$300 million. The education and agriculture projects subsequently presented have an estimated cost of \$390 million and \$440 million respectively, and a foreign exchange cost of \$160 million and \$190 million.

18. To implement the projects, the Chinese have a well organized system. Each ministry is equipped with its own bureaus of construction, maintenance and operation, and often also with its own production bureaus or factories for manufacturing the equipment required for its projects. However, the division of responsibility among the various bureaus and their accountability are so clearly defined and enforced that they virtually operate as contractors. Bank mission members were convinced that China has the competence and capacity to plan, design and implement such large and complex projects as those suggested for Bank financing, but that the country is weak in such areas as technology, innovation and know-how. This calls for a "higher quality input" by the Bank in project formulation and design to introduce technology and practices presently missing in China. In project implementation, China has a tremendous advantage through the central coordinating and review role of the State Capital Construction Commission. The Bank has not yet been able to fully assess the Chinese system of project implementation or to establish how the Chinese system can be meshed with Bank guidelines and procedures, particularly with regard to procurement. However, the Chinese have now agreed to set up a World Bank Projects Coordination Unit under the Capital Construction Commission to further expedite the processing of Bank projects, particularly the preparation of contract documents.

#### Proposed Work Program

19. Objectives and Initial Country Dialogue. The objective of initial Bank operations in China must be to (a) facilitate China's re-entry into the world development community; (b) assist Chinese officials in selecting and absorbing available technology from the wide range of Bank member countries; (c) provide technical assistance in investment planning and management in key infrastructure and other sectors; and (d) assist China to gain access to concessionary development capital, including the Bank Group's own resources. Our initial dialogue with the Chinese confirms their interest in these areas. The Chinese attach great importance to their relationship with the Bank and expect the institution to be a major source of both capital and technical assistance. They consider the country eligible for large amounts of IDA

funds, but recognize that only over the longer term will they be able to receive financing to the full extent of their IDA eligibility. They have also accepted that the Bank conducts its operations within a broader context of economic and sector work; their past discussions with the Bank have been candid, and they have agreed to allow the economic mission full access to the available data.

20. It is still too early to address the sector composition of lending. The Chinese initially expressed an interest in financing in the energy, and transport and communications sectors; the education, agriculture and industry sectors were subsequently mentioned as possible areas for financing. However, since the inadequate development of economic infrastructure seriously constrains economic growth, the initial emphasis of Bank operations will most likely be in electric power and transport. Of the 19 projects presented to Bank mission members for possible Bank financing over the next five years, the Bank has selected six projects (one project each in the agriculture and education sectors and two each in transport and energy) for presentation to the Board in FY82/83. One project might be moved forward to FY81, most likely that in the education sector.

21. The average size of Bank projects in China is expected to be large, given the size of the government's investment program and the size of most projects presently under implementation in China. This applies also to early lending operations, the estimated total cost of the six selected projects ranges from \$360 million to \$1,500 million. The following lending program tentatively assumes that the average loan size will be \$200 million and that cofinancing of projects will frequently be possible.

22. Possible FY82-86 Lending Program. Based on the preceding evaluation of China's development record, capital needs and absorptive capacity, and taking into account the current volume of lending to other large, populous countries, a level of lending to China of at least \$3-4 billion per year would be justified. Achievement of this level of lending depends both on the time needed to develop and initiate a full program of operations, as well as on the Bank's capacity to accommodate this additional financial commitment to China within its overall lending program. Based on these two criteria, we do not anticipate that this level of lending can be reached before FY86.

23. The proposed progression of lending assumes an initial build-up of operations from three projects in FY82 to five projects in FY83 and ten projects in FY84. An initial review of the projects for which the Government is seeking external financing, together with a comparison with the expansion of Bank operations in Indonesia after 1968, indicates that such a build-up is possible. In the case of that country, the number of lending operations jumped from zero in FY68 to four in FY69 and eight in FY70. Mission members also agreed that Chinese ministries are much better organized than the Indonesian Government was in 1968.



