PRIVATE SECTOR ASSESSMENT

PEOPLE'S REPUBLIC OF CHINA

ASIAN DEVELOPMENT BANK
November 2003

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PREFACE

In March 2000, the Asian Development Bank (ADB) adopted a Private Sector Development (PSD) Strategy to articulate in more detail how private sector development would be supported in providing the economic and employment growth needed to achieve ADB's overarching objective of poverty reduction in the Asia and Pacific region. To implement the PSD Strategy, private sector assessments (PSAs) are to be formulated for each developing member country of ADB.

The main objectives of the PSA are to provide a critical review of PSD, identify major constraints and priority areas for further development, and suggest actions to be incorporated into ADB's PSD Strategy as part of the overall country strategy and program. The People's Republic of China (PRC) was selected as one of the flagship countries for which a PSA will be conducted. In view of the size of the PRC's economy, the PSA is focused on addressing these objectives. Thus, sectors in which ADB has not been involved and/or does not envision a role in the near term are not discussed.

The methodology, analytical framework, and report structure for this PSA are as follows. The PSA begins by summarizing PSD based upon findings from studies sponsored under ADB technical assistance work that involved extensive consultations with the Government, private sector and international agencies—including a workshop to discuss the PSA held in Beijing in March 2003—other documentation, and additional research conducted by ADB. The macroeconomic environment is described, followed by a discussion of the policy, legal, and institutional framework. Impediments to PSD are identified, drawing on two ADB business climate surveys, one with domestic enterprises and another with foreign investors operating in the PRC. Findings from studies by other domestic and international agencies and interviews and consultations with key players influencing PSD are incorporated into the PSA. Separate sector assessments are followed by an examination of the impact of other funding agency activities in support of PSD to help identify areas for possible collaboration as well as ADB niches. The last sections build on an assessment of ADB's PSD assistance and outline ADB's PSD strategy for 2003–2006.

This report was prepared by ADB staff and a consultant, Mika Maramuto, under the overall direction of the East and Central Asia Department, with the support of ADB's PRC Resident Mission (PRCM). The work was led and supervised by Debra Kertzman, Financial Sector Specialist from the East and Central Asia Department, Governance, Finance and Trade Division (ECGF); and Edgar Cua, Principal Programs Officer from the PRCM. The report team received valuable support, insights, and guidance from Shamshad Akhtar, Deputy Director General of Southeast Asia Department; Noy Siackhachanh, Director of ECGF; and Bruce Murray, Country Director of the PRCM. Technical support was provided by Zhuang Jian, Wang Lan, Wu Aihua and Gan Mei of the PRCM. The perspectives and judgments expressed in this report do not necessarily reflect the views of ADB or its Board of Directors.

I would also like to acknowledge and express our appreciation for the support given by many ADB staff members who provided substantial guidance, comments, and advice.

Muhammad E. Tusneem
Director General
East and Central Asia Department
Manila, November 2003

CURRENCY EQUIVALENTS

(as of 30 April 2003)

Currency Unit	–	yuan (CNY)
CNY1.00	=	$0.1208
$1.00	=	CNY8.2770

NOTE

In this report, "$" refers to US dollars.

ABBREVIATIONS

ACFIC	All China Federation of Industry and Commerce
ADB	Asian Development Bank
AMC	asset management company
BOT	build-operate-transfer
CBRC	China Banking Regulatory Commission
CGC	credit guarantee company
CGS	credit guarantee scheme
CIRC	China Insurance Regulatory Commission
CPDF	China Project Development Facility
CSRC	China Securities Regulatory Commission
DFID	Department for International Development (of the United Kingdom)
DRC	Development Research Center (of the China State Council)
EU	European Union
FDI	foreign direct investment
FIE	foreign invested enterprise
GDP	gross domestic product
IFC	International Finance Corporation
IPO	initial public offering
IPR	intellectual property right
JV	joint venture
MOC	Ministry of Commerce
MOF	Ministry of Finance
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
MOST	Ministry of Science and Technology
NGWT	National Guidelines on Water Tariffs
NPC	National People's Congress
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
PBOC	People's Bank of China
PPA	power purchase agreement
PPI	private participation in infrastructure
PRC	People's Republic of China
PSA	private sector assessment
PSD	private sector development
PSRP	Power Sector Restructuring Plan
QFII	qualified foreign institutional investor
RCC	rural credit cooperative
SAIC	State Administration of Industry and Commerce
SASAC	State Asset Supervision and Administration Commission
SDPC	State Development Planning Commission
SETC	State Economic Trade Commission
SME	small and medium enterprise
SOCB	state-owned commercial bank
SOE	state-owned enterprise
SPC	Supreme People's Court
SPGC	State Power Grid Corporation
TA	technical assistance

TVE	town or village enterprise
UNDP	United Nations Development Programme
VC	venture capital
WTO	World Trade Organization

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EXECUTIVE SUMMARY

The People's Republic of China (PRC) is the fastest growing economy in the world. The rapid development and integral role of the private sector is one of the most significant features of the PRC's transition to a market-oriented economy. In 2000, the relative weight of private enterprises in the economy was 33% of the gross domestic product (GDP), which increases to 63% of the GDP when combined with other nonstate sector enterprises, most of which are small and medium enterprises (SMEs).

The PRC has more than 20% of the world's population and needs to provide jobs for more than 26% of the world's workforce. In 2002, the nonstate sector accounted for 90% of total employment. Private enterprises created jobs at an average growth rate of 19% in contrast to the national job growth rate of 1.2%. Thus, nonstate enterprises, especially private sector enterprises and SMEs, are the main engine for creating jobs that are necessary to absorb new labor market entrants, a significant number of displaced workers from the state sector, and underemployed rural labor. The private sector must create jobs for the PRC to win its war against poverty.

Private sector investment has increased rapidly over the past 5 years. By 2001 total nonstate sector investment almost matched that of the state sector. Continuing robust growth and its entry into the World Trade Organization (WTO) in 2001 has made the PRC the most attractive destination for foreign direct investment (FDI) in the world. For more than a decade the PRC has attracted the highest FDI in the region. FDI inflow started to dramatically increase in 1992 and reached a new record of $52.7 billion in 2002, the largest amount of FDI in the world. Recently adopted investment guidelines promote broader foreign investment opportunities, encourage FDI in the poor western provinces to address regional disparity in development and living standards, and enable more foreign investment in the PRC through mergers and acquisitions.

The successful transition to a market economy and the growth of the private sector in the PRC is unique. The PRC has used a "dual-track approach" that encourages the development of the private sector in tandem with reform of the state sector. Under this approach, private sector development (PSD) has been promoted incrementally through different localities instead of nationally. The incremental and decentralized approach has enabled the Central Government to replicate successes and isolate problems, avoid some problems that other transitional economies have faced, and increase the role of local governments and officials.

Several policy milestones in PSD are noteworthy: (i) Deng Xiaoping's speech on economic reform in 1992, (ii) constitutional recognition of the role of the private sector in 1999, (iii) Jiang Zemin's 2001 announcement that private entrepreneurs can become Communist Party members, and (iv) the PRC's entry into the WTO in 2001.

Although the PRC is adopting a framework that supports the rule of law and promotes economic reforms, the institutional capacity for a modern enterprise economy is not fully in place and many other constraints to the development of the private sector continue to exist. Surveys of foreign and domestic private firms conducted by the Asian Development Bank (ADB) reflect seven major impediments to PSD: (i) weaknesses in the policy environment, lack of transparency, and market entry and exit restrictions; (ii) problems in the legal environment, including weak implementation of the rule of law; (iii) lack of financing options; (iv) infrastructure constraints; (v) human resource constraints; (vi) lack of management know-how; and (vii) poor access to reliable information and professional services.

Policy bias against private sector market entry and exit takes numerous forms including hurdles in licensing and registering businesses, listing requirements that favor state- owned enterprises (SOEs), and arbitrary application of fees. The current environment lacks sufficient transparency and an effective competition policy. Local protectionism exists in various forms, making it difficult for many private companies to enter new markets and multiplying opportunities for corruption.

The legal environment continues to pose operating challenges. Ambiguous property rights continue to be clarified and redefined. Private property rights are not accorded the same treatment as public property rights. Although an adequate legal framework exists in many areas, enforcement is not consistent, transparent, or predictable. In many instances, there is insufficient public consultation when drafting laws or regulatory impact assessments to avoid unintended consequences that discourage PSD. Nor is there comprehensive access to all promulgated national and local laws.

Lack of access to financing, particularly bank loans or alternative financing, is the most serious constraint to the development of domestic private firms. The absence of a diversified financial sector capable of serving the broad spectrum of entrepreneurs' needs for financial services leaves the state banking system as the dominant supplier of financing. However, state-owned commercial banks (SOCBs) are not yet sufficiently market-oriented. Due to lack of financial capacity, the nonperforming loan problem, and lack of creditor protection in bankruptcy procedures, banks, particularly SOCBs, are reluctant to provide financing to private sector firms, instead favoring SOEs. In addition, small private firms tend to have weak financial statements, making credit analysis based on cash flow difficult, and insufficient collateral. New rules making loan officers personally accountable for bad loans may also contribute to limited bank financing opportunities for the private sector. Private sector banking is still at a fledgling stage.

Capital markets continue to exist primarily to finance SOEs, although the quota system for listing was abolished in 2000. Retail investors with a short-term investment outlook dominate the equity market. Institutional investors need to be encouraged and developed. Structural and legal obstacles impede the development of the corporate debt market, securitized investment products, and the venture capital and leasing industries.

The private sector requires further improvements in physical infrastructure to operate efficiently and increase productivity. Major constraints include problems with land and office space, transportation, power supply, water and sanitation, and telecommunications. Improved infrastructure in the central and western regions is critical to attracting new FDI or reinvesting of profits earned by foreign firms already operating in the coastal region.

Human resource constraints include the lack of managerial capacity and skilled professionals. Private firms need to weigh higher labor costs, including mandated social security costs, against their ability to remain competitive. Poor corporate governance practices and the lack of transparency in operations also affect the ability of domestic enterprises to expand operations.

Availability of reliable information and professional legal, accounting, and consulting services is limited under the prevailing business environment. However, these skills are critical to future PSD. Although access to economic, market, and production information has improved in recent years, the quality and reliability of information is still inconsistent, posing challenges to enterprises making strategic and marketing plans.

Many funding agencies are providing assistance to the PRC to address these impediments. Assistance generally takes the form of policy dialogue, experts financed by special assistance or trust funds, or direct investment in private sector companies. Most funding agencies share common development assistance goals, including SOE restructuring, SME development, social security reform, and WTO accession. Given the size of the PRC, each intervention has been limited in magnitude and geographic coverage. To increase the impact of their assistance, many funding agencies forge partnerships and arrange joint projects and programs.

The three main ways that ADB supports PSD are through (i) creating enabling conditions for business; (ii) generating business opportunities; and (iii) catalyzing private investments through direct financing, credit enhancements, and risk mitigating instruments. Since 1988, ADB has sought to create enabling conditions through technical assistance (TA), public sector lending, and catalyzing direct investments in private sector firms. ADB's TA projects designed to support the private sector total $24.1 million and have encompassed (i) financial sector support, (ii) enterprise support, (iii) private participation in infrastructure, and (iv) laws and regulations to promote PSD. Recent assistance has been characterized by a greater focus on enterprise support and capacity building, addressing specific constraints on private participation in infrastructure (i.e., water tariff studies) and development work to help create a rule-based business environment. ADB's public sector lending program has focused on loans to finance construction of highways, roads, power plants and transmission lines, and water treatment facilities. ADB's private investment portfolio (approvals) as of end-2002 consists of five equity investments totaling $79.3 million, including investments in an equity fund aimed at SMEs, an environmental fund, and three funds that primarily support private investments in infrastructure, and four loans totaling $151.5 million in the infrastructure and financial sectors.

ADB's PSD Strategy is set within the framework of its basic strategic thrusts and based on lessons learned. First, the right policy environment is key to the long-term vitality of businesses. Second, ADB assistance, if combined with the efforts of public and private sector participants to address development challenges, can provide solutions resulting in greater benefits for the PRC. ADB needs to intensify its efforts to further refine and determine strategic criteria for private sector interventions, given that ADB's assistance accounts for less than 1% of FDI inflow into the PRC.

This Private Sector Assessment includes recommendations for promoting financial sector reform and private investment in infrastructure. Using the public sector window, ADB should continue to facilitate financial sector reform through (i) continued support to SMEs from the supply and demand sides, including the creation of an enabling environment for alternative financing options, and (ii) continued capacity-building support. Other possible interventions include the establishment of a comprehensive social security system, strengthened governance of financial market supervisors to enable them to act as transparent regulators, and policy dialogue aimed at creating an enabling framework for sustainable microfinance programs. Through the public sector lending program, ADB should continue to address infrastructure constraints. As for the private sector window, ADB should explore investment opportunities in infrastructure, capital markets, financial sector, and environment industry. ADB should consider taking equity positions in new or existing financial institutions, such as commercial banks, insurance companies, and fund management companies to broaden ownership, improve corporate governance, and introduce international best practice standards. Since the bulk of FDI has been invested in the manufacturing, industrial, and real estate sectors, there is no catalytic role for ADB to support stand-alone projects in those sectors.

The PRC's planned massive infrastructure investments for the next 5 years cannot be realized without private sector participation. ADB should continue to support the creation of an enabling environment for private sector participation in infrastructure, focusing on specific impediments. ADB should continue to mobilize capital for large- and medium-scale infrastructure projects, both start-up and existing projects, especially in the central and western regions, in response to private sector constraints and poverty reduction needs. Multiproject financing schemes should be employed to enable ADB to reach out to smaller projects.

In addition, ADB should intensify its efforts to assist the Government in creating a rule-based business environment by helping draft and modify laws that can affect development of the private sector and creating a pilot mechanism for public consultation and access to laws and regulations. As part of its public-private partnerships, ADB should create mechanisms to disseminate institutional knowledge, such as international best practices and lessons learned from ADB's projects, in support of the private sector. ADB should also re-evaluate its current institutional setup, particularly staffing and resource implications in the field, to better implement its PSD Strategy.

SECTION I

MACROECONOMIC ENVIRONMENT

A. Macroeconomic Overview

The People's Republic of China (PRC) has grown at an average rate of 7.6% during the last 5 years, making it the fastest growing economy in the world. The substantial growth in private sector activity has brought about changes in market fundamentals to address the gaps and inefficiencies of state-owned enterprises (SOEs) and harness the entrepreneurial drive of the population.

Thus far, the PRC has tackled macroeconomic management well. The PRC's low vulnerability to external shocks has helped it maintain macroeconomic stability despite structural distortions both at the output and input levels and at the financial and enterprise levels. Contributory factors include the large internal market, large foreign exchange reserves, low dependence on high technology, use of expansionary fiscal and monetary policy, and high consumer and investor confidence (Table 1).

Table 1: Selected Macroeconomic Indicators

Item	1998	1999	2000	2001	2002	2003	2004
Real GDP Growth Rate							
(% in constant prices)	7.8	7.1	8.0	7.3	8.0	7.3	7.6
Agriculture	3.5	2.8	2.4	2.8	2.9	2.8	2.9
Industry	8.9	8.1	9.6	8.7	9.9	10.0	11.0
Services	8.3	7.5	7.8	7.4	7.3	6.2	7.1
Gross Domestic Investment							
(% of GDP)	37.7	37.4	37.1	38.6	38.5	38.2	38.5
Gross Domestic Savings	39.8	39.4	38.0	38.6	38.7	38.2	38.5
Current Account Balance/GDP (%)	3.1	1.6	1.9	1.7	1.9	1.6	1.5
Fiscal Balance/GDP (%)	(2.1)	(2.9)	(2.8)	(2.6)	(3.0)	(2.8)	(2.6)
International Reserve (gross, $ billion)	145.0	154.7	165.6	212.2	286.4		
Consumer Price Index	(0.8)	(1.4)	0.4	0.7	(0.8)	0.5	1.0
Money Supply (M2) Growth (%)	14.8	14.7	12.3	14.4	16.8	15.5	16.0
Debt-Service Ratio (% of export)	10.9	11.5	10.0	10.0	7.3	–	–
Exchange Rate (CNY/$, average)	8.3	8.3	8.3	8.3	8.3	–	–
GDP Per Capita ($ current)	750.0	792.0	856.0	912.0	964.0	–	–
Official Unemployment Rate (%)	3.3	3.1	3.1	3.6	4.0	4.5	4.6
Urban Unemployed (millions)	5.7	5.8	6.0	6.8	–	–	–
Xiagang Workers (millions)[a]	9.0	9.4	9.0	7.1	–	–	–
Adjusted Unemployment Rate (%)	8.5	8.1	7.8	7.3	7.1	–	–

– = data not available, CNY = yuan, GDP = gross domestic product.
[a] Officially defined as "temporary leave" requested by SOEs, but in reality *Xiagang* means laid-off.
Sources: International Monetary Fund; *Asian Development Outlook*; Asian Development Bank *Key Indicators 2002; EIU Country Profile 2003.*

Macroeconomic stability is a precondition for attracting private investment and creating pro-poor markets. Macroeconomic reforms should continue to be carefully managed and sequenced to preserve macroeconomic stability. This macroeconomic environment will continue to attract foreign direct investment (FDI) and mobilize domestic private investment.

