



COUNTRY PARTNERSHIP STRATEGY PROGRESS REPORT
FOR
THE PEOPLE'S REPUBLIC OF CHINA
FOR THE PERIOD 2006-2010

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

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CURRENCY EQUIVALENTS

(as of November 7, 2008)

US\$1.00 = RMB 6.83

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	IBRD	International Bank for Reconstruction and Development
ABC	Agricultural Bank of China	ICBC	Industrial and Commercial Bank of China
ASEAN	Association of Southeast Asian Nations	IDA	International Development Association
CADFund	China-Africa Development Fund	IDF	Institutional Development Fund
CAREC	Central Asia Regional Economic Cooperation	IEG	Independent Evaluation Group
CBRC	China Banking Regulatory Commission	IFC	International Finance Corporation
CCB	China Construction Bank	MIC	Middle Income Country
CDB	China Development Bank	MIGA	Multilateral Investment Guarantee Agency
CDM	Clean Development Mechanism	MINEFE	French Ministry of Economy, Finance and Industry
CHUEE	China Utility-Based Energy Efficiency Finance Program	MoF	Ministry of Finance
CIC	China Investment Corporation	MSE	Micro and Small Enterprises
CIRC	China Insurance Regulatory Commission	NCMS	New Cooperative Medical Scheme
CPF	Carbon Partnership Facility	NDRC	National Development Reform Commission
CPS	Country Partnership Strategy	NPL	Non-Performing Loan
CSRC	China Securities Regulatory Commission	PBoC	People's Bank of China
ERL	Emergency Recovery Loan	PSU	Public Service Unit
ESCOs	Energy Service Companies	RMB	Renminbi (Chinese currency)
EVA	Economic Value-Added	ROSC	Report on the Observance of Standards and Codes
Eximbank	Export-Import Bank of China	SARS	Severe Acute Respiratory Syndrome
FAO	Food and Agriculture Organization of the United Nations	SASAC	State-owned Assets Supervision and Administration Commission
FDI	Foreign Direct Investment	SEA	Strategic Environmental Assessment
FIAS	Foreign Investment Advisory Service	SME	Small- and Medium-sized Enterprise
FYP	Five Year Program	SOE	State-Owned Enterprise
GDLN	Global Development Learning Network	TA	Technical Assistance
GDP	Gross Domestic Product	TCC5	Technical Cooperation Project V
GEF	Global Environment Facility	WBG	World Bank Group
GMS	Greater Mekong Subregional Economic Cooperation		
GoC	Government of China		

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**Country Partnership Strategy Progress Report
For
The People’s Republic of China**

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I. COUNTRY CONTEXT

1. In line with China's good progress in implementing its 11th Five Year Program (FYP), cooperation under the World Bank Group 2006-2010 Country Partnership Strategy for China (CPS) is well on track to fulfill or exceed most strategic targets. The CPS is coterminous with the FYP, a 'people-centered' strategy aiming to achieve a harmonious society by balancing economic growth with distributional, ecological and environmental concerns. The CPS, through its alignment with FYP goals and the Bank's strategic themes, has provided the framework for a strong two-way relationship with the Chinese authorities and stakeholders. Also under the CPS, the China program is well aligned with four of six new WBG strategic priorities.¹

2. During the first two years of CPS implementation, cooperation has deepened and expanded both through the lending and AAA program and through China's new role as an IDA donor. Implementation of the CPS has largely proceeded as envisaged however there has been a more intensified engagement in a number of areas, including: *China's integration into the world economy*, especially regarding south-south learning; *energy efficiency, environment and climate change*; and, more recently, *integrated urban-rural development*. Bank support for *disaster and risk management* generally, and earthquake reconstruction, specifically, in the wake of the tragic May 2008 Sichuan earthquake (see Box 1) has been mobilized. This Progress Report takes stock of the implementation of the Partnership Strategy and outlines intensification of Bank Group support in the areas cited above. Two forthcoming reports provide more detail and complement the Progress Report: *The Mid-term Evaluation of the 11th Five year Program* discusses China's progress and the remaining agenda and the *China Country Economic Memorandum* discusses strategies for rebalancing the economy.

Recent Developments

3. The October 2007 17th Communist Party Congress and the March 2008 11th National People's Congress (NPC) reaffirmed the harmonious society as the nation's long-term goal. A new Cabinet was formed during the NPC. The organizational structure was also streamlined including the creation of five 'super ministries': Industry and Information Technology; Transport; Labor Resources and Social Protection; Environmental Protection; and Housing and Urban-Rural Construction. An energy bureau was created within the National Development and Reform Commission (NDRC). The new leadership remains focused on promoting coordinated and balanced regional development, while ensuring that the rural economy does not fall further behind the more developed urban areas. Recently a series of domestic challenges have commanded leadership attention, including the February snow emergency, the May earthquake (Box 1) and inflation sparked by high food and oil prices.

¹ Supported WB priorities include: (i) offer competitive solutions in middle income countries, (ii) support global public goods such as addressing climate change, (iii) overcome poverty and spur growth in the poorest countries, and (iv) enhance knowledge and learning.

Box 1. The May 2008 Wenchuan Earthquake and the Bank Group Response

On May 12, 2008 an earthquake of magnitude 8.0 struck southwestern China, centered in Wenchuan County, Sichuan Province. The official death toll from the devastating earthquake is more than 69,000, with more than 18,000 people still missing, about 374,000 people injured or disabled, and an estimated 15 million people displaced. There was widespread damage to infrastructure, housing, water supply and sanitation, power transmission, and reservoirs. Moreover, secondary disasters including landslides created more than 35 large "earthquake lakes" posing long-term risks to over 700,000 people. The Bank Group is providing support through a variety of modalities: (i) *advisory services* – immediately following the disaster, experts were mobilized and a Global Good Practices Workshop was organized for more than 100 central, provincial and local officials. In addition, seventeen Good Practice Notes were prepared for the government. Analytical and advisory services on catastrophe risk management and funding which were underway before the earthquake, have been accelerated. (ii) *grant support* – a US\$1.825 million grant from the Global Facility for Disaster Reduction and Recovery (GFDRR) was immediately mobilized after the disaster to support the government's damage and needs assessment and reconstruction planning, and to promote south-south collaboration and learning on disaster risk reduction. A \$1 million GEF grant was approved to identify and assess potential environmental impacts and risks associated with the release of hazardous chemicals and waste in five affected counties. Additional grants of \$100,000 from the Italian Trust Fund For Culture in Sustainable Development and Euro 2 million (US\$ 2.5 million) from the Treasury and Economic Policy General Directorate (DGTPE) of the French Ministry of Economy, Finance and Industry (MINEFE) have also been confirmed. (iii) *portfolio* – Some 30 Bank supported projects are under implementation in the affected areas. Preliminary damage assessments were conducted after the earthquake, with further assessments and remedial actions to be undertaken as may be warranted. (iv) *emergency lending* – At the Government's request, the Bank is preparing a \$710 million emergency recovery loan (ERL), scheduled for a December 2008 Board review, that will finance infrastructure, health and education reconstruction in Sichuan and Gansu provinces. The planned lending will not breach the Single Borrower Limit. The IFC Sichuan Earthquake Reconstruction program will assist the recovery of the private sector by: (i) stabilizing the financial condition of existing clients; (ii) accelerating the flow of funds to SMEs and permanently increasing access to finance; (iii) supporting rural recovery; and (iv) capacity building. The first project, Chengdu Small Enterprise Credit Guarantee Company Limited, was approved on July 31, 2008. IFC also collaborated with the provincial government to hold a workshop in Sichuan on investment opportunities and TA is being provided to financial institutions, manufacturing and agricultural enterprises.