24. An immediate issue is whether China should receive any significant amount of IDA funds, since, at least during the IDA-6 replenishment period, it would be withdrawing resources from other countries, whose creditworthiness for Bank lending might be more limited than China's, or even nonexistent. The Bank's strategy should be to maximize China's borrowing from IBRD (and minimize borrowing from IDA) within prudent credit limits. At this point, only a notional proportionality can be presented. The proposed progression of lending over FY82-86 envisages a blend of one-half IDA and one-half IBRD funds, except during IDA-6 when a blend of one-third IDA and two-thirds IBRD is assumed.

	<u>FY 82</u>	<u>FY 83</u>	<u>FY 84</u>	<u>FY 85</u>	<u>FY 86</u>
	----- (\$ million) -----				
Bank	400	650	900	1,250	1,750
IDA	200	350	850	1,250	1,750
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Total	<u>600</u>	<u>1,000</u>	<u>1,750</u>	<u>2,500</u>	<u>3,500</u>
	===	=====	=====	=====	=====
No. of Projects	3	5	10	12	16

To further reduce demands on IDA, particularly in the initial years, a blend of one-quarter IDA and three-quarters IBRD funds during IDA-6, and of one-third IDA and two-thirds IBRD for the other years, could be considered, but this proposal might not be acceptable to the Chinese Government. These overall amounts, as well as the proportions of IDA/IBRD financing, should, of course, be amended in light of the conclusions of the economic mission and the results of a comprehensive policy dialogue with the Government over the next eight months.

File

China: Basic Data

<u>Area:</u>	3,748,800 sq. miles (9,597,000 sq. km.)			
<u>Population (end 1979):</u>	970.92 million			
<u>Annual rate of population increase (1978-79):</u>	1.2 per cent			
	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980 1/</u>
<u>National income 2/ (in billions of yuan)</u>				
At current prices	267.7	301.4	337.0	371.5
At 1975 prices	264.3	296.1	316.4	332.2
<u>GDP (in billions of yuan, at current prices)</u>	302.3	341.2	381.4	420.0
<u>GDP per capita (US\$)</u>	176	215	256	288
<u>Annual percentage changes in selected economic indicators</u>				
National income (in real terms)	8.0	12.0	7.0	5.0
Gross industrial output	14.3	13.5	8.5	8.4
Gross agricultural output	1.7	9.0	8.6	--
Gross fixed investment	6.4	29.8	3.6	2.7
Budgetary revenue (GFS)	...	28.2	-4.6	-3.7
Budgetary expenditure (GFS)	...	31.6	14.6	-8.8
Currency in circulation	...	8.7	26.4	29.2
Total credit	...	...	16.2	18.3
Consumer price index	...	-2.8	1.7	5.3
Agricultural procurement prices	...	3.9	22.1	...
Value of imports (trade basis)	...	51.0	43.9	17.4
Value of exports (trade basis)	...	28.4	40.2	31.1
<u>Ratios to GDP</u>				
Agricultural production	32.5	31.2	34.3	31.1
Industrial production	39.7	41.4	40.4	43.8
Total investment	27.5	31.7	29.4	26.5
Budgetary revenue (GFS)	28.9	32.9	28.0	24.5
Budgetary expenditure (GFS)	27.9	32.6	33.4	26.6
Imports of goods and services (trade basis)	4.6	5.6	7.0	7.4
Exports of goods and services (trade basis)	4.9	3.7	5.6	6.3
Currency in circulation	...	6.2	7.0	8.2
Total credit	...	54.5	56.7	60.8

China: Basic Data (continued)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u> <u>1/</u>
<u>Balance of payments (US\$ mn.)</u> <u>3/</u>				
Exports, f.o.b.	8,050	9,745	13,987	17,900
Imports, c.i.f.	-7,627	-11,399	-17,266	-20,968
Trade balance	423	-1,654	-3,279	-3,068
Current account balance <u>4/</u>	911	-447	-1,528	-1,189
Capital account	-402	-338	2,201	486
Overall balance (deficit -)	509	-785	673	-557
<u>International reserves</u> <u>3/</u>	1,499	753	1,433	857
<u>Exchange rate</u> (Yuan to the dollar, average during the year)	1.828	1.661	1.541	1.496

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1/ Estimates.