At the 10th National People's Congress (NPC) held in March 2003, new macroeconomic targets were set forth for 2003 including (i) achieving real gross domestic product (GDP) growth rate at 7%; (ii) creating 8 million new jobs for urban residents and confining the rate of registered urban employment to 4.5%; (iii) containing inflation at 1%; and (iv) keeping the fiscal budget deficit within 3% of GDP (China Daily 2003).

B. Profile of the Private Sector

1. Private Sector Contribution to the Economy

It is very difficult to quantitatively measure the role of the private sector in the PRC. The current "narrowly defined" method, which is used in official government statistics, is based on the number of employees and ownership structure of an enterprise and does not accurately take into account the role of the private sector in the transitional economy. However, a broader definition may lead to double counting.

The narrowly defined method includes only (i) self-employed (*geti hu),* the first business category that the State Council defined as "private sector" in 1981; and (ii) private enterprises (*siying qiye)*, a new business category introduced in 1988 as "for profit" organizations that are owned by individuals and employ more than eight people. This method does not take into account a significant number of "private firms" that opt to be defined as collectives or town and village enterprises (TVEs) by sharing ownership with local governments. These firms, which put on a hat of collective ownership ("red hat firms"), have better access to land, assets, finance, and markets. Some experts estimate that 50–75% of red hat firms are in fact private firms.[1]

Foreign-funded enterprises (e.g., equity joint ventures [JVs]) can be SOEs or private enterprises, depending on their shareholding structure. Wholly owned foreign enterprises do not fall within the narrowly defined definition of "private enterprise, "neither do enterprises in transition from collectives to privately owned companies (e.g., shareholding cooperative enterprises, joint ownership enterprises). To better understand the role of these firms in the economy, the term "nonstate sector firm" is thus used to refer to all firms that are not SOEs.

Using this terminology raises major statistical challenges. First, because the economy is in transition it is difficult to obtain accurate statistical data on private sector activities, particularly data comparable with the state sector. Second, it is difficult to determine with any degree of certainty how many red hat firms are private companies or how many foreign-funded firms are nonstate sector firms. Thus there is a strong possibility for double counting in available statistics (Appendix 1).

Table 2 shows the number of "narrowly defined" domestic private enterprises for 1993–2001. In 2001, there were about 26 million such private enterprises operating in the PRC. Dwarfed by the absolute number of individually owned enterprises, privately owned enterprises increased at an average annual growth rate of 32% over the past 8 years.

Table 3 illustrates recent trends in the number of enterprises above the designated size (annual income over 5 million yuan [CNY]), divided by sector. State-owned and state-held companies declined from 2000 to 2001, both in absolute number and as a share of total enterprises. The

[1] The International Finance Corporation (IFC) has concluded generally that about half of collectives are in fact private companies, although some areas and sectors have a higher proportion of private companies. (IFC 2000b). Experts interviewed for this report responded that about 70–100% of collectives are actually private companies.

nonstate sector increased in importance, with private enterprises as the main contributors to this change. Private enterprises grew by 64% in number and their share of the total number of enterprises increased from 14% to 21%.

Table 2: Number of Domestic Private Enterprises
(million)

	Individually Owned Enterprises (Geti Hu)		Privately Owned Enterprises (Siying Qiye)	
Year	No.	Growth Rate (%)	No.	Growth Rate (%)
1993	17.70	–	0.238	–
1994	21.90	24	0.432	82
1995	25.30	16	0.654	51
1996	27.00	7	0.819	25
1997	28.50	6	0.960	17
1998	31.20	9	1.201	25
1999	31.60	1	1.509	26
2000	25.71	-19	1.762	17
2001	24.33	-5	2.029	15
Average Growth Rate		**5**		**32**

Sources: China Statistical Yearbook 2001 and 2002; and ADB. 2002. Draft Report on Technical Assistance to the PRC for Private Sector Development. Manila.

Table 3: Number of State and Nonstate Sector Industrial Enterprises[a]

Item	2000		2001		
	No.	Share (%)	No.	Share (%)	Growth (%)
National Total of All Industrial Enterprises	**162,886**	**100.0**	**171,256**	**100.0**	**5**
State-Owned and State-Held Enterprises	43,652	26.8	35,902	21.0	-18
Nonstate Sector Enterprises	119,234	73.2	135,354	79.0	14
Collective-Owned Industry	37,842	23.2	31,018	18.1	-18
Shareholding Cooperatives and Joint Ownership Enterprises	13,362	8.2	13,098	7.6	-2
Limited Liability Corporations	11,989	7.4	17,584	10.3	47
Shareholding Enterprises	5,086	3.1	5,692	3.3	12
Private Enterprises (Siying Qiye)	22,128	13.6	36,218	21.1	64
Foreign/Special Administration Regions Funded Enterprises	16,490	10.1	18,257	10.7	11
Enterprises from Hong Kong, China; Macao, China; and Taipei,China					
Foreign-Funded Enterprises	11,955	7.3	13,166	7.7	10
Others	382	0.2	321	0.2	-16

[a] Includes only industrial enterprises with annual sales income of more than CNY5 million.

Source: China Statistical Yearbook 2002.

a. Gross Domestic Product

The economy has undergone a fundamental change since the reform process began in 1978, from complete reliance on state-owned and collective enterprises to a mixed economy where private enterprises play an increasing role. The economic transformation is evident from the falling ratio of GDP contributed by SOEs from 58% to 37%. Private enterprises and those in transition grew at a compound annual growth rate of 26% from CNY19 billion ($2.29 billion) in 1978 to CNY2,950 billion ($356 billion) in 2000. Their share of the total economy increased from 5% to 33% during this period (Table 4).

Table 4: Gross Domestic Product for 1978-2000
(CNY billion)

Item	1978	1985	1990	1995	1997	2000[a]	Growth Rate[b] (%)
Total	**362**	**896**	**1,858**	**5,848**	**7,345**	**8,940**	**16**
State-Owned Sector	209	429	904	2,222	3,078	3,308	13
Share (%)	57.7	47.8	48.6	38.0%	41.9	37.0	–
Nonstate Sector	153	468	954	3,626	4,268	5,632	18
Share (%)	42.3	52.2	51.4	62.0	58.1	63.0	–
Collectives	134	363	711	2,327	2,490	2,682	15
Share (%)	37.0	40.5	38.2	39.8	33.9	30.0	–
Private (and others)	19	104	244	1,299	1,778	2,950	26
Share (%)	5.2	11.6	13.1	22.2	24.2	33.0	–

[a] ADB estimates: Breakdown for 2000 is derived from data disclosed by the National Bureau of Statistics (China Daily). Break down for 1978-1997 (Zhongguo Jingji Zhuangui 20 Nian).
[b] Compound annual growth rate between 1978 and 2000.

Sources: Zhongguo Jingji Zhuangui 20 Nian (Chinese Economic Transformation for Twenty Years). 1999. p.57, National Bureau of Statistics; and Tongji Ziliao (Statistical Data) 1999. No. 9, China Daily, 26 March 2002.

Box 1:

Zhejiang Province—The Most Developed Private Economy in the PRC

Zhejiang Province has the most developed private economy in the PRC. The economic output of the private sector accounts for 95% of the province's total. In 2000, 6.8% of the PRC's GDP came from this province, which has only 3.7% of the national population. The private economy has developed at a rate of 34% over the last 10 years. In July 2002, Zhejiang Province overtook Shanghai, the PRC's largest industrial city, in exports. The province's stellar economic development over the past 20 years is regarded as a miracle throughout the PRC.

Before 1978, Zhejiang Province was an undeveloped agricultural province with a weak industrial base and limited natural resources. The success of this province is attributed to the role of the private sector, the driving force of economic growth over the past 20 years.

Currently, there are more than 1,000 specialized villages and towns throughout this province, each engaged in the manufacture of a single product (shoes, glasses, lamps, and clothes). These products have captured a large share of the national market and some products (cigarette lighters, ties) are exported. Many enterprises from this province have become the leading companies in the PRC. In addition to the entrepreneurial drive of its residents, the local government has extended strong support to help the private sector develop and taken measures to stimulate growth of small and medium enterprises.

Zhejiang Province's GDP has ranked among the top five in the PRC for more than 10 years, its farmers per capita average income has been included in this list for the last 16 years, and its tax revenue also ranks highly.

Sources: "Zhejiang Benefits from Private Economy," CRI Online. 17 July 2002; "China's Private Economy Seeking Wider Development Space," People's Daily, 7 April 2002; and "Zhejiang Province Overtakes Shanghai in Exports," People's Daily, 28 August 2002.

b. Industrial Output

An increasing trend of the private sector contribution to gross industrial output is shown in Table 5. Between 2000 and 2001 the share of the state sector, including state-holding industries, in industrial output decreased both in absolute and relative terms. The State accounted for only 23% of gross industrial output in 2001, while the nonstate sector, which includes private and foreign-funded enterprises, accounted for about 77%.[2] Empirical evidence also indicates that gains in productivity in the economy have come from the private sector. Overall labor productivity of foreign-funded enterprises in 2001 was CNY98,413/person a year, about 1.8 times higher than SOEs. (China Statistical Yearbook 2002).

Table 5: Gross Industrial Output Value of Enterprises with Sales Over CNY5 Million
(CNY billion)

Item	2000 Value	2000 Share (%)	2001 Value	2001 Share (%)	Growth Rate (%)
National Total	8,567	100.0	9,545	100.0	11.4
State-Owned and State-Holding Industry	2,466	28.8	2,237	23.4	-9.3
Nonstate Sector Enterprises	6,101	71.2	7,308	76.6	19.8
Collective-Owned Industry	1,191	13.9	1,005	10.5	-15.6
Shareholding Cooperatives/Joint Ownership Enterprises	380	4.4	385	4.0	1.3
Limited Liability Corporations	642	7.5	1039	10.9	61.8
Shareholding Enterprises	1,009	11.8	1,270	13.3	25.9
Private Enterprises (Siying Qiye)	522	6.1	876	9.2	67.8
Foreign/Special Administrative Regions Funded Enterprises					
Enterprises from Hong Kong, China; Macao, China; and Taipei,China	1,057	12.3	1,185	12.4	12.1
Foreign-Funded Enterprises	1,289	15.0	1,537	16.1	19.2
Others	11	0.1	11	0.1	0.0

Source: China Statistical Yearbook 2002.

c. Fixed Investment

The state sector historically accounted for the bulk of investment in fixed assets. However, investments by the private sector, individuals, and other types of enterprises including foreign-funded firms have increased rapidly over the past 6 years, except in 1998. By 2001 the share of the nonstate sector surpassed that of the state sector (Table 6).[3]

d. Employment

The nonstate sector is the major source of employment, accounting for over 80% of total employment between 1997 and 2001. Its share of total employment reached 90% in 2001 and 2002 (Table 7). Although modest in terms of its share of total employment, between 1997 and 2001 the private sector accounted for 13% of total employment, of which private enterprises created jobs at an average growth rate of 19%, as opposed to the national growth rate of 1.2%. Over the same period, employment by the state sector and urban collectives fell by 8.8% and 18.2%, respectively, and their shares declined steadily over time. The private sector thus has a potential for absorbing a significant number of workers from other sectors, particularly laid-off SOE workers.

[2] A new statistical system adopted by the National Bureau of Statistics to measure industrial output includes only firms with more than CNY5 million in output. Therefore, a consistent historical comparison is not available. For historical data starting from 1980 up to 1999, see Appendix 2.

[3] However, it is difficult to gauge recent trends because the share of the state sector has now been combined with other types of nonstate sector firms.

Table 6: Total Investment in Fixed Assets by Ownership
(CNY billion)

Item	1997	1998	1999	2000	2001	2002	Average Growth Rate (%)[a]
Total	**2,494**	**2,841**	**2,985**	**3,292**	**3,721**	**4,320**	**11.7**[b]
State-Owned Sector	1,309	1,537	1,595	1,650	1,760	3,102[c]	7.9
Share (%)	52.5	54.1	53.4	50.1	47.3	71.8	–
Nonstate Sector	1,185	1,304	1,391	1,641	1,961	1,218	12.5
Share (%)	47.5	45.9	46.6	49.9	52.7	28.2	–
Collectives	385	419	434	480	528	590.1	7.7
	15.4	14.8	14.5	14.6	14.2	13.7	–
Individual	343	374	420	471	543	628	11.1
	13.8	13.2	14.1	14.3	14.6	14.5	–
Other Types	457	510	537	690	890		17.1
	18.3	18.0	18.0	21.0	23.9		–

[a] 5-year average growth rate for 1996-2001.
[b] 6-year average growth rate for 1997-2002.
[c] State-owned units and others.

Source: China Statistical Yearbook 2002, p.176 and http://www.stats.gov.cn.

Table 7: Employment by Ownership Unit
(share)

	1997	1998	1999	2000	2001	2002	Growth Rate[a]
Total Employment (million)	**696**	**700**	**706**	**712**	**731**	**729**	**1.2%**
State-Owned Sector	110 (15.9%)	91(12.9%)	86 (12.1%)	81(11.4%)	76 (10.4%)	71 (9.7)	-8.80%
Nonstate Sector	586 (84.1%)	609 (87.1%)	620 (87.9%)	630 (88.6%)	655 (89.6%)	658 (90.3)	2.80%
Urban Collective Owned Units	29 (4.1%)	20 (2.8%)	17 (2.4%)	15 (2.1%)	13 (1.8%)		-18.20%
Other Urban Units[b]	25 (3.6%)	48 (6.8%)	54 (7.7%)	63 (8.8%)	92 (12.6%)		38.50%
TVEs	131 (18.8%)	125 (17.9%)	127 (18.0%)	128 (18.0%)	131 (17.9%)		0.00%
Rural Households[c]	322 (46.3%)	322 (46.0%)	321 (45.4%)	330 (46.4%)	322 (44.0%)		0.00%
Private Sector Total	79 (11.3%)	95 (13.6%)	101(14.3%)	95 (13.3%)	97 (13.3%)		5.30%
Private Enterprises	13.5 (1.9%)	17.1(2.4%)	20.2(2.9%)	24.0(3.4%)	27.0(3.7%)		18.90%
Self-Employed	54.4(7.8%)	61.1(8.7%)	62.4(8.8%)	50.7(7.1%)	47.6 (6.5%)		-0.40%
Others[d]	10.9(1.6%)	16.7(2.4%)	18.2(2.6%)	19.8(2.8%)	21.9(3.1%)		19.10%

TVE = town or village enterprise.

[a] Average growth rates over 1997-2001.
[b] There are differences between the aggregate (or subtotal) and the sum of relevant categories in data sources: residual between total urban employment and the sum of all categories in urban employment.
[c] The difference between total rural employment and the sum of all rural categories.
[d] Including cooperative units, joint ownership units, limited liability corporations, shareholding corporations units with funds from Hong Kong, China; Macao, China; and Taipei,China; foreign-funded units.

Sources: China Statistical Yearbook 2002, p.117; Asian Development Bank Outlook 2003.

Gross job creation between 1997 and 2001 is estimated to be about 92 million, to which the private sector contributed 24 million (about 26%). Over the same period, 57 million jobs were lost. Thus, the economy generated net 35 million new jobs.

In the next decade, the PRC needs to generate between 90 and 300 million new jobs depending on different assumptions (Dahlman and Aubert 2001) for 40-50 million people to be redeployed from agriculture, SOEs, TVEs, and for new entrants to the labor force. The private sector needs to be further developed to create these jobs. Without these new jobs, the economic transformation will cause large numbers of people to fall into poverty, resulting in rising social tensions and social instability.

C. Small and Medium Enterprises

There are more than 8 million small and medium enterprises (SMEs) in the PRC accounting for 99% of total business establishments and 60% of industrial output.[4] SMEs also account for 60% of all sales and 57% of all profits generated, pay approximately 40% of all taxes, and account for more than 60% of all exports (ADB 2001d). For comparison, about 40 million SMEs throughout the Asia-Pacific Economic Cooperation (APEC) economies account for more than 95% of all business establishments, 35% of exports, and from 30% to 60% of gross national product (GNP). As of 2000, SMEs provided about 75% of the jobs in the PRC. Most of the 200 million labor force that migrated from rural areas to urban areas from 1978 to 1996 was hired by SMEs (ADB 2002c).