4. **China's economic performance has continued to be sound and prospects remain good, though new challenges are emerging.** Overall GDP growth has been very strong, 11.1% and 11.9% respectively in 2006 and 2007, much higher than envisaged. Growth continued along familiar lines, powered by industry, exports and investment. Demand and supply continued to grow broadly in line with each other, with potential output growth continuing to be boosted by high levels of investment and good productivity increases. Growth from 2006 to 2008 was sufficiently high to ensure that China will meet its 11th FYP objectives on GDP and GDP per capita. However, the global economic slowdown starting in the second half of 2008 will have a sharp effect on China's economy. Growth rates of exports, investment, and industrial production are all declining as 2008 comes to a close. There had been some concern with inflation in the first half of 2008, mostly driven by higher food prices. Inflation has moderated in the second half of the year and in the soft economic conditions is less of a concern. The

attention of policy-makers has shifted to maintaining robust growth. Looking ahead, growth will have to depend more on domestic demand, and a strong fiscal position can enable increased spending on infrastructure and social services in order to meet national objectives and keep the macro-economy growing at an acceptable rate. The Government in November 2008 announced a \$586 billion economic stimulus package. The emphasis will be on accelerating and increasing infrastructure and other investment, with many projects focusing on broad long term development, but also with a significant share going to the earthquake reconstruction effort. Most elements of the package imply higher direct government-influenced spending—in the form of investment or consumption—and should thus have a measurable impact on output in the short term.

The 11th Five Year Program

5. **There has been significant but uneven progress toward achieving the major objectives of the 11th FYP during its first two years of implementation.** Rather than emphasizing quantitative growth, which had been impressive over the past three decades, the Plan emphasizes the sustainability of growth – striving to address several imbalances in sustainability of growth and resource use; economic and social inequality; and the quality of and access to public services. To this end, striking progress has been made in improving public services including social protection, education, and health. There has also been significant progress in improving service delivery to rural areas. At the same time while conditions are improving in rural areas, they are improving even faster in urban areas and gaps in incomes and quality of life continue to widen. Substantial improvements have also been seen in reducing air and water pollution, managing industrial solid waste, increasing the efficiency of water use, and expanding forest coverage. On the other hand, energy intensity has been reduced, but more slowly than targeted and little progress has been seen in changing the economic and industrial structure. FYP implementation has benefitted from a high level of political commitment, appropriate administrative capacity, strong public support for Plan objectives, an accountability system linking implementation to performance assessments of local officials, and increased central funding. Nonetheless, the remaining agenda is significant and major work still lies ahead to achieve Plan objectives. The *Country Economic Memorandum for China* discusses these challenges in detail.

6. The CPS provides supports to the government in implementing the FYP through five pillars: (i) integrating China into the world economy; (ii) reducing poverty, inequality, and social exclusion; (iii) managing resource scarcity and environmental challenges; (iv) financing sustained and efficient growth; and (iv) strengthening public and market institutions. **Annex I and Annex II (the annotated CPS results matrix) provide a detailed description of Government goals, performance, and results in the five pillar areas, and WBG contributions toward their achievement.** A mid-term self-assessment of CPS goals by the WBG country team found that 60 of 75 intermediate outputs specified in the results matrix are either completed or well underway.

CPS Relevance, Results and Outcomes, and Operational Performance Objectives

7. **The ten priority outcomes featured in the CPS remain directly relevant to the 11th FYP objectives.** At the midpoint, performance is generally on track in most areas,

with the exception of expanding formal bank lending to SMEs, a process only recently initiated. Energy intensity reduction has received tremendous attention but the pace of progress has been slower than originally envisaged. Further details are elaborated in Annex I and annotated results matrix (Annex II), which has been slightly updated from the original CPS results matrix.

➤ Enhanced Chinese engagement in global and regional economic institutions	Very good
➤ Better approaches to improving rural public services	Very good
➤ An extended rural health scheme (NCMS), with fair financing	Very good*
➤ Reductions in the discriminatory aspects of urban social policy	Modest
➤ Improved metropolitan area management, especially for service delivery	Modest
➤ Improved land and water resource management, including improved water pricing	Good **
➤ A reduction in energy intensity by 20% by 2010	Limited
➤ Expanded commercially sustainable formal bank lending to SMEs	Limited
➤ Simplification of cumbersome or anti-competitive business regulations	Modest
➤ A new inter-government fiscal transfer system that improves equalization impacts	Modest

[* Less progress has been made on rural health insurance financing

** Good progress on land management, less on water pricing]

Demonstrable progress has been seen or is ongoing in the 9 guiding principles related to Bank performance featured in the CPS:

- (i) **Articulate a more sharply defined set of results.** The CPS results matrix differentiates well between inputs over which the Bank has significant control and policy and institutional reform outcomes to which the Bank Group contributes through demonstration projects or transactions and analytical work.
- (ii) **Emphasize scaling up through demonstration aspects.** Key examples include: urban environmental management, particularly wastewater treatment, where China has steadily increased capacity; rural health insurance and medical assistance; and water user associations. Bank support for strengthened M&E is also helping to extend capacity beyond projects directly financed by the Bank. IFC pioneered foreign investment in the banking sector starting with city commercial banks and supported pilot reforms in rural finance through creation of the United Rural Cooperative Bank. IFC's micro-credit investments tests fully commercial micro lending, and Bank and IFC projects (Energy Efficiency and CHUEE–China Utility-Based Energy Efficiency Finance Program) stimulate commercial bank lending for energy efficiency.
- (iii) **Link lending and non-lending more effectively.** New rural health, vocational education, and migrant projects will help the Government to pilot new approaches consistent with findings from earlier Bank-supported analytical work and policy dialogue. The rural *minimum living standard allowance* program and increased financing for rural compulsory education also have been informed by the Bank's analytical work. In the transport sector, the Bank has helped to design legislation for an efficient, environmentally sustainable integrated transport system.