2/ Excludes nonmaterial services.

3/ Staff calculations (see SM/81/43, 2/18/81, Section IV:3d and Appendix VII).

4/ Includes official transfers.

Fund Relations with China  
(January 31, 1981)

- Representation:** The People's Republic of China assumed representation of China in the Fund on April 17, 1980.
- Quota:** China's quota was increased from SDR 550 million to SDR 1.2 billion on September 26, 1980. On December 28, 1980 China's quota was further increased to SDR 1.8 billion in connection with the Seventh General Review.
- Status:** China continues to avail itself of the transitional arrangements of Article XIV.
- Use of Fund resources:** China made a reserve tranche drawing of SDR 218 million effective November 4, 1980 and of SDR 150 million effective January 8, 1981.
- Fund's holdings of renminbi:** SDR 1.8 billion or 100 per cent of quota.
- SDR position:** After the allocation of SDR 122.4 million on January 1, 1981, China's total net cumulative allocation was SDR 236.8 million; holdings were 344.4 million, or 145.5 per cent of total net cumulative allocations.
- Exchange arrangements:** China notified the Fund on August 15, 1980 of its exchange arrangements. China's currency, the renminbi, is linked to a basket of internationally traded currencies, weighted with reference to their importance in China's external transactions and the trends in their relative values. The representative rate is determined as the mid-point between the buying and selling rate of the renminbi to the U.S. dollar. As of January 29, 1981, the representative rate for the renminbi was Y 1.5846 per U.S. dollar.
- Fund visits to China:** There have been two earlier missions to China. The first mission (March 1980) discussed the various aspects of China's membership of the Fund. The second mission (June 1980) gathered the information necessary for the quota paper.

Relations of China with the IBRD

**Representation:**

The People's Republic of China assumed China's representation in the World Bank on May 15, 1980.

**Increase in capital:**

On August 8, 1979, the Bank's Directors recommended that the Board of Governors approve a resolution authorizing China to subscribe to an additional 4,500 shares of the capital stock. This resolution was adopted on September 3, 1980, and the increase became effective on September 25, 1980, bringing China's subscription to 12,000 shares.

**Missions:**

1. In July 1980, an acquaintance mission of senior officials of the Bank visited China to evaluate the overall environment within which the relations between the Bank and China would be conducted, to assess the institutions in China concerned with economic development and implementation of projects, to initiate a dialogue with the Chinese authorities on a work program, and to identify a small number of projects which could be suitable for financing by the Bank.

2. During the period October-December 1980, an economic mission visited China. This mission consisted of a general economic team, an educational specialist, and small sector teams in agriculture, industry, transport, and energy. The purpose of this mission was (a) to review the performance of the economy since the establishment of the PRC in 1949 and the Government's current development priorities and constraints; (b) to assess China's creditworthiness; (c) to establish a data base; (d) to identify major policy areas for future work; and (e) to provide a preliminary framework for conducting the Bank's operational work and formulating a medium-term country assistance strategy, including priorities among, as well as within, sectors.

Relations of China with the IBRD (Continued)

Lending activity: The Bank has agreed to begin the preparatory work on a small number of projects, parallel to the economic and sector analysis that was initiated by the economic mission in October. These projects are in the areas of higher education, agriculture, transportation, and energy. Projects are at various stages of preparation.

The future volume of lending to China will depend on the balance struck between China's financial needs as they emerge from the present readjustment period and the ability of the Bank to meet those needs without violating its own financial constraint.

Recent Changes in the Exchange and Trade System

In a cable communication received on January 24, 1981, the Chinese authorities have provided the following information:

"In foreign transactions, there is only one exchange rate in China, i.e., the official rate of renminbi quoted by the State general administration of exchange control. This rate applies to all foreign transactions of China, including foreign trade, loans or aid, transportation, insurance, tourism, overseas Chinese remittances and remittances to or from foreign diplomatic or commercial representations in China and assessment of customs duties on imports and exports.