D. Foreign Direct Investment

For more than a decade, the PRC has attracted the highest FDI in the region and has been the second largest recipient of FDI in the world, after the United States (US) (Figure 1). Continuing robust economic growth and entry to the World Trade Organization (WTO) has made the PRC more attractive to foreign investors. Despite the deterioration in the global corporate environment, followed by the 11 September tragedy in 2001, the PRC overtook the US as the largest recipient of FDI in the world. On an actual basis, $52.7 billion was invested in 2002, a 12.5% increase from 2001. In 2002, contracted FDI was $82.8 billion, a 19.6% increase from 2001 (Table 8) (ADB 2003).

Table 8: Foreign Direct Investment, 1996–2002
($ million)

Item	1996	1997	1998	1999	2000	2001[a]	2002
Total—Actual	41,726	45,257	45,462	40,319	40,715	46,850	52,700
(Contracted)	(73,276)	(51,003)	(52,102)	(41,200)	(62,400)	(69,200)	(82,800)
Regional Total	41,880	44,901	45,284	39,935	40,333	–	–
Coastal Area	36,206	37,679	38,604	34,415	34,886	–	–
Share (%)	86.5	83.9	85.2	86.2	86.5	–	–
Central Area	3,914	4,714	4,329	3,683	3,594	–	–
Share (%)	9.3	10.5	9.6	9.2	8.9	–	–
Western Area	1,759	2,507	2,351	1,837	1,852	–	–
Share (%)	4.2	5.6	5.2	4.6	4.6	–	–

– = Data not available.
[a] Ministry of Foreign Trade and Economic Cooperation (MOFTEC). *China Daily*. 15 January 2002.
Sources: *China Statistical Yearbook*, 1998, p.642; 1999, p.599; 2001, p.607. MOFTEC. http://www.stats.gov.cn

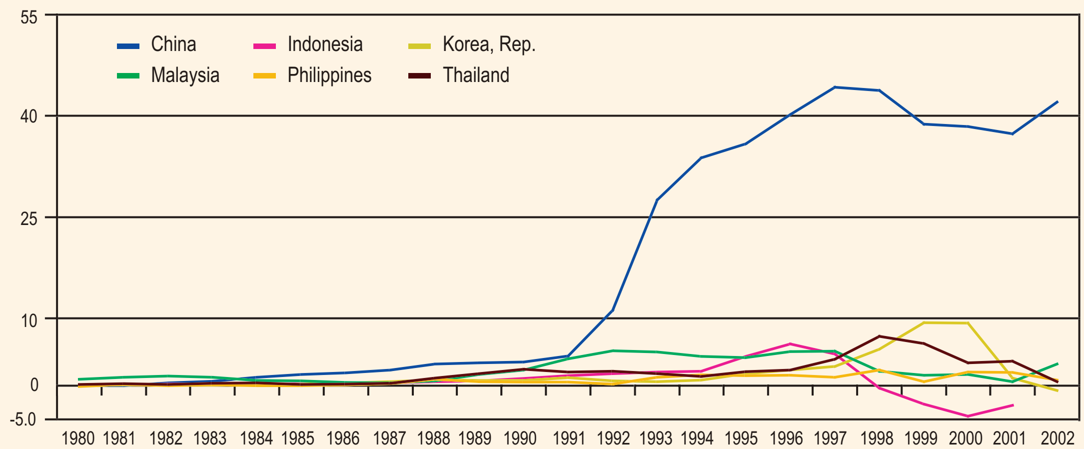
As of end-October 2002, the PRC had approved 417,655 foreign-funded enterprises, with contracted foreign investment reaching $820.28 billion and actual foreign investment utilization amounting to $439.94 billion. Foreign invested enterprises (FIEs) currently account for 10% of the PRC labor force, employing 23 million people (Trade Point Beijing 2003).

FDI has played a major role in the PRC's transition to a market-oriented economy and has been an effective way to transfer technology and managerial expertise to the PRC, although it is

[4] See data released by the State Economic and Trade Commission (SETC). SME statistics include both state sector and nonstate sector SMEs.

highly concentrated geographically and its sectoral distribution is uneven. In 2000, about 86% of investments went to the coastal provinces, and the central and western regions accounted for about 9% and 5%, respectively (Table 8). The manufacturing sector attracts about 60% of FDI, followed by real estate management (11.4%) and social sectors (5.4%) (Appendix 2). One empirical analysis found that FDI's geographical distribution is determined mostly by the level of GNP, infrastructure development, level of general education, and coastal location (Broadman and Sun 1997).

Figure 1. Foreign Direct Investment, Net Inflow
($ Billion)



Sources: Global Developement Finance 2002, CD-ROM, and Asian Development Outlook 2003.

SECTION II

POLICY, LEGAL, AND INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR DEVELOPMENT

A. Policy Framework

1. Background

Official documents define the PRC's economic system as a socialist market economy, although the economy also falls within the prevailing international definition of a "transition economy"—a centrally planned system evolving toward market institutions. In this context, it is important to review briefly how the Government's perception toward the private sector has changed over time, as well how these changes have found expression in relevant laws, regulations, and policy pronouncements.

For more than 40 years, beginning with the establishment of the PRC in 1949, the private sector lacked legitimacy in the eyes of the Government. Although the Government embraced the importance of the private sector in the economy, a lingering suspicion about the role of the private sector and private property rights and the need for reforms to be advanced by consensus led to a more cautious and gradual approach to reforms.

Decentralization also has contributed to the unique market transition in the PRC. Since 1958, the PRC economy has been organized regionally, which enables isolation of different reforms and local experimentation, primarily in rural areas. Although this system enables flexibility, it requires the cooperation of local governments, who may have vested interest in the status quo, to ensure success.

In the recent past, private sector development (PSD) can be divided into four phases: (i) the development of individual businesses following the official revival of private business, 1978–1985; (ii) the emergence of the private sector as a supplement to the public sector, with the rise of privately run enterprises, including a large portion of "red hat" (disguised state sector) firms, 1986–1991; (iii) the performance by the private sector as an important component of the economy, with the rapid development of private firms and an emphasis on a rule-based system and the building of market institutions, 1992–2000; and (iv) the post-WTO era. Appendix 3 shows the evolution of the Government's private sector strategy over the past 20 years, including government perceptions of the private sector and the legal basis and constitutional status of the private sector.

After the 3rd Plenum of the Chinese Communist Party's 11th Central Committee first began market-oriented reforms in 1978 (soon after the official conclusion of the Cultural Revolution), individual enterprises were revived as a way to respond to mounting pressures of unemployment and economic stagnation (International Finance Corporation [IFC] 2000b). The Government called the "individual economic sector" a necessary "supplement" to the state and collective sectors and proceeded to introduce reforms incrementally. New policies were tried in selected provinces, prefectures, counties, and firms and involved specific sectors. The main private players were self-employed individual enterprises. Experiments that were successful were replicated.

In 1987, the 13th National Party Congress of the Communist Party of China (Communist Party Congress) officially recognized the "private economic sector" as a necessary supplement to the state sector. The following year, for the first time, the rights and interests of the private economy were protected by an amendment to the Constitution. This spurred an increase in privately run enterprises, which received an official category designation in 1988. During this period, the treatment private business entities received often depended on the whim of local authorities, which is an important reason why so many privately run firms opted to register as collectives or TVEs.

The next stage of PSD is characterized by the 14th Communist Party Congress in 1992, which endorsed a "socialist market economy" as the PRC's reform goal. In 1993, the Government designed the first grand strategy for transition to a market economy that called for the creation of a "level playing field" through a rule-based market system that addressed property rights, ownership issues, and the building of market institutions (IFC 2000b). Following the official recognition of the private sector as an important component of the economy at the 15th Communist Party Congress in 1997, the Constitution was amended in 1999 to recognize the role of the private sector and provide a basis for future changes in the legal, policy, and regulatory environment to support development. In 1999, the NPC adopted the Law for Individual Wholly Owned Enterprises.

A new era for private enterprises began in 2001. PSD was given further impetus when the Government facilitated the registration of private enterprises. The minimum capital requirement for private businesses was lowered to CNY1 and requirements for bank certificates and other bureaucratic approvals to prove sufficient capitalization of a firm with a limited number of employees were eliminated. On 1 July 2001, at ceremonies marking the 80th anniversary of the founding of the Communist Party, President Jiang Zemin announced that for the first time private entrepreneurs could become party members.[5] Another significant event was the PRC's accession to WTO that obligates the Government to extend foreign-owned businesses rights and privileges that are currently denied to domestic private firms.

2. Restructuring of State-Owned Enterprises

a. Development of the Nonstate Sector

The development of a vibrant nonstate sector preceded SOE restructuring. The nonstate sector emerged in the 1970s through reform of the agriculture sector and adoption of measures to "generate huge increases in productivity, income and output with negligible state investment (Cao 2001).

Prior to economic reforms, a collective farming system known as the people's commune system, which replaced private farming in rural areas of the PRC in the late 1950s, existed. Under this system, there was a three-tier ownership structure with people's communes at the top, production brigades in the middle, and production teams at the bottom. Individuals were not allowed to own major means of production or conduct nonagricultural business (Shuhe Li 2000) In 1979, Draft Regulations on the Development of Commune Brigade Enterprises were adopted by the State Council. These regulations provided local governments and households with some autonomy from the Central Government, replaced the people's commune system with the township village system, and developed the household responsibility system. Assets formerly owned by people's communes were sold to farmers at low prices, enabling household-based business to accumulate the necessary start-up assets at low cost (Shuhe Li 2000). Farmers were granted individual leaseholds on land formerly used by communes and a high degree of autonomy and flexibility in production and sales, provided that certain state quotas were met. Surpluses generated over established quotas

5 Jiang Zemin's "Three Represents Theory," which provides, among other things, that the party must represent the development of all of the PRC's advanced productive forces (including private businesses), opened the door to letting businessmen join the Communist Party.

were allowed to be sold at free market prices. Production output increased enormously and generated a very high rate of household savings and increased living standards.

In the early 1980s, individuals were permitted to conduct business in agriculture-related sectors, while communes, brigades, and production teams were allowed to conduct business in some nonagriculture sectors. In 1984, the Central Communist Party and the State Council issued the Report on Creating a New System in Commune Brigade Enterprises*,* which renamed commune brigade enterprises as TVEs, relaxed restrictions on collective businesses, and allowed private businesses (nonstate sector firms, collectives, and privately owned firms) to operate outside of agriculture (Shuhe Li 2000).

b. Restructuring of State-Owned Enterprises

When SOE reforms were initiated in 1978, emphasis was placed on the gradual termination of government support for working capital through directed credit from state-owned commercial banks (SOCBs). However, ongoing concern about the ability of SOEs to remain solvent and the increasing amount of available private funds led the Government to allow SOEs to convert into shareholding companies.

The restructuring of SOEs continues to be a complicated process based upon decentralization of the economy, the role of local governments and their competing claims over property rights (Section II.A.3. Ambiguous Private Property Rights), and the impact on the PRC's enormous workforce (Jukka 1999). The program for restructuring can be divided into three stages (DFID 1999).

(i) Stage 1 (1979–1984) involved the expansion of operating and management rights of SOEs, giving them greater control over wage setting and production decisions.

(ii) Stage 2 (1985–1993) involved the separation of ownership from operational control, additional increases in the responsibility of enterprise managers, enterprise responsibility for profits and losses, experimentation with joint stock companies, removal of price controls, adoption of programs to address social security concerns, and liberalization of the labor market.

(iii) Stage 3 (1994–ongoing) involves the ongoing adoption of policies aimed at developing a modern enterprise system in which SOEs adopt modern methods of corporate governance and become market oriented, and related reforms in the banking and social sector.[6]

At the end of 1998, the Government launched a 3-year SOE bailout program to help weak large and medium SOEs and encouraged debt-to-equity swaps to transfer their long-standing debt to SOCBs, to asset management companies (AMCs). In furtherance thereof, the Government announced that for the first time, foreign investment could be used in asset restructuring of SOEs.[7]

In June 2001, the State Council adopted a regulation requiring SOEs to sell state-held shares when issuing new equity and pay the proceeds into the newly established National Social Security Fund (NSSF).[8] However, subsequent stock market declines, which reflected shareholder concerns with the dilution in the price of existing shares, caused the Government to indefinitely delay such

[6] The Government is pursuing social security reforms to support SOE restructuring. With ADB assistance, social security reforms are being pilot tested in Liaoning Province, which has one of the largest concentrations of SOEs in the PRC (ADB 2001c). A National Social Security Fund was established in 2000 and a social security law is being drafted with ADB assistance.

[7] In 1998, the SETC promulgated Asset Restructuring by SOEs Using Foreign Investment Tentative Provisions. Article 2 states that foreign investments may be used in (i) the direct investment and acquisition of an SOE by foreign investors; (ii) the provision of working capital; and (iii) the repayment of the debts of the enterprise.

[8] The NSSF raises funds primarily through the sale of government shares in SOEs and budgetary allocations by the Ministry of Finance (MOF). This Fund was established to address shortfalls in the Government's pay-as-you-go social security system resulting from the inability of bankrupt SOEs to contribute to provincial social security pools. As of March 2003, the Fund controlled about CNY80 billion ($9.7 billion). New regulations introduced in December 2001 allow the Fund to invest up to 40% in equities and an additional 10% in corporate bonds. Previously, investment was limited to bank deposits or government bonds (Economist Intelligence Unit 2003).

sales (Economist Intelligence Unit 2002, Shirai 2002). In January 2002, the Government announced new proposals to sell state-owned shares that immediately led to a sharp decline in share prices and the Government's subsequent decision to postpone such sales.

In February 2002, the Government announced a new *Foreign Investment Industrial Guidance Catalogue* and encouraged foreigners to take part in key SOE reforms. In June 2002, in response to the pressure to slow the pace of public offers of additional state-owned shares, provisional regulations were issued by the China Securities Regulatory Commission (CSRC) to allow companies to sell additional shares only if (i) their weighted average net return on assets over the last 3 years is at least 10%; (ii) their assets-liabilities ratio is not less than the average industry level; (iii) projects funded by their previous share issues are 70% complete; (iv) where the number of new shares exceeds 20% of the total, approval of more than half the votes of shareholders holding tradable shares has been obtained; and (v) where the company's earnings drop by 50% or more after the additional offer, the main underwriter's underwriting business is curtailed or suspended (Shirai 2002).

In August 2002, the southern city of Shenzhen, with the support of the State Council, sold noncontrolling shares in five major SOEs in the energy, water, gas, transportation, and food sectors (Shenzhen Energy, Shenzhen Water, Shenzhen Gas, Shenzhen Public Transportation, and Shenzhen Food) through international tender (Southcn 2003).

In November 2002, the Government issued new regulations that became effective in January 2003, to clarify the regulatory framework for restructuring SOEs and unlisted companies with state shareholdings (other than financial institutions) by foreign investors through equity or asset transfers.[9] Under the regulations, foreign investors are required to contribute capital, advanced technology, and business management experience to target SOEs, and prior to approval of such acquisitions, submit a comprehensive restructuring plan for the target SOE that includes, among others, a strategy for improving corporate governance and addressing employee concerns.

In November 2002, the CSRC and the People's Bank of China (PBOC) issued a joint circular to allow qualified foreign institutional investors (QFIIs) to purchase nontradable shares held by the Government and other institutions through public tender.[10] As discussed in detail in Section IV.A.2.a, these shares account for more than two thirds of the PRC's stock market capitalization (Business Times 2002 and China Law and Practice 2003f). Procedures under this circular and related regulations allow foreign fund management institutions, insurance companies, securities companies, and other types of asset management institutions (e.g., commercial banks) that meet certain criteria (ranging from 5 years of sector-related experience for fund managers to 30 years experience for insurance companies, management of at least $10 billion in assets over the last fiscal year, etc.) to apply for approval to invest as a QFII in A share listed companies.[11] Once approved, QFIIs are required to open a special domestic currency account with a domestic bank and use domestic securities companies while trading. Regulations govern acquisitions of controlling interests, minimum and maximum purchase ($50 million, $80 million), investment limits for each QFII (10% of the total), and aggregate percentage of shares held by all QFIIs held in a single company (20% of the total).[12]

New regulations that came into effect on 12 April 2003, which were prepared with ADB assistance, also clarify and restrict the scope of foreign corporate acquisition activity in the PRC.[13] Among others, these regulations provide a framework for acquisitions of registered capital in limited liability companies, allow acquisitions with shares and capitalization of new FIEs with assets

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9 *Use of Foreign Investment to Restructure State-Owned Enterprises Tentative Procedures* (China Law and Practice 2002).
10 QFIIs can also invest in listed convertible bonds, closed and open-end funds, and initial public offerings, additional share issues, and rights issues.
11 See Section II.A.2.a. for a discussion of the A share market.
12 As of April 2003, a number of foreign institutions have applied for approval to invest as a QFII including Morgan Stanley, Deutsche Bank, UBS Warburg, and Goldman Sachs. The CSRC has approved three foreign banks to act as a custodian for QFIIs (Citibank, Hong Kong Shanghai Bank of China, and Standard Chartered) and five domestic banks (Industrial and Commercial Bank of China[ICBC], Bank of China, Agricultural Bank of China [BOC], Bank of Communications, and China Construction Bank).
13 The CSRC issued new regulations in October 2002, followed by the issuance on 7 March 2003 of Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors by the former Ministry of Foreign Trade and Economic Cooperation and other agencies.

acquired from domestic enterprises, and create a new antimonopoly review process for foreign investors (China Law and Practice 2003a).