- (iv) **More innovative delivery mechanisms (SWAp, provincial lending, packaged intervention).** The Fujian transport SWAp has piloted a sector-wide approach to rural roads. Under rural health and rural migrant skill projects, central and provincial governments have taken on some repayment obligations to soften repayment terms to poorer jurisdictions. A pilot project to improve the quality and role of vocational education is being discussed in three provinces including Guangdong. Innovative financial products including RMB bonds (such as the first Panda bond), swaps, are under consideration. Dissemination of analytical work has also been significantly expanded through an improved WB website. (See paragraph 8 for other innovative initiatives.)
- (v) **Greater integration of WBG efforts.** The Bank and IFC are cooperating on China's global engagement (see Pillar 1 of Annex 1) and new urban-rural integrated development initiatives in Chongqing and in the financial and energy sectors. WBI's program has also been fully mainstreamed and decentralized, operating out of the Beijing office. In line with MOF's recommendation, further steps to integrate the Bank, IFC, and MIGA work programs are being explored, including annual joint planning discussions to identify areas for cooperation and deliverables. The Bank and IFC are also jointly developing policy recommendations to support more rapid scale-up of microfinance.
- (vi) **Facilitate engagement in poverty reduction and social sectors by blending Bank and central transfers to reduce repayment requirements.** Central, provincial, and municipal governments have taken on some loan repayment obligations to enable new health, vocational education, and poverty projects to target poor segments of the population on a grant basis. This is increasingly important as bilateral trust funds phase out (Para 10).
- (vii) **Simplify and streamline Bank project processes.** Additional financial management, procurement, and safeguards specialists have been relocated to Beijing to better serve clients. Procurement thresholds have been raised. A sector manager for the urban, energy, rural, transport and environment portfolio has been moved to Beijing. The Bank Group continues to explore avenues to further streamline and improve efficiency.
- (viii) **Lending volume maintained at around US\$1.5 billion.** Target of lending program around \$1.5 billion was achieved. It is expected that lending volume will be maintained between \$1 billion and \$1.5 billion per year.
- (ix) **Improve portfolio performance.** China's strong portfolio has been sustained with 93% of project outcomes rated by IEG as MS or better FY00-07 (compared with 77% Bank wide). China also outperformed the Bank in all quality at entry categories and surpassed MICs in all areas but one over the same period. Sixty nine projects are currently under implementation. With regard to current projects under execution, only 3 of 69 have been flagged as problems. In FY08, the disbursement rate was 24% with 5.3% of commitments at risk. The trust fund portfolio also shows strong performance. Currently there are 79 trust funds under execution. In 2008 the country team introduced a new risk management methodology for its trust fund portfolio.

8. **Program Innovation.** The China lending and AAA programs are based on innovative approaches. Several examples merit mention including: the *partnership with China Eximbank* described in Box 2; cooperation on *clean energy*; support for *migrant workers* in the urban economy; *cultural heritage conservation and sustainable local economic development*; and *sustainable forestry*.

- (i) **Clean Energy.** The WBG is expanding activities in support of China's efforts to reduce the energy intensity of the economy, air pollution emissions, and the carbon intensity of energy production. Bank Group activities are organized around four themes, building on a long partnership with China in the energy sector:
- a. *Renewable & Clean Energy.* Ongoing and new WBG initiatives support piloting and scaling up the use of wind, biomass, photovoltaic, coal bed methane technologies, as well as related institutional and policy reforms.
 - b. *Energy Efficiency (demand side).* The Bank Group is supporting the emergence of energy service companies (ESCOs) that industries can enlist to help them reduce their energy consumption, improve efficiency and scale up support to SMEs. As the ESCO market has expanded, WBG (including IBRD- and GEF-energy efficiency projects, IFC's CHUEE) activities have increasingly targeted improving financing mechanisms for ESCOs and strengthening related institutional capabilities. Further support is also being provided for industrial energy efficiency and the promotion of new products and technologies.
 - c. *Power Supply Efficiency.* Building on long collaboration in the power sector, the Bank is helping China to improve power markets, introduce clean coal technologies, and rehabilitate and close inefficient plants.
 - d. *Urban Heating and Buildings.* On a pilot basis in Liaoning, the Bank is supporting local efforts to introduce heating sector reforms, rehabilitate heating systems, improve building standards, and encourage integration of heating in urban planning.

These efforts are supported through a combination of traditional instruments, including IBRD, IFC, and GEF financed projects, analytical work, and technical assistance, and through newer instruments such as carbon funds. Programmatic approaches under the Carbon Partnership Facility (CPF), and use of Climate Investment Funds, which provide concessional loans for innovations and to catalyze commercial capital, are also under consideration.

- (ii) **Helping China's migrant workers make the urban transition.** Domestic labor migration is occurring on an unprecedented scale in China, and has placed pressure on social and economic institutions. In response, the Government has adopted new guidelines, policies, and pilot programs at all levels in recent years to facilitate migration and ease the transition of rural workers to urban centers. In support, the recently signed Migrant Skills project provides a combination of services to help migrants find employment, including: strong employer involvement in training; use of modular, competency based training; encouraging competition among diverse providers of training and employment services; and skills certification, licensing, and accreditation of providers of migrants. It will also provide migrants with access to labor market information.
- (iii) **Integrating cultural heritage conservation and sustainable local economic development.** Economic globalization and the rapid pace of urban development

in China threaten the country's unique cultural heritage. A series of the Bank-financed urban environment projects include components aimed at preserving important cultural heritage sites while demonstrating how investments in cultural conservation and planning can contribute to sustainable local economic development and poverty reduction. The first stand-alone cultural heritage project, the Gansu Cultural and Natural Heritage Project, was recently launched to help preserve nine unique heritage sites along the ancient Silk Road, invest in physical infrastructure at the sites to raise living standards and promote economic development, and strengthen capacity to manage the sites and develop the province's tourism industry.

(iv) **Sustainable forestry to improve local livelihoods and the environment.**

China is a forest-poor country with only 0.132 ha of forest per capita. Through a series of sustainable forestry projects, the Bank has assisted China to increase forest cover and local incomes, while reclaiming degraded land, protecting biodiversity, and reducing carbon emissions. Bank-financed projects have helped enlarge the gross of total forest resources and improve the quality of forests through introduction of advanced international afforestation technology and project management method, taking pressure off of natural forests and increasing household incomes and generating job opportunities. They have also supported establishment and improved management of forest and nature reserves. The most recent project, the Guangxi Integrated Forest Development and Conservation project, also includes a biocarbon fund pilot plantation that will demonstrate technical and methodological approaches to carbon sequestration and in turn receive revenues from the sale of carbon credits under the Clean Development Mechanism. IFC has invested in forest products companies that are developing plantations to provide sustainable supplies and increase carbon sequestration. IFC has also provided technical training for rural households that manage plantation operations of Stora Enso, a leading paper producer in Guangxi.

Box 2: Charting New Partnerships; Enhancing South-South Cooperation

Formal cooperation with China Eximbank began with the signing of two Memoranda of Understanding (MOU) between the World Bank and Eximbank (May 2007) and IFC and Eximbank (June 2007). Established in 1994, Eximbank is China's state policy bank for international economic development and cooperation. It serves as a key channel of financing for imports and exports, overseas construction contracts and investment projects, and is the only arm for concessional lending. Since the MOU signings there has been a series of workshops, seminars and training events in Beijing and Washington on topics, including fiduciary and financial management, procurement, environmental safeguard analysis and social impact analyses. Opportunities for co-financing in Africa are being explored with joint missions and joint sector work is being planned.