Since January 1, 1981 we have introduced the internal settlement price system for foreign trade transactions. This price is formed by adding to the official rate an "equalization price" for balancing export and import profits and losses. At the moment, the official rate is around RMB 1.50 per U.S. dollar and the equalization price around RMB 1.30 per U.S. dollar. Added together, the internal settlement price is RMB 2.80 per U.S. dollar. This price is to be used by the Bank of China for settling trade payments (including trade under bilateral agreements) and ancillary expenses (including transportation and insurance related to trade). The foreign trade corporations (subsidiaries of the Ministry of Foreign Trade), trade corporations under the jurisdiction of regional or municipal authorities and enterprises authorized to engage in the import and export business are to sell their foreign exchange from export proceeds to the Bank of China at the official rate plus the equalization price and they are to buy foreign exchange from the Bank of China for acquiring import goods at the official rate plus the equalization price. The Bank of China is in charge of balancing the import and export profits and losses. The funds needed for this purpose are to be provided by the State Budget.

The new responsibility assigned to the Bank of China is a measure that has been taken in line with the current reform of China's administrative system of foreign trade. Over the years, China's foreign trade has been monopolized by the State, who decided on the plans for imports and exports, these plans were carried out by the foreign trade corporations (under the Ministry of Foreign Trade) who handled both imports and exports. They settled trade payments through the Bank of China at the official rate. The Ministry of Foreign Trade was in charge of balancing export and import profits and losses which were then absorbed by the State Budget.

In order to bring into play the enthusiasm of local authorities, government organs and enterprises, a reform in the administrative system of China's foreign trade has recently got under way, according to plan and by stages. Under the guidance of the overall foreign trade plans and policy of the State, regional authorities and government organs have been authorized by the State Council to set up their own import and export corporations. But they are to take care of profits and losses by themselves. Some large enterprises and complexes have also been authorized to engage in import and export business. Since they do not handle both imports and exports, they cannot

balance profits and losses by themselves, nor through the Ministry of Foreign Trade. Hence the internal settlement price system, effective 1981, whereby the Bank of China is in charge of balancing export and import profits and losses.

The internal settlement price system involves only a change in the method of internal balancing of export and import profits and losses. It has no effect on China's economic relations with foreign countries, nor does it affect the exchange rates of renminbi against foreign currencies. In the past, the compensation trade was subsidized by the Ministry of Foreign Trade, but now is subsidized by the equalization price. It is only a change in form. Transactions between foreign trade corporations and enterprises producing export commodities or acquiring imported goods continue to be settled at domestic prices. The prices of import and export goods remain largely unchanged, so the bonuses and taxes paid and subsidies received by enterprises producing goods for export or acquiring imported goods are in no way affected.

The measure has just been introduced. We need to go through a period of practice before attempting an assessment. We expect it will stimulate the enthusiasm of regional authorities, government organs and enterprises, and urge them to stress more effective financial management but it is too early to predict its overall effectiveness. We welcome your valuable comments and suggestions.

As a consequence of the restructuring of economic system and the introduction of a retention quota system of foreign exchange, some enterprises holding foreign exchange that they have earned from retention quotas sometimes may wish to sell this foreign exchange, in exchange for renminbi, while some other enterprises which have been authorized to import may be in short of foreign exchange. In order to help balancing the surplus and shortage of foreign exchange between enterprises, the Bank of China has established in a few areas a trading system of foreign exchange on an experimental basis. The trading is mainly limited to nontrade foreign exchange retained by national enterprises. The would-be seller and would-be buyer register with the Bank of China. The Bank of China acts as an intermediary in channeling the seller's foreign exchange to the buyer and levies a commission (most at 0.1 per cent) on both sides of the transaction. Currencies to be traded are U.S. dollars, pounds sterling, and Hong Kong dollars. The transaction is settled at the internal settlement price for foreign trade transactions. All transactions are spot transaction, and must be handled through the Bank of China, direct transaction between any units and enterprises is not allowed."