3. Ambiguous Private Property Rights

Private sector growth in the PRC has occurred despite the absence of clearly defined property rights. As discussed above (Section II.A.1. Background), prior to economic transition, there was no property rights system in the PRC. Consistent with the approach to market reform, transformation of property rights has been gradual—ambiguous property rights continue to be clarified and defined (Section III.D.1. Legal Status of Private Sector).

Although property rights are generally viewed as the exclusive ownership over specific assets, they can be divided into three components: (i) right to use specific assets (user rights), (ii) right to receive revenue from specific assets (extractor rights), and (iii) right to transfer specific assets through sale or gift (transfer rights). In the PRC, these components have been unbundled, separated, and delinked. The Government continues to retain user rights and transfer rights over property that has been sold. Public ownership prerogatives continue to exist and reside more often in provincial and municipal bodies than at the national level. TVEs cover a wide range of cases with some involving direct local government control, and others entailing leases to managers who enjoy substantial autonomy or private ownership with formal protection by TVEs.

Conversion of many TVEs to individual shareholdings has become popular in numerous localities. The merger of SOEs, bankruptcies, shareholdings, and sales of SOEs have helped formalize private property rights. Notwithstanding, formalization of property rights has not ended shared authority over user rights and transfer rights. As part of the agreement to transfer such rights, local governments often impose restrictions on the resale of assets or the firing of employees (Section II.A.2.b. Restructuring of State-Owned Enterprises).

Until recently, the Government continued to own rights and regulate/administer state assets leading to governance concerns, while control over such assets was fragmented. Although for some years state assets were supervised centrally or at the local level under administrative guidance of the National Administration Bureau for State Owned Property (NAB) or a variant of it at the provincial level, the NAB was subsequently abolished. The Ministry of Finance (MOF) became the state representative in SOEs, responsible for monitoring and evaluating SOE performance. The State Economic and Trade Commission (SETC), under the overall direction of the State Council, exercised macro management and direction over enterprises with state ownership and oversaw policies, guidelines, and restructuring programs for SOEs.

To address governance concerns and improve SOE performance, the State Asset Supervision and Administration Commission (SASAC), a ministry level body under the State Council, was recently created to administer state property, other than SOCBs (Section II.C. Institutional Framework). SASAC is responsible for dividing definitely the shareholding structure of firms that are either owned or co-owned by the Central Government and local governments and overseeing the sale of SOEs to foreign and domestic investors (Beijing Review 2003a). As discussed above, SOE reforms have stalled in recent years because the Government has not been able to clarify the ownership composition of approximately 180,000 SOEs worth an estimated CNY6 trillion ($724.9 billion) (National People's Congress 2003). Initially, SASAC will oversee state assets in enterprises owned and controlled by the Central Government.

Provincial authorities will correspondingly establish SASACs. Under the authority of SASACs, state asset management institutions will be organized to preserve and increase the value of state assets. These institutions, which will not have any regulatory powers and will be legal appointees under a contract based system, will be authorized and approved by SASACs, which will supervise and administer these institutions instead of being directly involved in management and business.

4. Small and Medium Enterprises

The Government's commitment to the development of SMEs is reflected in a series of policies, action plans, and lawmaking initiatives.[14] In May 1998, President Jiang Zemin commented that the development of SMEs should be considered an important part of economic strategy. Subsequently, in July 1998 an SME Department was established within SETC to strengthen the coordination of SME development support. SETC also chaired the National Leading Group for SME Promotion and Development. There are SME divisions at the provincial- and municipal-level economic and trade commissions in 24 provinces that have been instrumental in improving enabling conditions for the local business environment.

To directly address the constraints SMEs face in accessing financing, PBOC issued *Guidelines on Strengthening Credit Support to Efficient SMEs with Sound Credit Standing and Marketable Products.* The Guidelines require, among others, SOCBs to establish departments specifically responsible for serving SMEs. Commercial banks are also preparing to launch "onlending" services, through which they will offer long-term credit to regional banks for onlending to SMEs.

To improve SME access to finance, *Guidelines on Establishing SME Guarantee Systems* were adopted in June 1999 to enable the establishment of pilot credit guarantee companies (CGCs) in more than 70 cities (Box 2). Tax authorities exempt nonprofit credit guarantee and reguarantee institutions for SMEs from paying business taxes for 3 years. According to SETC, there are currently 300 CGCs nationwide (except in Tibet), of which 220 were granted tax exemptions based on the predetermined criteria. Among the 220 CGCs, 38% were private companies.[15] Approximately CNY10 billion ($1.21 billion) has been raised for guarantees that stand at 4–5 times leverage ratio.[16] In addition, during the last 3 years, the Shanghai Municipal Government successfully established a new credit reporting system targeted at SMEs through commercial banks based on a prudential assessment of creditworthiness.

To support SME development and provide overall guidance, SETC set up the State Leading Group on Supporting SMEs with high-level representatives from MOF, PBOC, the Ministry of Science and Technology (MOST), State Administration of Industry and Commerce (SAIC), CSRC, and policy banks and commercial banks.

In August 2000, the State Council issued "policy measures" propagated by SETC to encourage and promote SME development. The Government identified 25 measures under eight broad categories: (i) fostering structural adjustment; (ii) promoting technology modernization; (iii) expanding support for fiscal policy; (iv) widening financing channels; (v) speeding up establishment of a credit guarantee system; (vi) setting up social service support system; (vii) creating a fair competition environment; and (viii) strengthening leadership and guidance. These policy measures are reflected in the new law on Promotion of Small- and Medium-Sized Enterprises (Promotion Law) that was adopted in June 2002. The new law, which took effect in January 2003, encompasses general principles supporting SMEs and specific services provided in the forms of funding support, technology innovation, and expansion of marketing and service systems, and should improve the enabling environment for SMEs. Under this law, a private enterprise or SOE that meets numeric requirements in terms of assets and personnel will be defined as an SME and entitled to tax exemptions or deductions depending on how many laid-off workers they hire. This new law and Shanghai pilot credit reporting system were supported through ADB technical assistance (TA). Another recently approved ADB TA will help develop policies and regulations in establishing the SME Development Fund, an alternative financing mechanism proposed in the new law (ADB 2000b and ADB 2002g).

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[14] The latest guidelines on enterprise size, as agreed upon by State Development Planning Committee (SDPC), the National Statistics Bureau, MOF, and SETC define medium enterprises as enterprises with annual sales of CNY50 million and general assets of CNY50 million and small enterprises as enterprises with annual sales of less than CNY50 million and general assets of less than CNY50 million.

[15] SETC.

[16] SETC.

Notwithstanding these developments, due to a less transparent historical policy environment in which many firms used to operate, as well as lack of information, many SMEs are not aware of recent policies that will benefit them, or they simply have no time to understand the new policies. There is thus a need for concerted efforts among government agencies and local governments to create a mechanism to publicize information regarding policy changes that affect SMEs.

Box 2:

Credit Guarantee Schemes in the PRC

Credit guarantee schemes (CGSs) are promoted by the Government to help facilitate bank lending to small and medium enterprises (SMEs) that lack assets or adequate financial records to obtain bank loans independently. Business organizations, local governments, and individuals are encouraged to establish CGSs. Because banks should be able to lower their risk of lending to SMEs by obtaining guarantees from the CGSs on all or part of their loans, the Government envisages a rising supply of formal finance to SMEs.

CGSs vary in terms of their size, scope, and quality of their activities. A majority of CGSs funded by the Government are not well structured; neither do they make decisions based on commercial considerations. Some appear to be assuming the credit allocation function of banks. The current structure of CGSs thus presents potential hazards to the financial system as risks are transferred from financial intermediaries to CGSs.

Few CGSs seem to be very active and large enough to have a meaningful effect on the volume of bank lending. Smaller CGSs have limited credibility with banks and need to use their own cash as collateral to induce banks to lend. Larger and more credible CGSs typically offer to guarantee loans up to CNY3 million ($360,000). Some CGSs guarantee 100% of the value of loans. Guarantee fees range from 1 to 1.5% of the guaranteed amount.

CGSs employ project analysis and approval processes that are similar to banks but tend to be more flexible in analyzing investment projects because they seek additional credit information to support their business decisions and may use a local investigative agency for supplementary information about potential clients.

There is no central regulatory oversight of CGSs. ADB, through technical assistance (TA) 3543, provided recommendations on a legal and regulatory framework for CGSs, including the establishment of a central reguarantee program. Under TA 3493, ADB provided recommendations to the Shanghai Municipal Government to develop commercially funded CGSs in Shanghai.

Sources: ADB, 2000, 2001, 2002. ADB. 2002. Technical Assistance to the PRC for Private Sector Development. Manila; ADB. 2001. Technical Assistance to the PRC for Development of Financing Policies and Mechanisms for SMEs. Manila; and ADB. 2000. Technical Assistance to the PRC for Development of Small and Medium-Sized Enterprise Credit Support System. Manila.

5. Foreign Direct Investment

Government policy toward FDI has changed significantly in the last 20 years and evolved through several stages. In the initial stage from 1978 to 1985, foreign investors were restricted to export–oriented operations. This stage saw the establishment of "export processing" zones largely for Hong Kong, China businesses in Guangdong, the four original special economic zones (Shantou, Shenzhen, Xiamen, and Zhuhai), and with the subsequent addition of Hainan, all of which offered foreign investors preferential treatment such as tax incentives. The second phase, 1986–1991, provided a clearer policy direction exemplified in the draft list of industrial sectors to which FDI was encouraged, restricted, and prohibited. Foreign investors were also allowed to manufacture and sell numerous goods domestically.

In 1990, a new economic zone was created in Pudong, Shanghai. The Government also introduced legislation and regulations to encourage foreign investment into high-priority sectors (energy, communications, and transportation) and regions. Time restrictions on the establishment of JVs were repealed, assurances against nationalization were provided, and foreigners were allowed to become chairs of JV boards.

In 1991, the PRC became a member of APEC that provides for free trade and cooperation in the region. In 1992, the amount of FDI started to increase dramatically following Deng Xiaoping's announcement to further stimulate economic reforms by expanding the successful experiments into other regions in addition to the coastal cities, and the PRC began to attract much more FDI than other neighboring countries (Figure 1).

In the mid-1990s, the Government authorized the establishment of wholly foreign-owned enterprises, now the preferred form of investment. Previously foreign investors were required to form JVs with PRC firms to enter the market (American Embassy in the PRC 2002). Foreign banks were also authorized to open branches in Shanghai and foreign investors were allowed to purchase special B shares of stock listed on the Shanghai and Shenzhen Stock Exchanges (collectively Exchanges).[17]

From 1993 onward, major changes occurred in the nature of reform. Laws were revised in 2000 to ease export performance and domestic content requirements. The NPC endorsed the "go west" policy in March 2001. This policy is a priority in the Tenth Five-Year Plan (2001–2005) and is designed to address the substantial disparities in regional living standards that have emerged during the course of 20 years of reform when the strategic focus was on attracting FDI in the coastal region. Preferential measures to facilitate development in the western region include raising the Central Government's budget allocation for large-scale projects in this region and giving foreign-funded firms participating in the economic development of this region the same preferential policies as those located in the coastal economic zones.[18]

In April 2002, pursuant to the PRC's accession to WTO, new guidelines were issued to open more industries to foreign investment (Section II.A.6.c. WTO Accession). While ownership regulations continue to require domestic investors to have a controlling stake in companies in certain industries, these industries account for less than 6% of the total. Foreign investors are currently allowed to establish wholly owned subsidiaries in almost 90% of all industries.

6. Trade Liberalization

a. Import and Export Rights

The pre-reform trade regime in the PRC was initially dominated by 10–16 foreign trade companies (FTCs) that had a monopoly in the import and export of specific products. The number of FTCs was incrementally expanded with trading rights provided to branches of the FTCs controlled by the Central Government, regions, and localities, resulting in thousands of firms. JVs between domestic and foreign firms and firms located in the special economic zones were also allowed to trade. Subsequently, large producing firms began to gain direct foreign trade rights (Ianchovichina undated).

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[17] See earlier discussion (Restructuring of State-Owned Enterprises) on new regulations to permit foreign mergers and acquisitions of SOEs and privately owned enterprises and discussion, infra, in Section II.A.2.a on B share market.

[18] See Draft TA Report on Attracting FDI to Western China, March 2003, Monash International, prepared under *Technical Assistance to the PRC for the Study of Foreign Capital Utilization for the Western Region*. Note that these measures do not yet appear to have had any significant impact on FDI based on the Government's current focus on infrastructure, poverty, and environmental protection projects.

Since 2002, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) has lifted controls over import and export rights. However to obtain such rights, a firm is required to meet certain conditions such as a minimum registered capital over CNY5 million (over CNY2 million for high-technology companies) that was reduced to CNY3 million in 2003, and will be further reduced to CNY1 million in 2004 (China Daily 2002o).

Since early 2002, 32,000 domestic enterprises have been granted import and export rights. MOFTEC has also sent a draft proposal on granting FIEs full trading rights to the State Council for approval. Upon approval, 50,000 FIEs will be able to import and export products without being subject to state trading or designated trading (China Daily 2002o).

b. Barriers to Trade

During the 1990s, the PRC made substantial progress in reducing the number of nontariff barriers to trade. The number of products subject to quotas and licenses was estimated to have fallen from 1,247 tariff lines in 1992 to 261 in 1999.[19] The amount of tariffs also significantly decreased during this period. In addition, as part of WTO accession, the PRC further reduced average import tariffs from 15.3% to 12% on more than 500 dutiable items and is committed to reduce tariffs on more than 5,300 commodities to 11% in early 2003 (ADB 2003).

c. WTO Accession

The year 2001 marked the PRC's entry to WTO. On 21 February 2002, the State Council issued revised provisional regulations on guiding foreign investment (Order 346). On 12 March 2002, the Government approved new foreign investment guidelines to allow wider foreign investment opportunities. These guidelines became effective on 1 April 2002.[20] The number of industries open to foreign investors increased from 186 to 262 and the number of industries where restrictions apply was reduced to 75 from 112.

The new *Catalogue for Sectoral Guidance of Foreign Investment* expanded the number of sectors where FDI is "encouraged," and reduced the number of "restricted" and "prohibited" sectors. Areas where FDI is encouraged include new agricultural technology and comprehensive agricultural development, energy, transportation, new material industry, and energy-saving and environment-friendly technology and equipment. The new guidelines also encourage and permit investments by wholly foreign-owed enterprises in some new sectors, such as exploration of natural resources, but only in the central and western regions. Foreign-invested projects for encouraged investment categories will be subject to less stringent legal and administrative requirements. Also, the new guidelines reflect specific sectoral opening requirements set by the PRC's WTO accession protocol (Appendix 4). Under the guidelines, foreign investment in broadcasting, utilities, and weapons production is still prohibited.

Entry into WTO requires the PRC to amend existing laws, regulations, and administrative practices and adopt new laws and regulations to comply with WTO rules and obligations (Box 3). The Government is committed to making necessary changes in laws and regulations that include codifying existing administrative practices into written laws and regulations to increase predictability and transparency. Intense efforts are being made to revise laws and regulations on trade, technology transfer, investments, banking, insurance, securities, taxation, customs, intellectual property, telecommunications, health, professional services, and other subjects to bring them into compliance with the WTO regime. As of September 2002, at least 2,300 government regulations have been reviewed and either amended or repealed by more than 30 government agencies (China Law and Practice 2003e and ADB 2001h). The Government's announcement that if there is a conflict between domestic laws and

[19] Elena Ianchovichina citing personal communication with Nicholas Lardy.
[20] The full Chinese text of the official new catalogue is accessible at State Development Reform Commission's (SDRC) web site, http://www.sdpc.gov.cn. Please see Appendix 4 for an unofficial translation.

WTO obligations, the latter will rule, is an indication of the Government's commitment to adapt to the WTO rules-based regime. However, notwithstanding the PRC's WTO accession, most of the preferential policies for foreign-funded companies continue to remain in effect.

Box 3:

Highlights of the PRC's WTO Commitments

The PRC's WTO commitments accession are many and complex, covering such areas as tariffs, quotas, export subsidies, agricultural trade, telecommunications, banking, insurance, and other sectors and issues. The following is a summary of the more important commitments.

Tariffs, Export Subsidies, and Quotas

- The PRC will cut its average import tariff for agricultural products from 13% to 14% by 2004 based on a tariff-cum-quota system with import quotas increasing over time.
- The average tariff on industrial products will be cut from 18.5% to 9.4% by 2005, with tariffs on automobile imports cut from the current 80–100% range to 25%, tariffs on information technology products such as computers, semiconductors, and Internet-related equipment reduced from an average of 13.3% to zero, and tariffs on products such as wood, paper, chemicals, and medical equipment reduced to 7% by 2003.
- The PRC will eliminate export subsidies, quotas, and quantitative restrictions on imports within 5 years of joining WTO.