A crucial part of making the partnership work is building a mutual understanding of approaches to financing development activities. Under the auspices of the *staff exchange program* two Eximbank staff are currently seconded to Bank headquarters where they are working on energy and transport projects in the Africa Region. Two new secondees will join the East Asia Region Headquarters and the Sydney Office in early 2009 and another Eximbank staff member will work in the Africa Region. The Eximbank secondees have provided Bank colleagues with valuable insight into Eximbank's approach to project financing through seminars, workshops and day-to-day interactions.

Given China's remarkable success in reducing poverty over the last thirty years, the World Bank has begun to look more systematically at lessons from China, and to promote *south-south collaboration* in areas of knowledge sharing and investments. This initiative, still in its early stages, brings together different Bank regions and departments with their Chinese, African, Asian and Pacific Island counterpart institutions. The Bank is working closely with MoF, Eximbank, State Council Leading Group Office of Poverty Alleviation and Development and CDB in this area. Promoting South-South investment including Chinese outward investment in developing countries is one of MIGA's operational priorities. MIGA is conducting joint activities in support of Chinese outward investment with MoF, the Ministry of Commerce, Eximbank, Sinosure, and Chinese companies, and plans to expand cooperation in this regard with other Chinese agencies such as China-Africa Development Fund, China Development Bank, China Mining Association, and China International Contractors' Association.

Work on *knowledge sharing* is also underway. With support from WBI and the East Asia and Africa regions, MoF, Ministry of Commerce and State Council Leading Group Office of Poverty Alleviation and Development hosted a ten-day seminar for 31 senior officials from 18 African countries to exchange views on development experiences. Through provincial site visits, participants interacted with local government officials, farmers and entrepreneurs to gain a better understanding of innovative aspects of China's reforms and how they might be adapted. The event, envisaged to be the first in a series, examined China's agriculture and rural reforms, infrastructure development, FDI and trade and engagement with Africa. A number of GDLN events also contribute to the dialogue.

II. THE COUNTRY PARTNERSHIP STRATEGY -- LOOKING FORWARD

9. **As China aggressively pursues the objectives set in the 11th FYP, the World Bank Group's Country Partnership Strategy remains highly relevant and well-aligned with China's development goals.** With continuity in 11th FYP objectives and sustained GOC action, most of the outcomes and outputs articulated in the CPS and results matrix remain valid and on track.

10. **The supporting WBG program of assistance will continue to closely follow the program laid out in the CPS.** China has shown demands for IBRD resources, with borrowing in fiscal years 2006, 2007, and 2008 at the upper range of the \$1-1.5 billion annual lending volume requested by the Government. At the Spring 2008 Bank-China annual lending program discussions, the Government indicated its interest in continuing its financial cooperation at approximately this level through 2011 (excluding the emergency lending proposed in FY09) and a three year indicative pipeline of projects has been identified. Strategically, the pipeline already reflects a growing emphasis on the third pillar of the CPS, including new projects to improve energy efficiency and reducing greenhouse gas emissions. Additional project(s) are also anticipated to demonstrate new approaches to more integrated urban-rural development. Government demand for the Bank's analytical work also remains high. Future AAA work will place increasing emphasis on shorter policy notes and broader and deeper dissemination and areas of joint collaboration are expected to increase. Although most bilateral trust fund resources for project preparation and implementation available to China have been gradually winding down, the WBG program will continue to rely extensively on global program trust funds which play a significant role in China.

11. **The Bank Group programs, including IFC and MIGA, continue alignment with CPS priorities as described above, with a heightened emphasis on the environment.** IFC is focusing on climate change, access to finance in rural areas, and increased investment flows to western China. Its program is expected to range from \$400 to \$600 million per year over the remaining CPS period. MIGA guarantees are expected to continue to focus on the areas of water supply, waste water treatment and solid waste treatment in the next few years with expected gross exposure at about \$50 million a year. MIGA has an ongoing Memorandum of Cooperation with Sinosure (China's official export credit insurance agency) and has strengthened its cooperation with China Eximbank. It is also looking to strengthen cooperation with partners at the central and provincial levels including the China Africa Development Fund. Both IFC and MIGA will continue to work with Chinese counterparts and companies to support Chinese outward investment.

12. **The Bank Group will continue to work with Chinese counterparts to emphasize scaling-up, linkages between lending and non-lending activities, and to explore innovative delivery mechanisms** including possible project support for integrated urban-rural development (the Chongqing initiatives will pilot this approach). New clean energy/energy efficiency projects in the pipeline offer a major opportunity for scaling-up. Engagement in poverty and social sectors will continue through analytical work and implementation of four new projects that will, among other innovations, test new modalities for loan repayment. Additional project-level engagement in the social sectors may be possible under planned projects in integrated urban-rural development or should the Bank help to finance earthquake reconstruction. As China's continues to develop and play an increasingly influential role in the global economy, the WBG will intensify its support for China's global integration and participation in south-south cooperation to share its considerable development experience. (See Annex 1 for more detailed discussion of areas for intensified cooperation.) The WBG will also continue to work with counterparts to streamline procedures and to improve responsiveness to China's needs, including through decentralization that has taken place and intensified

IFC-WB cooperation. WBI's program, which has been both decentralized and mainstreamed, will increasingly emphasize support for China's global engagement and south-south learning.

13. **During the remainder of the CPS period the Bank Group will continue to support the strengthening of economic governance in China.** The Bank is working with the newly established Discipline Inspection and Supervision Institute and Tsinghua University to develop governance and anti-corruption training that will be delivered through a national network of training centers to a large number of officials in central and local government. This training complements the analysis that will be conducted in the forthcoming Report on the Observance of Standards and Codes (ROSC) for accounting and auditing. This will be a diagnostic assessment to identify the strengths and weaknesses of the existing institutional framework that underpins accounting and auditing practices, the extent of compliance with national accounting and auditing standards in practice, any gaps between these standards and international standards, and the effectiveness of enforcement mechanisms. The Bank Group is further assisting with strengthened governance over public resources through analysis and advice on dividend policy for SOEs and on budget management and transparency, as well as through capacity building for CIC. In addition, the National Bureau of Corruption Prevention has expressed a desire to discuss possible cooperation with the Bank in certain areas including the development of governance and anti-corruption training.