ROUTING SLIP		DATE
OFFICE OF THE SENIOR VICE PRESIDENT, OPERATIONS		
NAME		ROOM NO.
M <sup>r</sup> STERN.		
URGENT.		
To Handle		Note and File
Appropriate Disposition		Note and Return
Approval		Prepare Reply
Comment		Per Our Conversation
Full Report		Recommendation
Information		Signature
Initial		Send On
REMARKS		
<p>I THINK AN EXCEPTION IS JUSTIFIED IN THIS CASE SINCE AUSTRALIAN FIRM WAS SELECTED ON NORMAL CRITERIA. UNLESS LEGAL DEPT. HAS SOME OBJECTIONS I PROPOSE TO TELL THE REGION TO GO AHEAD. DO YOU AGREE?</p>		
FROM		
Fred V. [Signature]		

## OFFICE MEMORANDUM

TO: Mr. Frank Vibert (Senior Adviser, SVPOP) DATE: February 17, 1982  
 Ms. Elizabeth Wetzel-Apitz (Legal Adviser for Cofinancing, LEG)

FROM: Y. Kimura (Acting Chief, AEADF) *Y. Kimura*

SUBJECT: CHINA - Australian Cofinancing of the  
Lubuge Hydropower Project Preparation Work

1. Following our conversation of February 16, please find below some background on the Lubuge situation and our justification for requesting special treatment of the proposed Australian cofinancing.

2. Financing of the consultants services for preparation of the Lubuge project was originally proposed under the UNDP Umbrella Project. The Bank, as executing agency for the Umbrella Project, selected the Snowy Mountains Engineering Corporation (SMEC) of Australia following the Bank/UNDP standard selection procedure for consultants. Thereafter, we were informed that the Chinese Government had reduced the allocation of UNDP funds for the second phase of the Umbrella Project (from the original proposal of \$2.2 million to \$800,000), because it needed more UNDP funds for non-Bank-financed projects. At about this time, the Australian Government heard that SMEC had been selected for preparation of the Lubuge project and offered to finance the cost of the firm's services. In view of the shortage of UNDP funds, we welcomed the offer of funds from Australia and advised the Chinese Government to make an official request to the Australian Development Assistance Bureau (ADAB) in accordance with its required procedures.

3. ADAB has agreed to finance SMEC's services on condition that the Bank administer its contribution and that a memorandum of understanding be concluded between the Bank and ADAB regarding a general exchange of information on the progress of project preparation. ADAB has rejected the alternative of channelling the funds through the UNDP Umbrella Project, partly because the Bank levies an 11% overhead charge for administering UNDP funds. We explained to the Australian ED's office that the Bank does not usually administer tied bilateral aid, and cited the precedent established by Bank management in response to Norwegian and Belgian offers of assistance. However, if we maintain our current position, the Australians will withdraw their offer.

4. We feel that making an exception in this case is justified on several grounds. First, now that the Bank is making a significant effort to solicit cofinancing from bilateral and other sources, it should perhaps be less stringent in applying its rule of not administering such aid. Since the Australian offer was in response to the Bank's campaign to promote participation by bilateral donors in Bank projects, we feel the Bank should be prepared to administer the funds and accommodate the donor's conditions. (The question of charging a fee for our services will also be an issue and we recommend that a special exemption be given on this also.) Second, for the Lubuge project, the money was not offered as tied bilateral aid, but was, rather, offered to finance the services of a firm already selected. Finally, we would like to stress our particular difficulty because of shortfalls in

UNDP allocations for project preparation in China. To compensate for cutbacks, we have had to seek cofinancing for this work in order to maintain our planned operations program. The loss of the Australian cofinancing would seriously jeopardize preparation of the Lubuge project, as its UNDP funds have already been reallocated to other projects.

5. For these reasons, we would like to urge that the Bank make an exception for the Lubuge project, by agreeing to administer the Australian aid.