Telecommunications

- The PRC will phase out all geographic restrictions on paging and value-added services within 2 years of joining WTO, on mobile/cellular services in 5 years, and domestic wire line services within 6 years.
- The PRC will allow 49% investment by foreign telecom service providers from the date of accession to WTO, 50% foreign ownership for value-added services within 2 years of joining, and 50% foreign ownership for paging services within 3 years.

Banking

- The PRC will allow full market access to foreign banks within 5 years of joining WTO.
- Foreign banks will be allowed to conduct local currency business with PRC enterprises 2 years after WTO accession, and will be allowed to conduct local currency business with individuals after 5 years.
- Foreign banks will have the same rights (national treatment) as PRC banks.
- The current geographic restrictions on foreign bank operations will be removed within 5 years of joining the WTO.

(continued next page)

d. New Ministry of Commerce

At the 10th NPC, a decision was made to establish a Ministry of Commerce (MOC) by incorporating the domestic and foreign trade administrations of MOFTEC and SETC. The role of the MOC includes regulation and administration of foreign and domestic trade (equal treatment, level playing field), formulation of reform programs for the retail and distribution sectors, and formulation of foreign investment policies.

Box 3: (continued)

Insurance

- The PRC will permit foreign property and casualty firms to insure large-scale risks nationwide immediately upon accession, and will eliminate all geographic limitations for future licenses over 5 years, allowing access to key cities of priority US interest in 2–3 years.
- The PRC will expand the scope of activities for foreign insurers to include group health and pension lines of insurance, which represent about 85% of total premiums, phased in over 5 years after joining WTO.
- The PRC will allow 50% foreign ownership and remove JV requirements on foreign life insurers, and phase out internal branching restrictions.
- For nonlife insurance, the PRC will allow 51% foreign ownership upon WTO accession.
- The PRC will award licenses for insurance business based solely on prudential criteria, with no economic needs test or quantitative limits on the number of licenses issued.

Other Commitments

- The PRC has provided a broad range of commitments to open up the country's professional services, including legal, accountancy, taxation, management consultancy, architecture, engineering, urban planning, medical and dental, and computer-related services.
- The PRC will allow unrestricted access to the market for hotel operations with the provision to set up 100% foreign-owned hotels within 3 years of joining WTO, with majority ownership allowed upon accession.
- The PRC will allow trading rights (the right to import and export) and distribution rights for foreign firms, in areas such as wholesale and retail trade, after-sale service, repair, and maintenance.
- The PRC will allow imports of motion pictures and 49% foreign ownership in JVs involved in distributing motion pictures.
- The PRC will ensure that SOEs will make purchases and sales based solely on commercial considerations, such as price, quality, availability, and marketability; and provide foreign firms with the opportunity to compete for sales and purchases on nondiscriminatory terms and conditions.
- The PRC will allow foreign nonbanking firms to provide auto financing.
- The PRC has agreed to US safeguards remaining in place for another 12 years after WTO accession to prevent a sudden surge in imports damaging US producers. It also agreed to let the US maintain its current method of evaluating whether the PRC's goods were being dumped on the US market for 15 years.

e. Government Procurement

The Government, with ADB assistance, recently adopted new laws and regulations to expand opportunities for investors and promote competition in the PRC government procurement market.[21] This rapidly growing market was expected to have reached $12 billion in 2002. Multinational procurement groups have begun paying closer attention to this market and moving their sourcing to the mainland (Business Alert China 2002).

[21] Pursuant to ADB's *Technical Assistance to the PRC for Formulation of the Government Procurement Law*, ADB helped the Government draft and adopt a unified, comprehensive national framework for government procurement. In ADB's *Technical Assistance to the PRC for Implemetation of Tendering and Bidding Law and Related Regulations*, ADB helped the Government prepare implementing regulations under this law; develop and implement a campaign to disseminate the new requirements to the national, provincial, and local governments; establish an independent oversight agency; and train personnel to implement and administer the regulations.

The PRC began its first trial of government procurement in 1996, which developed quickly. In 2001, regional agents or centers of government procurement for goods, construction, and services emerged throughout the PRC, with total procurement volume reaching CNY65.3 billion ($7.9 billion), more than doubling the previous year (People's Daily 2002a). To promote transparency and provide national standards and practices for the purchase of goods, construction works and services by government and quasi-government entities, the Government Procurement Law (GPL) was adopted on 29 June 2002 and became effective on 1 January 2003.[22] Bidding for such contracts is subject to the 1999 Bidding Law (ADB 2000c).

Although adopting the GPL will provide opportunities for the private sector, further refinement is needed to ensure that SMEs and foreign suppliers will be able to participate. For example, under the GPL, priority is given to purchases of local goods, construction works and services, and every supplier, even where a consortium is entered into, is required to meet specific requirements to participate in government procurement bidding, including the professional and technical competence to perform government procurement contracts and a good record in paying local tax and social security contributions.

7. Labor

a. Mobility

Government policies regarding labor mobility (the *hukou* registration system) have been modified to reflect migration of a large number of rural workers to urban areas (Wing Cham and Li Zhang 1999). However, the system remains essentially unchanged and continues to impede the mobility of skilled labor and management.

The hukou registration system, which was formalized as a permanent system in 1958 to prevent wide scale urban migration, divides the PRC into rural and urban areas. The designation of a person's hukou registration place and status is inherited from his mother. Each citizen is required to register the place of regular residence in an urban center or rural settlement. Registration defines a person's rights for social and economic activities in a particular location.

Job eligibility may be limited to local hukou holders. Change of hukou registration and status requires government approval, which is not easily granted in the case of rural-urban migration. One needs to apply for both a permit to move and a migration certificate issued by the police in the places of designation and origin. The hukou registration authority will check up on the situation, the number of people moving, the reasons for the move, the time of the moving, their origin or destination, etc. (Wing Cham and Li Zhang 1999). The change in status is also subject to policy and quota controls. Persons who are recruited by the State or admitted by high education institutes are automatically entitled to migrate if such recruitment or admission requires migration.

Although the decision on whether to grant approval generally rests with the Ministry of Public Security (MPS), various government departments also have such prerogative. While hukou regulations state the procedures for migration, they do not specify the qualifications for migration. Different types of migration require different qualifications and documents that are decided by various government departments.

Formal migration from rural to urban areas is strictly controlled but flows in the opposite direction are allowed. Urban residents are allowed to move between cities but migration from small to big cities such as Shanghai and Beijing are more strictly controlled.

A series of measures was introduced in 1985 by MPS to address challenges raised by current increases in mobility. A system for administration of temporary residences (more than 3 months but less than 1 year subject to renewal) was organized for persons with short-term stays and without local regular hukou.

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[22] Procurement by the military and SOEs is excluded.

A new "blue-stamp" urban hukou was launched in 1992. This hukou permit is open to a wider population and includes more cities and towns, including large cities and special economic zones. Eligibility is primarily based on the assessed contributions to the urban economy. Eligible people include relatives of overseas PRC nationals; Hong Kong, China; or Macau, China investors, management, and technical staff who are employed by investors; relatives of overseas PRC nationals, Hong Kong, China; Macao, China; and Taipei,China compatriots who, with permission, purchase or build urban housing with foreign currency; persons who, with permission, purchase urban housing at market prices or build urban housing with their own capital; professionals and technical staff who work in developing areas; and other persons who make significant contributions to the urban economy. The new system helps legalize a part of the de facto urban population without committing central financial obligation and is administered by local governments who are given the flexibility to address their own needs. Applicants, in addition to having the means to live in urban areas where they intend to move, are required to pay fees for urban infrastructural construction. Blue stamp urban hukou holders are required to resume their original hukou status when moving out of the registered urban areas and are not considered as having gone through the process of changing their registration in the eyes of the Central Government.

In 1997, the State Council approved a policy document by MPS allowing 450 pilot towns and cities to grant urban hukou status for qualified rural hukou holders. Provincial governments are allowed to select some small cities and towns with a higher level of economic and infrastructural development with financial success for a 2-year experiment. Rural hukou holders who have stable nonagricultural jobs or stable living support and regular accommodations in selected towns and cities may apply for regular urban hukou after residing there for more than 2 years, but if approved will need to give up their use and right of land in the countryside. Successful applicants will then have the same right as those regular urban residents in respect to education, employment, subsidized foodstuffs, and social security and welfare benefits in the specified town or city. In contrast to blue stamp urban hukou, qualified applicants to this scheme do not have to pay a fee to the local government. Since regular urban residents still receive state subsidized welfare, the number of urban hukou holders under this program is subject to quota control that is set by planning departments in cooperation with related bureaucracies. This program increases the fiscal burden on local governments and directly competes with the blue stamp urban hukou program, which has resulted in income for local governments.

b. Unemployment

The concept of unemployment was unknown in the PRC until 1994 when SOEs began to lay off workers. As of 2001, the PRC had 20.8% of the world's population and 25.6% of the world's workforce (approximately 763 million people) (World Bank 2003). Although the size of this workforce gives the PRC a competitive advantage in providing cheap labor force, the increasing number of unemployed former SOE and TVE workers, number of rural surplus workers, the projected number of new entrants into the labor force, and problems in adequately funding social security, place increased pressures on the Government for a comprehensive solution.

It is difficult to gauge the number of unemployed workers in the PRC with any degree of accuracy. Unemployment statistics in the PRC only measure urban employment and do not take into account surplus rural workers who are limited by the hukou registration system from migrating into urban areas. Estimates of urban unemployment range between 8 and 9% (Jianjung 2002). The unemployment rate is much higher in the industrial rust belts in the North (Forney 2002), averaging at least 20%. Women have suffered disproportionately. Between 1995 and 2000, the number of urban female employees declined by more than 25% (Beijing Review 2003b). In addition, there appears to be at least 150 million surplus and idle workers in rural areas.

Unemployment has continued to rise notwithstanding steady GDP growth. During 1996–2000, with every percentage point of economic growth, the number of unemployed persons in urban areas grew by 520,000 (Asia Times 2002). Based on different economic assumptions (all based on continued economic growth), in the next decade the PRC needs to generate between 90 and 300 million new jobs to redeploy people from agriculture, SOEs, TVEs, and for new labor market entrants (Section I.B.1.d. Employment).

Helping the increasing number of laid-off workers and unemployed people find jobs is a crucial and pressing task facing the Government (China Daily 2002c, People's Daily 2002b), which, instead of direct intervention, has increasingly focused on the adoption of policies that support the hiring of laid-off workers; increased employment opportunities through promotion of SMEs, PSD and investment; development of labor-intensive industries; encouragement of training programs to retrain laid-off workers; and job aid for the unemployed with special difficulties. The Government's role has increasingly focused on the need to readjust its employment policy if the economy loses pace and unemployment mounts.

8. Land Use

All land in the PRC is owned by the State or a unit of the local government. In rural areas, most land is collectively owned and the rights belong to a local government unit. However, relevant laws do not clarify which unit of local government is the legal owner.

In 1988, the PRC amended its Constitution and Land Administration Law to permit the transfer of "land use rights" to private persons and entities. There are two types of land use rights under the law: allocated rights and granted rights. Allocated rights are indefinite usage rights subject to expropriation with limitations on leasing, mortgage, and other terms of transfer. Granted rights allow land to be used for a fixed period that may be extended with government approval. Granted rights may be leased, mortgaged, and transferred.

The State Land Administration has adopted rules to provide for a uniform system of registering interests in land. Land use rights on state-owned land and agricultural collective owned land are required to be registered. Other real estate interests, such as mortgages and leaseholds on land use rights, and building ownership, must also be registered. However, determining the rights to land may be difficult. In general, there are multiple registry offices with uncoordinated records,[23] land registry records are often incomplete, and rules do not indicate where or how required notice should be published. Although land registry offices in major cities appear to be efficient, outside these cities, land registry offices may not have opened, or be consistently staffed or sufficiently equipped. It may also be difficult to obtain access to registration records.

The registry office prepares both a registration card that is maintained in the registry office and a registration certificate that is given to the transferee. The card, not the certificate, constitutes the official registration and legal basis of the title. In addition, the PRC does not have a universal survey system. Property descriptions often use monuments such as local roads, buildings or other features as beginning points for descriptions of land. When land descriptions are inadequate, interest in the same land may be registered under different land descriptions (Palomar 2002).

9. Price Liberalization

Prices have been liberalized throughout the economy except for energy and other utility prices. Currently, more than 90% of retail prices are determined by the market and competition in producer and consumer products in the PRC is intense (Organisation for Economic Co-operation and Development [OECD] 2002).

[23] In Beijing, Shanghai, Shenzhen, and other business centers, registration records for buildings and land are maintained together.

10. Exchange Convertibility

Although the PRC Government controls foreign exchange capital account transactions, policies regarding current account transactions have been liberalized over the last 20 years as foreign exchange reserves have increased. The State Administration of Foreign Exchange (SAFE), under the authority of PBOC, oversees foreign exchange controls. Under existing regulations, unless otherwise approved by SAFE or exempted under relevant regulations, domestic enterprises operating in the PRC are required to price their goods and services in the PRC in yuan. Foreign exchange received by such enterprise in current account transactions, except for amounts approved by SAFE, are required to be sold to authorized foreign exchange banks in the PRC. Domestic enterprises may, subject to applicable regulations, purchase foreign currency from authorized foreign exchange banks only after they provide documents evidencing a current account payment obligation.

Foreign exchange received by a domestic enterprise in a capital account transaction from a foreign bank is required to be deposited in foreign exchange with an authorized foreign exchange bank in the PRC and may be converted to yuan only with the approval of SAFE. To satisfy foreign currency requirements for settling of capital account transactions, domestic enterprises are required to obtain the approval of SAFE before purchasing foreign currency from authorized foreign exchange banks.

Since 1994, FIEs have enjoyed liberal access to foreign exchange (American Embassy in the PRC 2002). Subsequent growth in foreign exchange reserves, which exceeded $475 billion as of the end of the first quarter of 2001, led to the SAFE decision to relax foreign exchange controls on both capital account and current account items (American Embassy in the PRC 2002).

FIEs are required to maintain a foreign exchange account for current account transactions pursuant to SAFE requirements. These requirements include SAFE permission to open the account, limitations on the amount of foreign exchange that can be held, and conversion of any excess foreign exchange into local currency.

The process for converting capital funds held in foreign currency by FIEs was simplified by the SAFE Circular on Reforming the Regulation of the Settlement of Foreign Invested Capital Funds that came into effect on 1 July 2002. This circular represents a policy shift in foreign exchange control from direct control by SAFE of FIEs to indirect control through authorized foreign exchange banks. Prior to this circular, foreign exchange laws required an FIE to first obtain SAFE approval to convert capital funds brought into the PRC from foreign currency into local currency, which took time. Under this circular, SAFE approval is no longer required if the FIE converts funds in a capital funds account opened with an authorized foreign bank.

B. Rule of Law

The transition from a command economy to a market–oriented economy makes legal rules matter. Direct government control over economic decisions is replaced by the rule of law that is necessary to protect private property and contract rights (World Bank 1997, IFC 2000b).

The rule of law is generally defined as (i) general, abstract rules that are prospective, never retrospective, in their effect; (ii) rules that are known and certain; (iii) rules that are equal in that they do not discriminate based on irrelevant distinctions; and (iv) a separation between regulators and the regulated (IFC 2000b). The rule of law in the business environment is expected to guarantee transparency, predictability, and consistency.

The PRC demonstrated its commitment to the rule of law by including the principle of "governing the country according to law" in the 1982 Constitution. Article 5 states that "all state organs, the armed forces, all political parties and public organizations, and all enterprises and institutions must abide by the Constitution and the law. All acts in violation of the law must be investigated." The Constitution also states that "no organization or individual is privileged to be beyond the Constitution or the law." These provisions are clear and self-explanatory (ADB 2002c).

In 1997, the 15^{th} Communist Party Congress explicitly cited the rule of law as a guiding principle in an official document and proposed to create a comprehensive framework with Chinese Characteristics by 2010 (Zhenmin 2002). The 1999 Constitutional Amendment upgraded the status of the private sector from a "supplement" to public ownership to an important component of the socialist market economy and guaranteed legal protection of private property rights.

Although the PRC's legal system is a mix of common law and the continental legal system (German civil law system model) with less emphasis on legal precedent, it differs fundamentally from western law in many reports. For example, in practice, it lacks an independent judiciary.

Prior to economic reforms, economic laws were scarce. Since 1979, the volume of legislation and regulation has grown rapidly. Commercial laws began to develop in the 1980s and accelerated in the 1990s. From 1979 to mid-2000, the Central Government promulgated 311 new pieces of legislation, 700 sets of regulations, and over 4,000 administrative rules. In 2001, NPC and its Standing Committee passed 23 major laws. From 1980 to mid-1999, provincial governments approved 7,448 local laws and regulations, many of which affect the private sector (ADB 2002c).