III. RISKS

14. The CPS identified six risks. Below is a current assessment.

- (i) ***stagnation in the reform process:*** China's 11th Five Year Plan, which was reaffirmed at the 17th Communist Party and 11th National People's congresses, underscores the importance of ensuring the economic, environmental, and social sustainability of reform. In the first two and a half years, efforts on implementation have demonstrated strong commitment and significant progress has been made toward achieving the major objectives of the Plan. However, important challenges remain.
- (ii) ***weakness in the financial sector:*** Financial market reform and deepening has been significant, but significant challenges remain: improving accounting practices, developing more robust systems for management reporting and centrally linking the branch networks, and risk management. With efforts to improve corporate governance in large banks untested, there is a risk that with a slowdown, non-performing loans could re-emerge as a concern. Banks also have significant exposure to the property sector, where prices may face downward pressure during the slowdown. Progress and interim results have been achieved in Rural Credit Cooperative reforms but improvements in corporate governance, internal control, capital adequacy, financial performance, regulation and supervision still have a long way to go. Fears of stock market overheating have abated with the pronounced fall of stock prices in the last 12 months, and the direct exposure to the global financial crisis appears to be limited. However, there are fundamental issues facing the capital markets including: (i) the markets do not yet provide much financing to firms; (ii) the market product offerings are very limited and the markets are fragmented; and (iii) the securities industry is still emerging with inefficiencies

remaining in the markets, and the investor base remains relatively unsophisticated. The monitoring and enforcement capacities of the CSRC are still limited and it is struggling to cope with the stock market growth, the introduction of new institutions and products to the market, and the globalization of markets.

- (iii) **debt management:** China's domestic public debt remains modest, even including reasonable estimates of local government debt and even as the government faces possibly substantial contingent liabilities from financial system risks. China's total external debt is also low, and debt sustainability is further strengthened by solid FDI and continued current account surpluses. Thus, even though the institutional set up for public debt monitoring and management remains fragmented, debt is unlikely to be a source of significant risk.
- (iv) **cross border emergency such as SARS or the avian flu:** While the pandemic risks cannot be ruled out, the Government is aware of the risks and is actively working to address concerns in the core public health system. A 2003 Bank-financed SARS and infectious diseases operation helped to put together framework for responding to SARS and other public health emergencies. While progress has been made, this is a medium/long-term agenda and the Government continues to work on it. An avian flu operation, currently under implementation, provides TA for the formulation of government responses to animal and human health issues. The Bank is also doing further analytical work to better crystallize the issues.
- (v) **external shocks:** The global financial crisis thus far did not have much direct effect on China because its banks have little exposure to the risky assets that were at the heart of the crisis. However, there will be a powerful indirect effect. As major developed economies slow down, the growth of China's exports is declining. That in turn has spillover effects on investment. In the second half of 2008 growth of exports, industrial production, and investment all dropped sharply. The growth of consumption has held up well so far, but it is a small part of GDP and may also be affected indirectly as some export-oriented factories close and workers made redundant. China is relatively well positioned to adjust to this new global situation. It has had prudent fiscal policy for some years and has accumulated a large amount of reserves. China has already responded to the softening economy with looser monetary policy. It has good potential to stimulate the economy through fiscal policy: accelerated infrastructure investment, greater social spending, perhaps tax breaks to stimulate innovation and investment, and the Government announced a \$586 billion economic stimulus package in November 2008. However, no one can predict with certainty how smooth will be the adjustment from an export- and investment-driven growth pattern toward one relying more on domestic demand and the service sectors. There is a significant risk that China's growth will slow down substantially from the heady rates of recent years
- (vi) **urban-rural disparities, social exclusion and dissatisfaction:** the 11th FYP places considerable emphasis on mitigating social and economic disparities between coastal and inland regions and rural and social populations, and the government leadership underscores this agenda. The Chongqing integrated development initiatives are specifically designed to pilot coordinated urban-rural development, and continuing support to the Government on social protection and health systems place strong emphasis on lagging regions and disadvantaged populations. Nonetheless, under the current patterns of growth, with urban productivity and

income growing significantly faster than rural ones, it is difficult to prevent the urban-rural income gap from widening further.

(vii) *natural disasters (new)*. The WBG is working to assist the government in enhancing capacity to plan for and respond to natural disasters through a variety of modalities. (See Box I)

IV. CONCLUSION

15. The main challenges and goals of the 11th FYP described in the CPS and the strategy to address them remain valid. Performance is on track and in some cases, such as the social sectors, has exceeded expectations. Implementation of this CPS has proceeded as envisaged (with only slight shifts in relative areas of emphasis – e.g., intensified focus on energy, environment and resource management and support for China's integration into the world economy) and is delivering expected results. There is sustained high demand for the Bank's lending and knowledge-based services. The progress described in this Report provides a favorable basis for a continuation of implementation of the 2006-2010 Country Partnership Strategy.

Annex 1 PROGRESS TOWARDS 11TH FIVE YEAR PROGRAM GOALS AND BANK CONTRIBUTIONS

1. The following section discusses key areas of progress by CPS pillar. Annex 2 complements this text with an updated matrix detailing progress toward CPS milestones noting Government achievements and World Bank Group support.

Pillar 1 – Integrating China into the World Economy

2. **Over the past few years China has become an important and influential player in the global economy.** With greater integration, China's policy decisions increasingly affect the global economy, and vice versa. With a trade surplus of \$262 billion (2007), it has become the world's third largest trading economy. FDI inflows in 2007 exceeded \$83 billion and there has been growing outward FDI with more than 5,000 Chinese investment entities investing in more than 170 countries. China's foreign assistance has also increased, particularly in Africa. A recent World Bank report, *Building Bridges*, estimates that China's financing commitments in Africa rose from around US\$1.5 billion per year in 2004 and 2005 to US\$7 billion in 2006. China's shift towards a flexible exchange rate and the creation of a sovereign wealth fund, the China Investment Corporation (CIC), has also featured in China's global emergence. This growing international role presents both opportunities and challenges. China's successes have resulted in a growing demand from other nations to engage with and learn from China's experiences, and for deeper involvement and leadership in international organizations and institutions. Moreover, China's expanded trade and investment ties in some less developed countries and its domestic resource needs have led to questions and requests for more detailed information.

3. **China has also played an increasing role in international economic institutions.** In 2007 China made its first contribution to IDA 15. It also signed an MOU to join the Inter-American Development Bank. China hosted a China-Africa Summit in 2006 and the African Development Bank's Annual Meeting in 2007. The China Development Bank created the China-Africa Development Fund (CADFund) in 2007 to help promote and finance Chinese private sector FDI in Africa. China has increasingly engaged in bi-lateral and multilateral dialogue on international issues and its representatives have both participated in and observed at international forums and in some country donor forums. The Bank and IFC have initiated partnerships with Eximbank which are discussed in Box 2 in the main report. Bank analytical work has captured global attention and helped to increase global understanding of China's economy. Of particular note, the Bank's Quarterly Economic Reports are valued by both China's policymakers and global audiences. In addition, the Bank also has increasingly partnered research with China's universities, think tanks and ministries and expanded support for south-south learning including through WBI and IFC. IFC is also engaging with Chinese enterprises to identify investment opportunities in Southeast Asia and Africa. Building on workshops and conferences on risk mitigation tools and opportunities and constraints for overseas investment held in 2005 and 2006 MIGA has further intensified cooperation with the Ministries of Finance and Commerce in promoting overseas investment.