Cleared with & cc: Messrs. Howlett, Beach (AEP)

cc: Messrs. Jaycox, Koch-Weser, Berk (AEA), Wyss (AEP), Vorkink (LEG)

LM:YK:hk



# Record Removal Notice



<b>File Title</b> China - General - Loan Committee Project File		<b>Barcode No.</b>  1058384		
<b>Document Date</b> 11/6/1980	<b>Document Type</b> Memorandum			
<b>Correspondents / Participants</b> To: A. Razafindrabe, Executive Director From: T. T. Thahane, Vice President and Secretary				
<b>Subject / Title</b> Inclusion of China Among IDA Recipients				
<b>Exception(s)</b>				
<b>Additional Comments</b> Declassification review of this record may be initiated upon request.		The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.		
		<table border="1"><tr><td><b>Withdrawn by</b> Bertha F. Wilson</td><td><b>Date</b> October 11, 2023</td></tr></table>	<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023
<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023			



# Record Removal Notice



<b>File Title</b> China - General - Loan Committee Project File		<b>Barcode No.</b>  1058384		
<b>Document Date</b> 9/9/1980	<b>Document Type</b> Board Record			
<b>Correspondents / Participants</b>				
<b>Subject / Title</b> China - Increase in Subscription (Record of Voting)				
<b>Exception(s)</b>				
<b>Additional Comments</b> Declassification review of this record may be initiated upon request.		The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.  <table border="1"><tr><td><b>Withdrawn by</b> Bertha F. Wilson</td><td><b>Date</b> October 11, 2023</td></tr></table>	<b>Withdrawn by</b> Bertha F. Wilson	<b>Date</b> October 11, 2023
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International Bank for Reconstruction and Development  
International Development Association

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**WBG ARCHIVES**

R80-129/3  
IDA/R80-85/3

FROM: Vice President and Secretary

August 26, 1980

CHINA - Supplement to the IBRD/IDA FY81  
Administrative Expense Budget

Attached is a memorandum from the President entitled "China - Supplement to the IBRD/IDA FY81 Administrative Expense Budget". In the absence of a request for discussion by an Executive Director prior to the close of business on Monday, September 8, 1980, the proposal will be deemed to have been approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Any questions on this memorandum may be referred to Mr. H. Vergin (X75833).

Distribution:

Executive Directors and Alternates  
President  
Senior Vice Presidents  
President's Council  
Vice Presidents, IFC  
Directors and Department Heads, Bank and IFC

THE WORLD BANK  
Washington, D.C. 20433  
U.S.A.

Office of the President

DECLASSIFIED

August 25, 1980

NOV 30 2022

WBG ARCHIVES

CHINA - SUPPLEMENT TO THE  
LBRD/IDA FY81 ADMINISTRATIVE EXPENSE BUDGET

A. INTRODUCTION

1. On May 15, 1980 the Government of the People's Republic of China assumed representation of China in the World Bank Group. Subsequently, in July discussions were held by the management of the East Asia and Pacific Regional Office with the Chinese authorities on an operational work program. Based on these discussions, this memorandum describes the proposed FY81 work program and presents for your consideration and approval a supplement to the approved FY81 budget to execute the work program for China.

2. In the Board discussion of the memorandum entitled "Review of World Bank Group Financial and Operating Programs and FY81 Administrative Budgets" (R80-129[IDA/R80-85, IFC R80-47], R80-129/1[IDA/R80-85/1, IFC/R80-47/1], R80-129/2[IDA/R80-85/2, IFC/R80-47/2]), we had pointed out that the Bank's FY81 program and budget, which you approved on July 3, made no allowance for start-up of operations in China because the content and timing of the Bank's FY81 work program in China were then still under discussion with Government authorities. These discussions have now advanced sufficiently to define the work required in FY81.

B. FY81 WORK PROGRAM FOR CHINA

3. The work program will include the major components discussed below.

a. Economic and Sector Work will consist of:

- (i) A program of desk studies designed to bring together the considerable knowledge of the Chinese economy that exists outside the Bank. This effort is now underway. These studies will serve as background material for the economic and sector missions which are scheduled to visit China in the Fall of 1980.

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- (ii) Preparation of an "Introductory Economic Report" on the Chinese economy that will:
- assess the Country's economic management, external capital requirements and creditworthiness;
  - review the Government's development strategy priorities and constraints;
  - establish an appropriate data base;
  - identify the major policy areas for future work; and
  - provide a preliminary framework for conducting the Bank's operational work and formulating a medium-term country assistance strategy.