Laws and regulations promulgated by NPC override local provincial laws. While NPC can issue overriding legislation, often such legislation is in the form of general principles and guidelines that permit broad interpretation. Implementing regulations by government agencies and local government officials clarify these laws but are often inconsistent. In addition, these regulations often include inconsistent interpretations (ADB 2002c).

The PRC's entry to WTO has accelerated the process of adapting the country's legal system. As a result of the PRC's entry to WTO, approximately 2,200 laws and regulations need to be modified or repealed (Section II.A.6.c. WTO Accession).

C. Institutional Framework

The institutional framework for a modern enterprise economy in the PRC is not fully in place. As discussed above, property rights are difficult to establish and corporate governance reforms are difficult to implement based upon state control of most listed companies and market institutions (Section IV.A.2.a. Capital Markets). A majority of SOEs and local governments do not have the skills needed to restructure business, implement new governance structures, manage the transfer of social benefits, or reschedule debts, making it difficult to effectively implement the policy environment for SOE reform. Although the Government appears committed to separating ownership from operational control, key managers continue to be appointed by government officials.

The economy is managed by the central and provincial governments and new regulatory agencies. Executive power is centralized in the State Council, which governs and regulates almost all economic activities and administrative issues in the PRC. The 10^{th} NPC held in March 2003, which included 65 private sector representatives, approved the restructuring of the government to, among others, reflect the increasingly important role of the private sector in the economy. New ministry-level agencies under the State Council were formed. The State Development Planning Commission (SDPC) was reorganized as the new State Development and Reform Commission and is expected to improve macroeconomic control. A new MOC was created to promote the reform of domestic and foreign trade and commerce and exercise the powers of SETC and MOFTEC, both of which were abolished. A new SASAC was established to take over the daily management of SOEs (Section II.A.3. Ambiguous Private Property Rights). The China Banking Regulatory Commission (CBRC) was also established to take over the banking regulatory role from PBOC, which will now be primarily responsible for monetary policy.[24] MOF continues to have primary responsibility for developing and implementing policy in areas including banking, social security (e.g., pension funds), and the government debt market. It is also responsible for development of national accounting standards and acts as the issuing agent for treasury bills and government bonds.

As per the reorganization, key economic sectors are now regulated by the following bodies:

(i) Banking and Finance: PBOC, CBRC, MOF;

(ii) Insurance: China Insurance Regulatory Commission (CIRC);

(iii) Securities Markets: CSRC;

(iv) Competition and Consumer Protection: Various bodies enforce commercial laws relating to competition and consumer protection, including SAIC; and

(v) Public Utilities: the newly established State Electricity Regulatory Commission (SERC) is responsible for supervising electric power while the Ministry of Construction supervises the management of water and sewerage.[25]

Regulatory bodies may not be fully funded from the national budget and may exist at the central level and/or at the local level. Central-level bodies are more responsible for policy making while local-level bodies are more responsible for enforcement. Local-level bodies may be part of local government and responsible to local officials who may control funding and personnel. Recently, public pressure placed a draft Law on Supervision of Administrative and Judicial Bodies high on the NPC's agenda. This draft law provides additional powers to People's Congress members at the national and local levels to supervise the functions of administrative and judicial government bodies (China Daily 2002f).

Since the late 1980s, the Government has corporatized some government departments that sell goods in market (e.g., the Ministry of Petroleum became the National Petroleum Corporation in 1988, the Ministry of Electric Power became the State Power Corporation in 1997).

Public sector employees number about 125 million (World Bank 2002b). Approximately 88 million public sector employee work in SOEs and 37 million are employed directly or indirectly in the government. Civil servants are recruited competitively and selection is based on examinations. Relevant regulations require them to be promoted on the basis of their ability and political integrity and rewarded according to performance. Civil servants are supposed to be compensated in line with remuneration received by SOE managers with the same level of responsibility. Notwithstanding, the gap between the compensation for civil servants and those in the private sector is substantial, especially in developed areas.

Reforms in the civil service have resulted in a dramatic increase in the education levels of leading PRC officials, although less than half of the civil service has graduated from university. Better-educated and younger officers have improved bureaucratic capacity (ADB 2002c). For example, younger and more qualified officials now staff key regulatory agencies such as the CSRC where, in 2001, 86% of employees had university or postgraduate degrees.

[24] The restructuring of the Government is ongoing and the role of new government agencies is still being clarified and discussed. Thus, this private sector assessment (PSA) continues to refer to the names of government agencies that have been abolished with respect to the adoption of key policies and regulations that impact private sector development.

[25] See footnote 85 regarding the establishment of SERC.

D. Nongovernment Organizations

Government policy does not encourage the development of nongovernment organizations (NGOs) (ADB 2002c, Far Eastern Economic Review 2002b). Indigenous NGOs are required to have a government department as their sponsor. In practice, most NGOs find few government departments willing to accept such a responsibility. The Government bars the registration of more than one NGO in a particular field in each region. NGOs are not allowed to set up regional branches and unless permission is granted, they cannot operate outside of the district where they are registered. Foreign NGOs are not allowed to register.

Box 4:

The All China Federation of Industry and Commerce

The All China Federation of Industry and Commerce (ACFIC) was founded in 1953 as a quasi–NGO and primarily serves as a bridge from the Party and the Government to industrial and commercial enterprises in the PRC, although it also provides other services to promote its members' economic interests. ACFIC is empowered to nominate members to the Chinese People's Political Consultative Conference (CPPCC) and National People's Congress (NPC), propose bills to NPC to promote the interest of its members, and liaise with government officials on politics and regulations affecting non-public business development. ACFIC recommends 60 delegates annually to NPC and 65 to CPPCC (every 5 years when they change terms) from its membership. Because of its participation in national legislative bodies, some senior officials of ACFIC may view it as a lawmaking body rather than a lobby for its membership. Some private entrepreneurs join a local chapter of ACFIC so that they can be nominated to the CPPCC and NPC.

ACFIC is empowered to (i) organize economic events such as trade fairs, exhibitions, technology exchanges, and other networking events; (ii) promote foreign economic and technological cooperation and trade, and support linkages between the PRC and foreign companies; and (iii) disseminate information on government policies, markets, new technology, and many other things.

Recently, ACFIC played a role in establishing the first nonstate-owned bank in the PRC, Minsheng Bank, as an advisor to the Government. The Chairperson of ACFIC is on Board of Minsheng Bank. ACFIC, through its chapters, conducts an annual survey of large enterprises, which reports on enterprise structure, operations, employment, and sales. It has also been involved in advising the Government on credit guarantee schemes (CGSs) to promote lending to small and medium enterprises (SMEs). However, in general, the Government directs ACFIC in what services it should provide.

As of 30 September 2001, ACFIC had 1.57 million members, of which 233,499 (13%) were private firms, although firms under various forms of nonstate ownership comprise 83% of membership. All sectors are represented. Most members are SMEs and individually owned enterprises (*geti hu*). ACFIC has 3,059 local chapters at the country level and above, of which 358 local chapters are located in major cities throughout the PRC, covering 95% of the nation's administrative regions. There are 18,581 chapters at the town and community levels, 461 of which were founded in 2001, and all of which are fee-based. The relationship of chambers at various levels is informal. There is no financial and/or administrative link between different chamber levels. Each chamber is independent and supported by its respective local government, which provides it with budgetary support. There is considerable variation in the organizational structure, size, and activities of different chambers depending on the local conditions and attitudes of local governments. The range of services provided by individual chapters varies considerably based on the regional situation, membership needs, and local government guidance. For example, chapters in the South seem greatly influenced by the example of the Hong Kong, China Chamber of Commerce, which operates more like the business-focused chambers of developed countries. ACFIC also has loose links with other organizations that have responsibilities for private enterprises or exist to provide services to them.

ACFIC employs 166 staff members, of which half occupy management positions. Staff are well educated and experienced. The entire ACFIC system employs more than 100,000 persons. ACFIC's revenues are comprised of an annual government appropriation and the fees collected for organizing events for members. Funding estimates for the vast ACFIC system may be more than CNY1 billion annually. ADB recently provided technical assistance to ACFIC to, among others, help it reassess its role in the transitional market economy and develop a future strategy focusing more on member services and less on its traditional political function.

Source: ADB. 2000. *Technical Assistance to the PRC for Private Sector Development*. Manila.

SECTION III

FACTORS IMPEDING PRIVATE ENTERPRISE DEVELOPMENT—BUSINESS CLIMATE SURVEYS AND VOICES OF PRIVATE SECTOR PLAYERS

A. General

As the fastest growing economy in the world with a largely untapped domestic market, high savings rate, and low labor costs, the PRC continues to attract both domestic and foreign investments despite numerous impediments including (i) policy bias and restrictions on market entry and exit; (ii) problems in the legal environment, including weak implementation of the rule of law; (iii) lack of financing options; (iv) infrastructure constraints; (v) human resource constraints; (vi) shortcomings of private sector enterprises; and (vii) poor access to reliable information and professional services. To help ensure that the private sector continues to grow, these constraints need to be addressed. Ways need to be found to create a better enabling environment while strengthening pro–poor market development.

B. Business Climate Survey

This private sector assessment (PSA) draws upon an ADB TA for developing the private sector, which included a survey of 723 domestic private enterprises and related interviews with 82 chief executive officers (ADB 2000a), and an independent business climate survey with 108 foreign investors through foreign chambers of commerce in the PRC (Appendix 5). Foreign firms surveyed were from Australia; Canada; Hong Kong, China; Italy; Japan; Republic of Korea; United Kingdom (UK); and US. These surveys were intended to complement a related survey conducted under a previous ADB TA project (ADB 2000b).

The PSA also drew on private sector surveys that both domestic and international organizations recently conducted. For domestic private enterprises, reference was made to a survey conducted by IFC on emerging private enterprises in 1999–2000 (IFC 2000) and an SME survey conducted by the Development Research Center of the China State Council (DRC) and Japan Bank for International Cooperation (JBIC) in 1999–2001[26] (Appendix 6). Previous survey reports by the American Chamber of Commerce (American Chamber of Commerce, PRC 2001b), the European Union (EU) Chamber of Commerce (EU 2002), the Swiss Chamber of Commerce, and the JBIC (JBIC 2001) were also used (Appendix 7).[27]

[26] As the sample of this survey includes not only private SMEs, but also those in the SOE sector, collectives, and TVEs, the overall results require careful assessment. However, the study provides a valuable comparative analysis between SMEs in the state sector and those in the nonstate sector.

[27] Also reviewed was a summary of results from the Fifth National Sample Survey on Private Enteprises conducted by the China Private Enteprise Study Group and the China Federation on the Private Economy (Beijing Review 2003c).

Views on the business climate vary. Government officials tend to rank the major impediments to PSD in the order of most to least important as ideological barriers, the legal and policy environment, the market environment, and shortcomings of the private sector itself (Liaowan News Weekly 1999).

Private businessmen tend to focus on more practical aspects. While domestic enterprises attribute their constraints to both internal and external factors, foreign companies cite only external factors. Critical operating challenges faced by domestic private enterprises are similar to those faced in other transitional economies and include (i) limited access to finance due in part to weak corporate governance and financial status, (ii) lack of professional management skills and/or managerial capacity, (iii) lack of marketing skills and/or strategies, and (iv) lack of access to information.

Top operating challenges cited by foreign companies reflect issues related to the Government and regulatory authorities including (i) lack of transparency, particularly concerning laws and regulations, and their weak and inconsistent enforcement; (ii) bureaucracy; and (iii) business and market scope restrictions. These surveys suggest that often-repeated complaints by foreign investors concerning the lack of a level playing field are still valid, although many expect that the PRC's entry into WTO will improve the situation.

Both domestic and foreign private businessmen report problems in the current market environment (Box 5). According to ADB surveys, domestic firms reported that they were affected by unfair competition (42% of sample firms) and fake products (19%), followed by taxation (11%), local protectionism (10%), and overregulation (9%). Foreign firms reported that the current market is characterized by overregulation (22%), unfair market competition (20%), local protectionism (17%), taxation (14%), intellectual property infringements (9%), and fake products (7%).

The PRC's market potential, particularly post–WTO implementation, is cited as the top reason for foreign investors' operations in the PRC (33%), followed by the PRC as a high priority emerging economy in their global strategy (27%), the need to make preemptive investments to have a foothold in a potential market (18%), and the need to service multinational clients operating in the PRC (11%). Foreign firms are generally optimistic about the long-term prospects of their PRC operations. About 87% of the sampled foreign firms responded that they will expand their operations in the PRC, of which 22% plan to expand rapidly, rather than gradually. By contrast, domestic enterprises have more mixed views on both the external business environment and prospects for their operations.

Box 5:

Voices of Domestic Entrepreneurs and Foreign Investors

A. Domestic Investors

"Bank loans are like umbrellas made of paper that can be used only on sunny days and are useless on rainy days."

"The PRC is a land where who you know determines a company's success as much as Western concepts of efficiency."

"Our most profitable province is XYZ; the company set up extremely good relationships with central and provincial level officials who provided it with generous pricing policies and market entry."

"If you don't get a sponsor in the local government, you are easy meat for any petty bureaucrat from the hygiene department, the traffic department, the tax department or any other department you care to name. And you get sponsors by making sure you entertain the right people and then making sure they have good time."

"Not only could we not borrow from a bank, but we could not even open a bank account. We had a very tough time convincing the authorities we were a respectable firm. In fact, it was only when I called a relative in the local government that we were finally given the green light."

"Various fees were overcharged. An enterprise opens a hotel, but even the meteorological bureau will charge CNY1,000 per year for its annual examination of lightning arrester."

"Bank loans are out of the question. We have no credit history and cannot satisfy their profitability and other requirements. Also, prospects for a company of our size to be listed in capital markets are dim, which is a major problem now. It costs at least $1 million for procedures. Corruption in the approval process is a big problem."

B. Foreign Investors

"Rule of law is lacking—this translates into a high business risk for us."

"There is inconsistency of production, quality, and environmental protection regulations implemented between local and multinational foreign invested companies."

"Frequent and sudden changes in the legal and regulatory framework remain business constraints. No transparent regulations were applied."

"Receivables are a big problem for any company. Most clients do not pay on time, some never do."

"Besides accounting skills, PRC managers at all levels need the 'soft skills' required to lead staff to achieve profit and quality goals."

"Import/export regulations are not business-friendly. We faced a lot of problems in importing foreign raw material."

"There are 'cultural barriers' in doing business in the PRC. Business people here seem to lack understanding of corporate governance and the strategic and efficient use of capital proceeds."

Sources: ADB. 2000. *Technical Assistance to the PRC for Private Sector Development.* Manila; CEO Interviews; *Finance Asia*; ADB PSA Team Interviews; AmCham-China White Paper; JBIC FY2001 Survey; and Swiss Chamber of Commerce Survey.

C. Impediment (1): Policy Bias—Market Entry and Exit

Although the private sector is now legally positioned as an integral part of the economy under the 1999 amended Constitution, there is growing emphasis on market orientation in allocating resources, and the policy environment is expected to improve further due to the PRC's WTO commitments,[28] a policy bias and discrimination against the private sector still exists. SOE-biased mentality among government officials, particularly local governments, seems to prevail. Based in part on fiscal decentralization, protectionism and over-regulation imposed by local governments can only be overcome with stronger directives from the central government to promote integration of provincial markets.

According to the ADB business climate survey, 79% of sampled foreign firms responded that they face market restrictions in one form or another due mainly to government permit or policy (34% and 32%, respectively) and regional protection (16%).

Bias against the private sector in market entry takes several forms, including hurdles in licensing and registering of businesses, restrictions on direct access to foreign trade, application of listing requirements, biased taxation policy and arbitrary application, and other anticompetitive practices.

1. Licensing and Registration

The private sector believes that current business registration requirements are both expensive and time-consuming. A rigid registration system in terms of details (a fixed site, business partner, scope of business) and minimum requirements (assets, sales, registered capital, etc.) for a private limited company in the PRC are among the highest in the world. For instance, there are 3 levels of required registered minimum capital for a limited liability joint stock company that must be confirmed as paid-up before a business license is issued: CNY100,000 ($12,000) for small businesses, CNY300,000 ($36,000) for retail trade, and CNY500,000 ($60,000) for wholesale trade or manufacturing. There are currently 4,000 activities that require licensing at the national level, many of which are imposed by government departments (China Daily 2002e). A more simplified licensing and registration framework would facilitate market entry by private enterprises, thus improving the business climate. A draft law on administrative licensing, proposed by the State Council, was first given approval by the top administrative body in July 2002. The draft law had a preliminary reading by senior legislators in August 2002. It stipulates that a government license is necessary only if the applicant's business is directly related to state security, national economic security, public interest, public health, the security of other citizens' life and property, exploitation of rare natural resources, or the distribution of rare public resources. It also states that only the NPC and its Standing Committee, the State Council, and provincial legislatures and governments have the right to issue an administrative license (China Daily 2002b).