4. **China is increasingly engaging in trade and trade facilitation with partner countries and regions.** After signing the Agreement on Trade in Goods of China-ASEAN FTA in 2004, it launched a number of RTA negotiations that cover trade with more than 30 economies around the world. Today, China has FTAs covering more than 15 economies, covering about one-fourth of its total trade. China has continued to make significant investments in infrastructure to facilitate trade with neighboring countries. It has engaged in ties with border countries through participation in the Central Asia Regional Economic Cooperation (CAREC) and in the Greater Mekong Subregional economic cooperation (GMS) frameworks. The *Bank Group's* support to China's trade agenda is fully demand-driven and generally takes the form of specialized policy notes requested by the Ministry of Commerce on topics including: architecture of RTAs (in goods and in services); trade in services (movement of people, lessons from financial services FTAs in Latin America, global trends in key services exports); specialized WTO issues (the environment and trade, geographical indications, and protection of biological diversity), and trade in agriculture (special and sensitive products, safeguard mechanisms, and cotton tariff policy).

Pillar 2 – Reducing Poverty, Inequality, and Social Exclusion

5. **The Government has taken major strides toward 11th FYP targets to balance rural and urban development** through its efforts to build a “new socialist countryside” and facilitate absorption of rural labor in urban labor markets. China is on track to achieve most related 11th FYP targets on or ahead of schedule, and in some cases has moved beyond the FYP targets. Among many notable achievements, the Government has abolished agricultural taxes and fees, introduced free compulsory education, introduced and expanded rural cooperative medical insurance schemes (NCMS), and, in a major breakthrough, extended the minimum living standard allowance to rural areas. The Government has increased transfers to rural areas, continued to rapidly expand the road and rail systems into interior regions, and has launched pilot projects to aggressively promote integrated urban and rural development. Average rural per capita incomes had nearly reached 11th FYP targets by 2007.

6. **As the Government has moved to rapidly expand social protection and health programs focused on the rural poor, the Bank has played a supporting role.** The Bank has provided policy makers with options and recommendations for strengthening rural social protection, health insurance, health care financing and increasing community participation in poverty reduction programs. The scale-up of the new rural cooperative medical schemes, for example, has emphasized demand-side interventions largely consistent with Bank recommendations. The speed and magnitude of some Government initiatives have exceeded what was anticipated in the CPS and have required the Bank Group team to move quickly to keep pace. For example, CPS goals to identify options for a national rural safety net policy framework and to finance free compulsory 9-year education became obsolete as the Government moved rapidly to roll out both initiatives nationwide. With a body of major analytical work in place, the Bank's focus is increasingly shifting toward quick-response policy notes and technical assistance to help the GOC pilot alternative implementation approaches (e.g., for new rural cooperative medical schemes), evaluate new initiatives (e.g., rural *minimum living standard*

allowance, rural compulsory education financing) and integrate lessons from pilots into policy (e.g., AAA on rural and national pension policy).

7. **Rural incomes have increased with the abolishment of agricultural taxes and expanded investment in agricultural infrastructure, technology, and extension.** These policies have largely succeeded in transferring resources to farmers and rural communities. China has been extremely successful in the past at increasing yields and has achieved full food security. As incomes increase the focus will move beyond yield enhancement to the productivity of agriculture, the quality of food, and increasing farmer's incomes through focusing on high value markets. The Bank's portfolio of agricultural and irrigation projects continues to successfully pilot institutional innovations (e.g., water user associations, public-private partnerships) and new technologies that increase productivity and allow small-scale farmers to enter high-value production chains and improve food safety. A very positive development is a new farmer's cooperatives law passed in mid-2007 which allows for more effective farmer groups, with the Bank helping cooperatives test different organizational structures.

8. **The Government has also accelerated reforms and pilot programs to facilitate migration of surplus rural labor to urban areas.** With internal labor migration occurring on a large scale (the total number of migrants in 2006 was over 130 million), guidelines, policies, and pilot programs have been adopted at all levels of government to facilitate migration and ease the transition of rural workers to urban centers. Nonetheless, rural migrants continue to face serious challenges. Bank analytical work and policy dialogue will now be complemented by pilot projects to strengthen labor regulation, migrant access to employment, and market-based vocational training. The Bank has increasingly supported development of infrastructure in small towns around larger urban centers, and is gearing up to support pilot programs to promote integrated urban-rural development in Chongqing. The Government has continued to enlist Bank support for transportation projects connecting interior regions with the coast, with the project pipeline shifting away from traditional expressway projects to railway, inland waterway, and urban transportation projects.

9. **New rural health and migrant projects, approved in FY08 are the first new IBRD-financed social sector projects in China since FY2004.** With the termination of IDA lending to China after FY1999, China's borrowing for social sector and poverty projects declined. As sources of concessional co-financing have phased out, three new social sector projects and a new poverty project have benefited from willingness of central, provincial, and municipal governments to take on some loan repayment obligations so that poor segments of the population could be targeted on a grant basis. Provincial and ministerial counterparts at mid-term CPS consultations expressed strong interest in the projects and their repayment arrangements, which could provide a model for further social sector projects if successfully implemented.

Pillar 3 – Managing resource scarcity and environmental challenges

10. **China is intensifying efforts to meet its ambitious goals for creating a more resource-efficient, less polluting society under the 11th FYP.** Four of eight "obligatory" targets in the FYP are directed toward resource efficiency and the environment, reflecting China's strong emphasis. In support, the Government has

launched a wide-ranging array of policy reforms, administrative measures, and investments promoting these goals. These efforts have begun to yield results: China appears to have reversed upward trends in energy intensity (beginning in 2002), air pollution (especially SO₂ emissions) and water pollution, to have improved efficiency of water use for industrial purposes, and to have expanded forest cover. Nonetheless, tremendous challenges remain. The annual rate of reductions in energy intensity is below rates needed to meet the FYP target. Air and water pollution exceed standards in most areas, water withdrawals exceed sustainable levels, and non-point sources of pollution constitute a growing challenge. Recent progress is likely to be difficult to sustain given China's continued capital-intensive, industry and export-led growth pattern, and a relatively heavy reliance on administrative measures, rather than pricing and other market incentives, to reduce resource intensity.

11. In line with China's strong emphasis, the Bank Group has steadily expanded its focus on related activities. Since FY06 the majority of Bank projects (including GEF and carbon trades) in China have an environmental objective, and IFC and MIGA's activities also have a growing environmental dimension.

12. China is undertaking a set of major initiatives to improve energy efficiency, expand use of renewables and address climate change. China's Energy Conservation Law was strengthened in 2007. The energy bureau under NDRC has been elevated to nation-wide in 2008. China has allocated energy intensity reduction targets to provinces and key state-owned enterprises, taken steps to curb expansion of energy intensive industries, and adopted more stringent environmental and efficiency standards. Special funds, including a local RMB Clean Development Mechanism (CDM) Fund, have been established to support energy efficiency, adoption of energy efficient technology, closure of inefficient plants, and emissions reduction.