An economic mission is expected to be in the field in the late fall and the Introductory Economic Report is expected to be completed by mid-1981.

- (iii) Preparation of introductory reports on the Agriculture, Education, Transportation and Energy sectors. These sector reports are expected to be completed in FY81 and will serve both as background papers for the Introductory Economic Report and for the initial lending operations.

The Chinese authorities are in the process of organizing counterpart teams to work with the economic and sector missions and are preparing the necessary background information. It is estimated that the country economic and sector work program will require about 14 staffyears of effort in FY81.

b. Lending Work

4. Project preparation and lending work will be initiated on six projects during the first half of FY81 of which 2-3 might be ready for Board presentation in FY82. Work on further projects would await the results of the economic and sector missions. This means that substantial preappraisal and appraisal work will be done in FY81. The lending work program is estimated to require about 10 staffyears in FY81 and has been "priced" on the basis of the Bank's actual FY76-79 experience in Indonesia plus an allowance to reflect start-up costs.



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c. Other Work

5. Based on preliminary discussions with Government, the Bank's Economic Development Institute (EDI) is formulating a training program for Chinese officials with emphasis on tools of economic management and project analysis. Chinese officials will participate in courses already in the Institute's FY81 curricula and work will be initiated on developing courses tailored to the special needs of China.

6. In the Bank's support and administration areas, work programs will have to be adjusted to provide the support required by the operational work program for China. Budget is included in this supplement for legal work and for special services to be provided by the Secretary's Department to the Office of China's Executive Director during the start-up period. While the full impact of China's entry into the Bank Group is expected to be reflected in the programs and budgets of other support departments in future fiscal years, an allowance has been made for yet unknown demands which are likely to arise as the China program proceeds.

C. ADMINISTRATIVE ARRANGEMENTS AND STAFFING IMPLICATIONS

7. The operational work program for China will be managed by the East Asia and Pacific Regional Office. A China Country Program Division has been established in the Programs Department and a Program Division Chief and a Senior Economist have been appointed. Project work will be the responsibility of the Regional Office's Projects Department. To carry out the proposed China work program, the Regional Office requires a total of 19 professional positions, 2 mid-level positions and 10 secretarial positions divided between the Projects Department and the China Programs Division. This staff will be supplemented by about 10 staffyears to be contributed by consultants and other Bank staff.

8. To enable the EDI to take steps to design a training program which meets the priority needs of China, it is proposed to provide the Institute with consultants and funds to allow for Chinese participation in about 9-10 courses/seminars in FY81.

9. To lay the necessary legal groundwork preparatory to the start of lending to China, it is proposed to provide the Legal Department with one additional professional position and one secretarial staff.

10. Resources will also need to be provided for the operation of the Office of China's Executive Director. Following established standards, administrative arrangements will be made for a Director, an Alternate Director, two Technical Assistants and three secretarial staff commencing November 1980.

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D. FY81 BUDGET REQUIREMENT

11. The table below sets out the budgetary implications of the FY81 work program for China.

	<u>Authorized Positions</u>			<u>FY81\$000</u>
	<u>Prof.</u>	<u>Non-Prof.</u>	<u>Special</u>	
East Asia & Pacific Regional Office	19	12	-	2,990
Economic Development Institute	-	-	-	180
Legal Department	1	1	-	130
Secretary's Department	-	-	-	100
Executive Director's Office	-	-	7	480
Support Departments	-	-	-	220
	<u>20</u>	<u>13</u>	<u>7</u>	<u>4,100</u>
	==	==	==	=====

E. RECOMMENDATION

12. It is recommended that a FY81 Administrative Expense Budget Supplement for IBRD/IDA of \$4.1 million be authorized to support the work program for China as outlined above. Approval of this budget supplement would bring the FY81 Administrative Budget for IBRD/IDA to a total of \$396.2 million.

Robert S. McNamara  
President

by Ernest Stern  
Senior Vice President, Operations