2. Import and Export Rights

Although there are no longer controls over import and export rights for private enterprises, to obtain such rights a firm is required to meet certain conditions, including a minimum registered capital of over CNY5 million (over CNY2 million for high-technology companies). However, as noted above in Section II.A.6.a, this amount has been reduced to CNY3 million in 2003 and will be further reduced to CNY1 million in 2004. See also Appendix 4.

[28] Private companies are still barred from a major role in key sectors including automobiles, retail, insurance, telecommunications, oil and gas, and logistics (American Chamber of Commerce 2002). See also Appendix 4.

3. Listing Requirements

Although private firms are allowed to list on the stock market, and the quota system previously imposed that favored SOEs has been abolished, policy bias in favor of SOEs continues to prevail because the Government's top priority remains to recapitalize ailing state-sector companies. *Fortune China* magazine revealed that the China 100[29]–the largest publicly traded companies in the PRC—are all SOEs, most of which are heavy industries, and none of which are agribusiness companies. The proposed second board for SMEs has yet to be established.

4. Taxes and Fees

Private businesses rank tax and nontax financial burdens as one of the main obstacles to further private sector development. ADB surveys reveal that private firms expressed dissatisfaction toward tax policy in general, and arbitrary taxes, fee collection, and a higher level of income taxes, in particular. For example, although by international standards the tax level for private enterprises in the PRC is low, the nontax financial burden (fees, arbitrary fines, forced investments, forced donations), was nearly twice the amount of paid tax in 1998 (ADB 2002c). The China Entrepreneur Confederation has raised this point with the Government.

In spite of government efforts, corruption remains a serious problem. According to one study, during the latter half of the 1990s corruption resulted in economic losses ranging from 13.2% to 16.8% of GDP (Angang 2002). A major component of these losses was tax fraud that resulted in estimated losses of 7.6–9.1% of GDP from 1994 to 1998. Although the Government has taken significant steps to fight corruption, including the rotation of personnel in sensitive positions at least once every 5 years and vigorous campaigns against corruption, more needs to be done (ADB 2002c).

Domestic firms also cite unequal treatment in tax obligations imposed on foreign-funded firms operating in the special economic zones. Foreign-funded firms enjoy liberal tax preferences (15% in the special economic zones, as opposed to 33% imposed on both domestic and foreign firms operating elsewhere) and multiyear tax holidays on profits— treatment not available to domestic enterprises. The more favorable tax treatment of foreign enterprises gives domestic enterprises an incentive to take money offshore and recycle it back into the PRC as FDI. Unauthorized tax breaks have also been offered by some localities keen in attracting foreign investment, depriving the state of revenue.

The Government is considering unifying the corporate tax rates for domestic and international companies, although no decision has been made on the level of the unified tax. Although the repeal of these tax breaks will help offset declining state tax revenues resulting from reduced import tariffs under WTO obligations and fund social welfare costs, this may discourage many foreign companies that currently enjoy a lower tax rate and could negatively affect FDI inflow.

5. Policy Bias

State-owned and private sector SMEs view the market environment very differently. According to the DRC-JBIC SME survey, over half of the sampled state-owned SMEs view the market environment as neutral. In contrast, private sector SMEs have more mixed views. As reflected in Table 9, state-owned SMEs are protected in markets where they operate. Sampled state-owned

[29] The China 100 list was compiled by the editors of *Fortune China* from the 1,088 PRC companies listed in Shenzhen; Shanghai; Hong Kong, China; London; and New York. The ranking was based on financial performance figures for the year 2000. Top five companies (revenues) are China Petroleum and Chemical ($39 billion), PetroChina ($29 billion), China Mobile ($7.8 billion), Baoshan Iron and Steel ($3.7 billion), and Legend Holdings ($3.5 billion). The bottom five companies with rankings 96 to100 are Shanghai Industrial Holdings ($379 million), Gansu Jiugang Group-Hongxing Iron and Steel ($377 million), Zhejiang Orient Holding ($375 million), Henan Shuanghui Investment and Development ($375 million), and Harbin Power Equipment ($366 million).

SMEs noted that their direct competitors are outside their regions, while private SMEs face increased direct competition with nonstate SMEs in the same market.

Table 9: SMEs' Primary Competitors
(%)

Item	SOEs in Local Market	SOEs Outside Local Market	JVs Inside Local Market	JVs Outside Local Market	Nonstate Firms in Local Market	Nonstate Firms Outside Local Market	Imported Goods
Overall	8.6	21.9	2.6	10.9	23.0	26.4	6.6
SOE	8.6	26.2	1.5	9.9	18.8	27.2	7.7
Collectives	12.0	17.2	2.6	10.4	29.3	26.7	1.6
Private	1.6	15.9	1.6	9.5	41.2	23.8	6.3
Sino-Foreign JV	3.8	17.3	11.5	19.2	15.4	19.2	13.5
Joint-Ownership	0	28.6	0	7.1	7.1	42.9	14.3
Others	10.2	23.1	2.8	12.9	19.4	24.1	7.4

JV = joint venture, SMEs = small and medium enterprises, SOE = state-owned enterprises.
Sources: DRC of the China State Council; *Chinese Small and Medium Enterprises Survey;* JBIC: *Journal of Research Institute for Development and Finance,* July. Vol. 7.

Policy bias against private enterprises contributes to the fact that many domestic enterprises tend to expand their operations vertically and/or horizontally, with no relation to their core businesses. Many domestic companies decide to remain "red hat firms" to continue to benefit from advantages that they enjoy from local governments in terms of secure access to land, assets, finance and markets, even after private ownership forms were created in 1988. This implies that a bias against private firms still exists.

Private firms suffer from political interference in their operations. Lack of coordination among relevant government agencies requires private firms to spend a substantial amount of time establishing a "relationship" with both central and local government officials. Some domestic companies cited good relationships with local and central government officials as a crucial factor for their success. Although central government policy has become more and more favorable for private enterprises, not all local governments have consistently implemented corresponding policies.

The prevailing environment also lacks an effective competition policy. Local protectionism still prevails in various forms, which makes it difficult for many private companies to enter a new market. A new Anti-Monopoly Law, drafted by SAIC, has been submitted to the State Council for deliberation and should help improve the market environment.[30]

Some progress is under way. With ADB assistance, the Government recently adopted a Government Procurement Law to enhance transparency and promote competition in the growing government procurement market (Section II.A.6.f. Government Procurement). A new state procurement system is being put in place with links to MOF through the IFC/United Nations Development Programme (UNDP) supported Fiscal and Budgetary Reform Project. The new system should also improve transparency and provide a more level playing field for the private sector to compete with the state sector for state contracts.

6. Market Exit

An investor needs to have the ability to sell its holdings in a domestic enterprise. Based on the undeveloped capital market and impediments to exit under the current legal framework, there is no reliable exit mechanism for investors in the PRC (Section 4.A.3.a. Venture Capital).

[30] See discussion in Section IIA.2.b. Restructuring of State-Owned Enterprises and footnote 13.

D. Impediment (2): Legal Environment

While the legal environment in the PRC has improved, many private sector players still believe that the environment is still not conducive to their development. Remaining shortcomings include (i) ambiguities in the legal status of the private sector, (ii) weak implementation of the rule of law, and (iii) lack of specific legislation.

1. Legal Status of Private Sector

Although the Constitution and other basic laws recognize the private economy as "an important component" of the socialist economy, the rights of the private sector are not adequately protected.[31] Reform of the legal system has focused on the "operation" of a market economy rather than on laws promoting the private sector. The Provisional Regulations on Private Enterprises promulgated in 1988 are outdated. Under these regulations, protection of private enterprises is too abstract and imbalanced and focuses too much on the obligations and duties of private enterprises rather than on their rights.

Although the policy framework supports the role of the private sector, the principle of protecting private property has yet to be enshrined in the Constitution or other basic laws. Enterprises in the PRC are distinguished and treated differently according to their ownership.

A draft of the PRC's first Civil Code has been submitted to the NPC Standing Committee for preliminary reading. The draft code is expected to offer more comprehensive protection of private property by including a volume on tangible property law with a chapter devoted to the protection of private property. This chapter will define and specify rights of possession in the PRC (China Daily 2002n).

In the absence of a legal guarantee of equal treatment of the private sector, and based on historical biases and the current discrimination on the private sector in market entry, financing, and the allocation of resources, doubts exist whether policy continuity will be maintained when there is a change in the overall political climate. As a result, domestic investors sometimes resist making further investments, preferring instead to move capital abroad and purchase overseas passports as a hedge against the future. At the annual session of the National Committee of Chinese People's Political Consultative Conference in March 2002, ACFIC called for a constitutional amendment to ensure stronger state protection of private property (China Daily 2002k). ACFIC recently raised this issue again during the 10th NPC. Without such amendment, some reformers believe that ambiguous property rights may become institutionalized.

2. Rule of Law

Despite significant progress in developing a rule of law during the past 20 years, more needs to be done to create a transparent and predictable legal system supported by consistent enforcement. According to surveys, foreign firms and investors cite weak implementation of the rule of law among the most critical operating challenges of doing business in the PRC. In particular, lack of transparent laws and regulations, inconsistencies among various laws and regulations, weak and inconsistent enforcement, contract repudiation, and weak capacity of the judicial system to enforce or rule on disputes, are cited as factors impeding operations.

[31] See discussion in Section II.A.3. Ambiguous Private Property Rights.

a. Drafting Process

In contrast to a centrally planned economy that has few private actors, a small role for the market, and a dominant government role, a market economy needs a different kind of regulation. This requires a shift in the perception that legislative drafting and the legal system generally is an internal government process that must in principle be kept secret. In a market economy regulations can be drafted more effectively if input from interested parties is considered. Although there may be problems with the large volume of comments, not all of which will be well thought out and useful, these problems are not unique to the PRC. Other administrative law regimes find ways of dealing with them (ADB 2002c).

Investors in the PRC cite many cases where important laws have been adopted without a clear understanding of potential negative market impacts (Jacobs 2001). Legislators and regulators should conduct a regulatory impact analysis to avoid unintended consequences that may discourage PSD. In this respect, opening the drafting process of new laws and regulations is widely recommended by foreign chambers of commerce in the PRC. Some experts consider that progress is being made in recent years. Still, active inputs from the public and industry groups concerned through two-way consultation during the drafting process not only will improve the quality of regulation, but will also serve as a test for practicability and enforceability of laws and regulations. Regulatory impact assessments, when done well, improve the cost-effectiveness of regulatory decisions and reduce the number of low-quality and unnecessary regulations (Jacobs 2001). In addition, adequate advance public notice is suggested before new laws and regulations go into effect.

The Law on Legislation, which came into effect on 1 July 2000, helped improve the transparency problem. This law affirms the hierarchy of regulatory instruments and establishes general obligations for public consultation and publication for (i) laws adopted by NPC; (ii) regulations of the State Council; (iii) administrative regulations issued by committees of the State Council, national ministries, provinces, counties, municipalities, and other bodies (e.g., CSRC); and (iv) independent and autonomous regulations issued by special economic regions and minority groups with rule-making rights. However, the Law on Legislation has not improved the quality or frequency of public consultation based in part on the fact that no minimum or concrete standards are stipulated therein. This is another area where further improvements are needed.

Continuity of policies also needs to be promoted by ensuring that regulations of local governments conform to central government policy, with all measures publicized before implementation.

b. Access to Laws and Regulations

Difficulties in accessing promulgated laws and regulations in published forms are perceived as hindrances to foreign investors. Inconsistent information is provided by different government agencies. However, some progress, though uneven among different agencies, has been made recently, particularly after WTO accession. For example, CSRC has listed capital markets-related laws on its web site.[32]

There should be a system in which a comprehensive list of all promulgated national and local laws and regulations are accessible in published form. This would enhance transparency and promote good business practices, thereby improving the business environment. There should also be better coordination between agencies on information exchange, agreements on allowing one agency's information to be disseminated by another, and education of private enterprises about where useful information can be obtained. In addition, court decisions should be accessible to help clarify legal requirements.

[32] http://www.csrc.gov.cn

c. Enforcement

Weak and inconsistent enforcement of laws and regulations is another concern of both domestic and foreign investors. The reasons for weak and inconsistent enforcement reflect several factors: (i) decentralized and multiple layers of administration, (ii) local protectionism, (iii) inadequate checks and balances on enforcement actions, (iv) ineffective sanctions and penalties to deter violations, (v) intrusive and excessive regulation, (vi) general weakness of the court system, and (vii) lack of transparency and ambiguity in legal requirements.

Because a great deal of economic activity is still carried out by different governmental units, uniform enforcement of various regulations remains difficult. It is difficult for one unit of the government to enforce policies on another and disputes between government units are usually resolved by the common superior.

Enforceability of contracts generally depends upon the identity of the contracting parties and the nature of the obligation on which enforcement is sought.[33] Because courts are under de facto local control, it can be difficult to enforce a contract against a powerful local enterprise.

Issues related to the enforcement of intellectual property rights (IPRs), as discussed below in Box 6, provide an illustrative example. In the first half of 2000, PRC authorities investigated and handled 139,000 IPR infringement cases involving an estimated value of CNY4.89 billion ($591 million) (American Chamber of Commerce, PRC 2001a). Many experts comment that the problem is not the law itself. In fact, the PRC IPR law is considered to be of international standard.[34] The issue is inconsistent enforcement of the IPR law and regulations.

3. Specific Legislation

Commercial and administrative laws and regulations relevant to the "life cycle" of private enterprises need to be strengthened.[35] As discussed above, more flexible registration and consistent licensing systems are needed to encourage the "birth" of more private enterprises. Fair and efficient dispute resolution mechanisms are necessary to minimize business costs and risks. Systematic and consistent bankruptcy laws are needed to provide for the orderly liquidation or rescue of enterprises and protection of creditors. Addressing these issues would support PSD.

a. Administrative Laws

Excessive administrative discretion and interference in private business through inconsistent interpretation of existing laws and regulations is a commonly cited complaint among businessmen, although some progress has been made. The PRC has constructed a framework of administrative law, including an Administrative Litigation Law (1990), the State Compensation Law (1994), the Law on Administrative Punishments (1996), the Administrative Review Law (1999), and the Law on Law-Making (2000). The framework, particularly the Administrative Review Law, provides some protection to private enterprises against arbitrary interference by authorities, including the right to appeal an administrative decision if the claimant believes that officials have acted outside their authority or refused to act when a proper application has been made. It also sets clear procedures and time limits for review.

[33] A new Contract Law, which became effective in October 1999, was adopted to address widespread fraud and the overburdened court system. Currently there are more than 4 billion contracts registered with government industry and commerce bureaus each year and the PRC courts handle more than 3 million disputes annually. (American Embassy in the PRC 2002).

[34] The amended Patent Law and its implementing rules became effective on 1 July 2001 and the Regulations on the Implementation of Integrated Circuit Layout Design and their implementing rules became effective on 1 October 2001. The new Copyright Law became effective on 27 October 2001 and the new Trademark Law became effective on 1 December 2001 to meet the requirements of the WTO agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). However, challenges still exist. For example, under the new Trademark and Copyright Laws, if proof of losses suffered by the victim is not demonstrated, the court may only grant an amount not exceeding CNY500,000, which may prove insufficient in many cases (Gide Loyrette Nouel 2002).

[35] ADB supports Government efforts to develop a legal system suitable for a market economy by financing the drafting of new laws (ADB 1999c and 2001h).

Box 6:

Inconsistent Enforcement of the IPR Law

Approximately 42% of the sampled firms in the ADB Business Climate Survey noted that they suffered to varying degrees from IPR infringements, of which more than one third cited serious problems including material losses.

IPR infringements are not only a concern of foreign companies. About 20% of domestic private firms noted that the issue of fake products negatively affects their operations. The DRC-JBIC SME survey portrays private firms' dual character as culprits of IPR infringements on one hand, and as victims on the other. In response to a question regarding the source of new product technology, more private firms cited their own research and development than did SOEs, collectives, and others. At the same time, private firms had the highest ratio of "imitating" other companies' products and the lowest ratio of "purchasing patents."

Applications and completed registration of IPRs more than doubled between 1995 and 2000 but counterfeiting activities have also increased. The Quality Brands Protection Committee estimates that 15–20% of foreign brands sold in the PRC are fakes. Similar rates of counterfeiting were reported for local brands. The Business Software Alliance estimates that more than 90% of business software in the PRC is pirated.

Weak enforcement of the IPR law in the past can be attributed to three factors. First, no clear enforcement mechanisms or procedures were in place. The 1998 Criminal Law stipulates that PSB handle IPR-related crimes. However, due to the unclear mandate of PSB, it is difficult to obtain public prosecutions. Moreover, no clear guidelines are set for other agencies to transfer alleged IPR cases. Second, there are difficulties with enforcement at the local level because of lack of awareness, resources, and political will or inability to act. Third, current penalties are inadequate to effectively deter IPR infringements.