13. Cooperation between the Bank Group and China on energy efficiency, renewable energy, and climate change mitigation has expanded beyond the levels anticipated in the CPS. To help China meet its goals, the Bank Group is expanding support for renewable and clean energy, energy efficiency in the power sector, in urban heating and buildings, and on the demand-side. Four new energy efficiency projects have been added to the IBRD lending pipeline, focused on improving industrial energy efficiency and co-generation, strengthening financial intermediation for energy service companies (ESCOs), and introducing new IGCC technology in the power sector. The Bank has also continued to support China's climate change mitigation efforts through analysis and pilot projects to improve the efficiency of urban public transport, strengthen forestry and land management, and reduce biogas emissions. These mitigation efforts are complemented with a growing WBG emphasis on helping China, which is highly vulnerable to climate change induced droughts and changing rain patterns, introduce new climate adaptation approaches into agriculture and water management. During the remainder of the CPS period the WBG will seek to help the authorities identify and pilot mechanisms that integrate climate change adaptation and disaster risk management (e.g., flood control, drought preparedness). IFC has integrated climate change into all of its projects, and has achieved marked success in partnering with banks to introduce energy efficiency financing, as well as market based waste to energy and water treatment

projects. In support of these initiatives, the Bank Group is putting a strong emphasis on assisting China to tap new sources of carbon financing as they become available.

14. **China is also taking steps to improve use of other resources and to strengthen environmental management, with generally positive results.** In addition to energy efficiency (see above), China has steadily expanded *wastewater treatment capacity*, where the focus is shifting to secondary towns and cities, and has also scaled-up the *concept of water savings in irrigated agriculture*. Less progress, however, has been made toward CPS outputs for piloting integrated metropolitan area planning, bulk water markets, and liberalizing water and energy markets. CPS goals to support improved approaches to *land, water basin, and forest management* systems are largely on track, although less progress has been made than planned toward addressing non-point sources of pollution. Strategic environmental assessment (SEA) methodologies have been introduced though significant capacity building is still needed. A study on SEA legislation is planned under the TCC5 loan. Of special note, Bank AAA on *land policy* and a joint pilot with FAO on rural land registration contributed to a Central Government decree on establishing a land registration system. Bank AAA has supported some path-breaking initiatives to *measure the economic cost of air and water pollution, to pilot bio-fuel projects, and to introduce green accounting* and circular economy concepts. Progress has also been made to support *China's contributions to global environmental goods*, including piloting approaches to stabilize greenhouse gas emissions, phase out persistent organic pollutants, reduce land-based coastal pollution, and demonstrate economically sustainable cultural and environmental heritage projects.

Pillar 4 – Financing Sustained and Efficient Growth

15. **China has made major strides in transforming its financial sector to become a modern, market-based system.** The financial sector with broad money over GDP at over 160% is highly liquid, with the banking sector as the dominant sub-sector in financial intermediation. Reforms have been significant (see Box below) and many banks are now compliant with the minimum capital adequacy ratio of 8%, accounting for 79% of the total banking sector assets. In February 2007, the CBRC issued "Guidance on the Implementation of the New Capital Accord by the China Banking Industry" (The Guidance), which proposed a step-by-step implementation plan of the New Capital Accord (Basel II) in China based on China's realities. It specified the objectives, principles, scope, methods, timetable and major measures of the implementation. Several large commercial banks with international experiences were selected to implement Basel II on a pilot basis from the end of year 2010. Sector reform still needs to be further deepened with additional improvements in corporate governance. Although lending practices have been strengthened, banks still require more work on strengthening in skills and technology, including improved accounting practices, more robust systems for management reporting and centrally linking the branch networks, and risk management.

Reforming the Banking Sector

Performance of the banking system began to improve following the October 2004 interest rate liberalization. Prior to that time, China maintained a tight control over both deposit and lending interest rates, which made it difficult for banks to make sufficient profits, particularly for smaller-scale loans. This move unleashed a rapid rise in supply of rural and micro credit, and holds the promise of expanding access to finance further, especially towards the lower ends of the market segments.

Another significant driver of banking sector growth has been the shareholding reform of the state-owned banks. Four large state-owned banks hold over half of banking sector assets. In the past, these banks functioned as an extension of the Government and were undertaking substantial directed lending with little service culture or incentives for prudent banking. The result of this legacy was a massive portfolio of bad debt (reportedly NPLs were over 25% of the total loan portfolio in 2002). As a result of this restructuring, these banks have witnessed improvements in profitability, asset quality, and earnings capacity and a striking difference has been observed between restructured banks and those that have yet to go through the process. By the end of 2007, the NPL *ratio* of major commercial banks stood at 6.7%, the weighted average capital adequacy ratio of commercial banks reached at 8.4%. The Government, led by financial sector authorities, has taken strong action to clean up the balance sheets of three of major banks – Bank of China (BOC), China Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC) – and to offer them for partial privatization. Minority stakes of around 30% of the three banks have been sold to major international banks and to public investors through record-setting IPOs (*in September 2007, following an October 2005 Hong Kong IPO which was 40 times oversubscribed, CCB raised US\$7.7 B in one of the largest domestic IPOs ever effected*). The Agricultural Bank of China (ABC), the only remaining state-owned bank not to have gone through the restructuring process, has been put on the agenda and restructuring options are currently being considered. The bank restructuring process has also been applied to the smaller banks in the market – the joint stock, city commercial, rural, and joint venture banks. As a result of this restructuring, these banks have witnessed improvements in profitability, asset quality, and earnings capacity and a striking difference has been observed between restructured banks and those of that have yet to go through the process.

The \$100 million Micro and Small Enterprise (MSE) Project, approved in early 2007, offers a good example of these reforms in action. Designed to promote policy and regulatory changes in promoting commercially sustainable MSE finance, since the project's launch over 20,000 micro and small loans were disbursed by about 40 branches of 10 participating financial institutions (RMB1.6 B total with an average loan size of RMB 60,000, and a NPL ratio well below 1%). The project not only enables the participating financial institutions to build up a portfolio of high-quality MSE loans, but also helps diversify business strategies, introducing a new credit culture and a new generation of credit officers who are able to make credit assessments based on willingness and capacity to repay loans rather than collateral or guarantees. The project is contributing to CBRC's and PBC's willingness to embrace the principle of commercial sustainability in promoting micro and small business finance. The project has attracted the attention of policy makers and practitioners from countries facing similar constraints and has led to south-south knowledge sharing throughout Asia.

16. The capital market has grown in size but fundamental weaknesses in regulation and supervision remain; market effectiveness needs to be enhanced through further reform and development. Over the past year China's stock markets have recorded triple digit rises in share prices and a wave of massive IPOs in its mainland markets. The Shanghai composite index rose by 97% in 2007 after a rise of 130% in 2006, but fell by more than 45% in the first six months in 2008. Shenzhen followed a

similar trajectory. By the end of May 2008, there were more than 1,500 listed companies on China's domestic exchanges. Total market capitalization reached about RMB 32.7 trillion or over 132% of GDP at the end of 2007, surpassing levels seen in many high income economies. The dramatic movements in stock prices over such a short span of time revealed continuing legacy problems as well as weaknesses in regulation and supervision. Although there are many retail investors, this is changing as new institutional investors emerge. Capital markets have benefited from a steadily improving regulatory environment underpinned by the end-2005 enactment of the Companies and Securities Laws and bolstered by the Securities Investment Fund Law, and complementary regulations and guidelines which covers listing, disclosure, trading, intermediation, corporate governance, shareholders rights, and supervision of the markets. The China Securities Regulatory Commission (CSRC) stepped up its activities in the past two years including restructuring securities brokerage firms and increased licensing of institutional investors and investment funds. By 2008 Chinese Accounting Standards will be largely harmonized with International Financial Reporting Standards. However, the markets have dropped by about 45% since the beginning of 2008. The markets are now priced at the level of April 2007, when the market boom began. In terms of global impacts, domestic stock markets have been sheltered from the sub-prime storm affecting the US and other markets. This is due to several factors, primarily because China's domestic institutions have relatively limited direct exposure to sub-prime assets in the US and many institutions most severely affected by the crisis do not have substantial direct exposure to domestic Chinese stock markets.

17. The insurance sector has experienced fast growth but penetration rates remain low at about 3% of GDP despite premiums which grew by more than 24% in 2007 and reached over RMB703 billion yuan. The sector appears one of the most open in terms of both inward foreign investment and outward investment; for example in July 2007, the China Insurance Regulatory Commission (CIRC) allowed for overseas investment of up to 15% of insurance company assets. *Catastrophe insurance for residential housing remains nonexistent*, and every year less than 5% of damages caused by natural disasters are funded by fiscal allocation and commercial insurance. The insurance industry also faces its own challenges as the CIRC continues to play a dual function as regulator and owner.

18. While much has been achieved, the unfinished agenda is significant and bears watching. Challenges include: (i) access to finance, as millions of rural-micro entrepreneurs remain underserved; appropriate policies to ensure fund flows to targeted segments of the economy; (iii) despite its size, the capital market is still underdeveloped, the corporate bond market remains small and the regulatory regime governing corporate bond market needs to be streamlined; (iv) the insurance industry has been growing rapidly but risks have been masked by rising premiums; (v) banking sector reform needs to be deepened; (vi) corporate governance needs continuous monitoring and enforcement; (vii) banking sector capacity for assessing risks needs strengthening; and (viii) ever-increasing financial services integration strains PBOC's capacity to oversee financial stability. Also, as the recent earthquake demonstrates, China needs to build up an integrated catastrophe risk management framework at the national level, supported by a well-designed and implemented mechanism that mobilizes resources from both the public and private sectors.

19. The World Bank Group has a sizeable financial sector program which provides significant *analytical and advisory support* to the central authorities, PBOC, the state policy banks and commercial institutions in areas, including: (i) integrated *rural finance and microfinance*; (ii) *rural credit cooperative* reform and restructuring; (iii) commercially sustainable *micro and small business lending* by commercial banks; (iv) *capital market reform and development*; (v) *corporate pension regulatory reform*; (vi) *housing finance market development* (including the housing provident fund, the mortgage insurance industry, standardizing the primary mortgage industry and promoting a healthy development of the secondary market through the pilot of mortgage-backed securitization); and (vii) *catastrophe risk management and funding*. The Bank's Group's engagement with Eximbank is discussed in Pillar 1. The Bank also provides *capacity building*: (i) to government-owned development banks for corporate governance strategies and risk management capacity; (ii) to central economic and financial authorities for managing financial stability, including resolution of failed financial institutions, buildup of a financial safety net, and preparation for an assessment of financial stability; and (iii) to CIC for corporate governance. IFC has invested in nationwide joint stock banks, city commercial banks, rural commercial banks and microfinance companies, providing technical assistance in corporate governance, risk management, information management and strategy, and partnered with banks to provide energy efficiency financing. IFC has also contributed to the property law which permits liens on accounts receivable and inventory, and the leasing law. Recently, the Bank has also been requested to undertake a Report on Observance of Standards and Codes (ROSC) - Accounting and Auditing review exercise in China.

Pillar 5 – Strengthening Public and Market Institutions

20. **Since 2006, China has continued market-enhancing reforms of state-owned enterprises** including diversifying ownership and “corporatizing” SOEs into joint-stock companies through the State-owned Assets Supervision and Administration Commission (SASAC), formulating SOE dividend policy and beginning to collect dividends, and initiating introduction of economic value-added (EVA)-based performance evaluations. Progress has also been made in the areas of property rights, bankruptcy, unification of corporate tax, and putting in place an array of market-friendly policies on market access, land use rights, taxation, export-import regulations and administrative approval procedures. Progress is on-track to meet three out of four related 11th FYP targets².

21. **The Bank's recommendations and long-standing policy dialogue have contributed to China's ongoing reforms of SOEs**, including earlier work on state assets management, and SASAC. Of particular note, Chinese officials acknowledged a recent policy note's contribution to the new SOE dividend policy, under which collection of dividends from SOEs began in 2008. Other Government policies and reform actions taken or announced by the government consistent with Bank recommendations include:

² The 11th FYP sets targets for: (i) services sector value-added as percent of GDP; (ii) services sector employment share; (iii) spending on research and development; and (iv) degree of urbanization. If the average annual rates of growth that were achieved during the first part of the 11th Five-Year Program (2006-7) are maintained, the 2010 targets will be met for targets 2-4. The share of value added for the services sector has, however, decreased marginally since 2005 from 40.3 percent of GDP to an estimated 39.1 percent in 2007

introducing economic value added (EVA)-based performance evaluation to strengthen focus on efficiency of capital use in SOEs by 2010; adopting disclosure standards of listed companies in SOEs by 2010. China is also, on a pilot basis, creating boards of directors in wholly state owned companies with significant participation of external independent directors, but ongoing experiments in 19 SOE groups are proceeding slowly.

22. **The Bank Group's investment climate survey of 120 Chinese cities has been well received**, especially by city governments around the country, with multiple examples of local governments taking action to improve their investment climates. FIAS and MIGA have also been supporting efforts by central and local officials to strengthen investment promotion services with a focus on central and western regions, including investment promotion skills workshops for provincial and municipally officials and a benchmarking study. A Bank study on Public Service Unit reform was well received by policy makers at various levels and widely disseminated, with follow-up actions mostly concentrated on local pilots.

23. **In the area of the fiscal transfer system and budget performance, the Government significantly expanded government transfers to poor provinces, and made some progress on achieving systemic reforms.** The Bank Group has provided some analysis and advice, and further work is under discussion. An IDF grant is supporting MOF's Treasury Department to enhance transparency, efficiency, and effectiveness of budget execution of special purpose transfer payments. There has also been an increased focus on monitoring and evaluation at different levels of the China-Bank Group partnership, including ongoing assistance to the Government in its mid-term review of progress under the 11th FYP.