PRC courts have considered IPR cases involving infringements of copyrights, trademarks, and patents in development of new plant species, commercial secrets, computer software, and networks. During the past 5 years, approximately 23,636 such cases were closed, 40% more than in previous years.

The years 2000 and 2001 brought various IPR legal reforms in the PRC. The Central Government established a national Anti-Counterfeiting Coordinating Committee chaired by Vice Premier Wu Bangguo in October 2000, exemplifying the Government's increasing commitment to combat counterfeits. Two sets of enforcement campaigns were pursued, the most recent starting in April 2001, and continue to be carried out throughout the country. However, foreign investors cited that the relatively limited effectiveness of recent enforcement campaigns indicates that enforcement measures and penalties lack a deterrent impact (EU 2002).

ADB = Asian Development Bank, DRC-JBIC = Development Research Center-Japan Bank for International Cooperation, IPR = intellectual property right, PRC = People's Republic of China, PSB = Public Security Bureau, SME = small and medium enterprise, SOE = state-owned enterprise.

b. Dispute Resolution Mechanisms

Weak dispute resolution procedures between the state and private businesses reduce the capacity of outsiders to challenge market insiders. This weakness is particularly debilitating when SOEs are competing with private firms, when policies are changing faster than administrative capacities, and when corruption is involved. The result is an uneven playing field, confusion about property rights, and less investment (Jacobs 2001).

Due to institutional weakness, legal experts are of the view that when "friendly consultations" prove to be ineffective, abbreviate arbitration,[36] mediation, and arbitration prove to be less costly, time-saving, and relatively fair, and present a better option than litigation for resolving disputes. Domestic arbitration forums are viewed as more objective and independent than the prevailing court system, which in general lacks independence from government authorities.[37] The PRC system thus relies less on lawyers and formal court proceedings and more on mediation to resolve disputes.

In a 2001 survey conducted by the American Chamber of Commerce in Beijing, 75% of respondents with experience in using arbitration in the PRC opined that such procedures were fair, efficient and less expensive than using a major international arbitration center (China Law and Practice 2003b). The two main domestic arbitration forums are the China International Economic Trade Arbitration Commission (CIETAC), established under the China Council for the Promotion of International Trade (CCPIT), and the Beijing Arbitration Commission (BAC).

The CIETAC offers a forum for dispute resolution in accordance with CIETAC Arbitration Rules. In 2002, CIETAC handled about 684 cases of which approximately half of the awards rendered were able to be enforced (Peerenboom 2001). The total amount involved was CNY11.28 billion ($1.36 billion) and 28% of these cases involved JV disputes. CIETAC Arbitration Rules provide for property preservation measures and interim protection of evidence by allowing the Arbitration Commission to refer applications to the people's court during the course of arbitration (Bateson et al 1999). Hearings last no longer than 1 day.

BAC, which was established in 1995, is also a well-respected forum for arbitration. BAC handled 666 cases in 2001 (China Law and Practice 2003b).

Mediation (*Tiaojie*) is another option that can be used when friendly consultations do not reach a satisfactory conclusion but where there are still prospects for reaching a settlement. The PRC has a relatively advanced mediation system ranging from a local resident's committee level to more sophisticated conciliation centers, including CCPIT and the China Chamber of International Commerce. The PRC has established 970,000 mediation committees that rely on the services of 8.8 million mediators. According to Ministry of Justice statistics, during 1980–1999, there were about 130 million civil mediation cases.

The Beijing Conciliation Center (BCC), which acceded to the International Federation of Commercial Arbitration Institutions in 1997, has also been active in promoting conciliation at an international level. BCC has agreements with major international centers such as the Hamburg Conciliation Center, the New York Conciliation Center, and the London Court of International Arbitration (Bateson et al 1999).

In the case of maladministration, complaints can be made to the administrative superior of the office or organization in question through the "letters and visits" (*xingang*) system. Many government departments have also established bureaus to handle complaints.

c. Bankruptcy Law

Private enterprises need clear guidelines and procedures not only at the development stage of their life cycle, but also at the stage of reorganization or closure of their businesses. One of the major issues concerning the prevailing bankruptcy law is that different types of enterprises are subject to different legal treatments. SOEs are subject to the State Enterprise Insolvency Law for Trial Implementation (adopted in 1986, but not implemented until 1988), while private enterprises are covered by Chapter 19 of the Code of Civil Procedures, the Company Law, and Supreme Court opinions. The Foreign Invested Enterprises Liquidation Procedures adopted by MOFTEC also govern the liquidation of insolvent FIEs.

[36] Abbreviate arbitration, based on documents-only procedures, is available at the request of both parties.
[37] With respect to the judiciary, it is important to note that under the Law on Judges (1985), no experience as a lawyer is necessary, although related work experience is required and political factors are considered. Judges do not have tenure and are occasionally fired.

There are various regulations issued by the Central Government that have been applied to SOE bankruptcies de facto in priority over the law. Small firms and proprietorships are handled in a fairly ad hoc manner under the Civil Procedures Law, where the annual number of bankruptcies runs into the thousands.[38]

Reorganization and liquidation processes are sometimes less than transparent and driven by administrative considerations rather than market forces. Laws and regulations governing bankruptcy are also inconsistent. For example, according to the prevailing Bankruptcy Law, liquidation proceeds are distributed to secured creditors ahead of workers, but SETC Circular No.492 of 1996 subordinates land mortgage rights to worker claims under the Capital Structure Optimization Program that was developed for a pilot group of industrial SOEs in 1994. The latter was intended to address the issue of entitlement of displaced labor. A major constraint on bankruptcy and restructuring continues to be the lack of financial resources to make substantial payments to workers or to compensate banks for the write-off of irrecoverable debts. Thus, a great number of insolvent enterprises remain on the books while their assets remain unutilized and debts remain unpaid.

A new bankruptcy law is under review and may be proclaimed in the near future. ADB has provided two TA projects in this area and has been actively involved in the drafting process, providing comments and suggestions to the NPC Finance and Economic Committee, which has been tasked to draft the law (ADB 1995c and 1997a). The revised law should be applied to both state and nonstate enterprises and would improve the legislative regime for business enterprises. However, due to the very sensitive nature of SOEs, SOE insolvency will be the subject of special State Council rules pursuant to the Bankruptcy Law. Protection for creditors is expected to be strengthened and a fairly sophisticated mechanism of court-supervised reorganization could be initiated by debtors or creditors.

As an interim measure, to address the difficulties and constraints in interpreting and applying existing bankruptcy regulations, the Judicial Committee of the Supreme People's Court (SPC) released several issues on Trial on Enterprise Bankruptcy Cases Provisions (provisions) in July 2002 that became effective in September 2002. The provisions govern both SOE and non-SOE bankruptcies and remain debtor-friendly. Among others, the provisions permit both debtors and creditors to petition for bankruptcy, provide a statutory presumption for a declaration of bankruptcy when there has been a continued failure of the debtor to pay debts owed, allow SPC to appoint an interim manager after the acceptance of the bankruptcy case, allow the liquidation committee to employ accountants and lawyers provided SPC approval is obtained, and provide SPC with the power to recommend to the relevant government authorities that they restrict any person/s responsible for the bankruptcy from being involved in company management for a specified time period. Employees still maintain a priority right to be paid before other secured creditors and only SOEs can apply to the court for reorganization/restructuring.

E. Impediment (3): Financing

Although the Government has removed discriminatory financing as a public policy, in practice private businesses still have problems obtaining access to financing. This problem still ranks as the number one issue for most domestic private businesses, specifically SMEs who are unable to obtain bank credit to finance working capital needs or access local equity and bond markets.

[38] Until the end of 2000, over 40,000 bankruptcy cases of both state and nonstate enterprises were heard by PRC courts. An SPC justice at the conference on the Bankruptcy Law (2002 Draft) in April 2002 indicated that there were 10,000 cases of insolvency of all types of enterprises in 2001. The vast majority involved SMEs (OECD. 2001).

Domestic private companies rely heavily on self-financing for both start-up and expansion. Both the 2000 ADB and IFC surveys found that their main source of funds was individual or household investment and retained earnings. The IFC survey also found that 90% of their sources of financing were internally generated, as opposed to 4% from bank loans. The DRC-JBIC SME survey found that 15% of SOEs compared with only 1.6% of private SMEs financed over 80% of their fixed investment through bank loans. Similarly, for working capital, more state-owned SMEs have access to bank loans than do private companies. Common reasons cited for difficulties accessing bank financing include (i) no credit guarantees or collateral and underdeveloped systems; (ii) no transparent financial statements of enterprises; and (iii) lenders' unwillingness or lack of experience lending to small-scale business (Appendix 6).

1. Restriction (1): Absence of Diversified Financial Sector

The absence of a diversified financial sector capable of serving the broad spectrum of entrepreneurs' needs for financial services leaves the state banking system as the dominant supplier of capital. However, SOCBs are not yet sufficiently market-oriented. The private sector accounts for only 7% of loan assets compared with 68% by SOCBs (Table 10).

Table 10: Market Share of Loan Assets, 4th Quarter 2000

Financial Institution	Market Share of Loan Assets (%)
State-Owned Commercial Banks	68
(i) Industrial and Commercial Bank of China, (ii) Bank of China, (iii) Agricultural Bank of China, (iv) China Construction Bank	
Rural Credit Cooperatives	11
Special Depository Institutions[a]	8
Other Commercial Banks:	7
(i) Bank of Communications, (ii) Shenzhen Development Bank, (iii) Guangdong Development Bank, (iv) China Merchants Bank, (v) China Minsheng Banking Corporation, (vi) China Everbright Bank, and (vii) Others	
Urban Credit Cooperatives	4
(City Commercial Banks): (i) Bank of Shanghai, (ii) Tianjin City Commercial Bank, (iii) Beijing City Commercial Bank, (iv) Nanjing City Commercial Bank, and (v) Others	
Finance Companies	1
Foreign Financial Institutions	1

a The category includes policy banks, trust and investment companies, and international trust and investment companies.
Sources: PBOC, Roland Berger Strategy Consultants.

Private firms have had limited access to the stock market that has served to primarily finance SOEs and enable them to take the first steps at diversifying their ownership. No explicit rules in the Securities Law or in administrative regulations prevent nonstate firms from seeking a public listing. However, until recently, the quota system and size requirements limited the number of private firms that could access the stock market. As a result, only 1% of the companies listed on the Exchanges are nonstate firms. In March 2000, the CSRC announced that the quota system on listings would be abolished and underwriters could determine the timing and pricing of new issues.

For unlisted companies, private equity investors are also deterred by the lack of clear asset title and weak corporate governance and disclosure (IFC 2000b).This leaves investors with little means of safeguarding their investment and little prospect of exiting the investment. In sum, private equity markets, such as venture capital (VC), have functioned in almost the same fashion as bank loans due to policy restrictions.

2. Restriction (2): Lack of Capacity

Based on lack of capacity, SOCBs are unable to inject large amounts of capital into SOEs to help them out of difficulty and at the same time provide substantial support for the private sector. PBOC requires all banks to implement a policy known as "responsibility to individual" that makes credit officers personally accountable for loans. This discourages banks from making loans to new companies, particularly unknown private companies. Thus, there is limited incentive for bank employees to initiate lending to private enterprises. Banks still do not consider a bad loan to an SOE to be as serious as a bad loan to a private enterprise (IFC 2000b). Moreover, there is ample evidence from surveys that local governments continue to encourage bank lending to SOEs by extending explicit or implicit guarantees or through other means. The priority of state banks thus remains to lend to SOEs, particularly existing companies in their portfolio.

Adding to the reluctance of SOCBs to lend to the private sector are controls on interest rates and restrictions on the use of transaction and monitoring fees. Currently, interest rates on loans to SMEs are allowed to fluctuate within 30% of the prime rate (Section IV.A.1.c. Regulation of Interest Rates).

Although policy discrimination against the private sector in financing is being reduced as a byproduct of commercializing SOCBs, SOCBs are also reluctant to grant loans to the private sector because of perceived high risks and management costs. However, contrary to banks' general perception concerning noncreditworthiness of private businesses, a comparative analysis based on the SME survey found that state sector SMEs are less creditworthy than private SMEs. For instance, account payable arrears to average operating income for private firms are lower than state sector SMEs (Table 11).

Table 11: Comparison of Creditworthiness of State Sector SMEs and Private SMEs—Accounts Payable Arrears and Coverage Ratio
(average operating income/arrears [times])

Year	1995		1996		1997		1998	
Overall	216	(16)	238	(15)	290	(13)	310	(11)
SOEs	404	(7)	453	(10)	596	(8)	656	(6)
Collectives	81	(31)	87	(27)	78	(36)	98	(28)
Private	86	(17)	76	(28)	88	(24)	78	(23)
Sino-Foreign Joint Venture	76	(15)	84	(29)	84	(40)	75	(42)
Lian Ying	267	(9)	191	(8)	166	(7)	193	(9)
Others	156	(30)	174	(31)	203	(26)	227	(24)

Sources: ADB PSA Analysis; State Council Development Research Center Survey; JBIC report.

To facilitate bank lending to SMEs, the Government has encouraged banks to set up separate departments that specialize in lending to SMEs, and business organizations, local governments, and individuals are encouraged to establish CGCs to improve SME access to bank credit. Banks should be able to lower their risk in lending to SMEs by obtaining guarantees from CGCs on all or part of their loans. However, although there are more than 300 CGCs in the PRC, no one seems to know the exact number based on the absence of regulatory oversight, and few appear sufficiently active and big enough to have an effect on bank lending (Box 2).

Another option to encourage increased access to finance by SMEs would be government support of a collateral guarantee program, including the certification of the value of an enterprise's assets, against which the enterprise could borrow. Banks and CGCs could cooperate to establish a system of collateral registration that could certify whether enterprises have already pledged assets as security for a loan.

3. Restriction (3): Lack of Transparent Financial Statements

Credit analysis of domestic firms in the PRC based on their cash flow is a challenging task. Private companies' financial statements are weak and do not meet international standards on transparency. When a company is formed, access to bank financing is almost nonexistent. Entrepreneurs are aware that their peers' balance sheets do not provide a sound basis to offer credit guarantees. Therefore, businessmen are reluctant to publicly support one another. As a result bank lending to private firms in the early stages of growth is practically nonexistent, at least until the company has grown to a sufficient size to attract the attention of state banks.

Most firms in the PRC do not maintain transparent audited records. Even where audited accounts are required, they may not represent the true financial position of a firm. Restrictions on registration under different categories of incorporation, and the burdens imposed by the tax system, provide firms with an incentive to underreport and misreport financial flows, number of employees, stock of assets, and such.[39]

In developed markets, banks prefer to look at the cash flow of a borrower, as long as it is a legal entity separate from the founder or family that owns it. But in the PRC, banks are concerned that opaque accounting standards and the *danbao* (guarantee) system could result in cash flows not ending up in the right place. Consequently, banks resort to asset-based loans instead of looking at cash flow. Banks tend to look only at assets such as property, land, and machinery. As a result, many companies stray from their core business by spending time and effort building up real estate portfolios that can be mortgaged for bank funding. In addition, the valuation of assets often depends on the borrower's relationship with the bank.

F. Impediment (4): Infrastructure

According to ADB surveys, the enabling environment for the private sector requires improvements in physical infrastructure, particularly land and buildings, roads, electricity, and telecommunications. However, major constraints differ depending on geographical location, the size of enterprises, and the industrial sector.

Constraints related to land and building sites are the main concern (26%), followed by poor roads (21%), power supply (17%), environment (10%) and water supply (7%). Table 12 shows the top five infrastructure constraints cited by sample firms in Beijing, Nanhai, Shenyang, Xi'an, and Wenzhou.

Three major constraints—land/office space, roads, and electricity supply—were cited by firms in all cities, although there were regional variations. For example in Xi'an, located in one of the western provinces, poor roads were the top infrastructure constraint. Roads were the second most important infrastructure constraint in all other cities except Nanhai in the south.

Companies in all five cities mentioned problems with a reliable supply of electricity. The environment, hygiene, and sanitation (such as wastewater treatment) were cited by sample firms in all cities (Nanhai cited it as the sixth constraint after Internet use) as a major constraint. In Guangdong, constraints relating to Internet use and demand are relatively high compared with the central and western regions.

Foreign firms also said that infrastructure improvements in the following areas are needed to improve the business environment: transportation (16%), environment and sanitation (16%), telecommunications (15%), Internet use (15%), and land/buildings (14%).

[39] (IFC 2000b). To encourage large firms to attract foreign investment and/or list stocks on overseas markets, the MOF in January issued a separate set of accounting regulations for selected joint stock companies that conform more closely to international accounting and disclosure practices than to the general standards in the PRC.

Table 12: Top Infrastructure Constraints Cited by Domestic Firms

Ranking	Total	Beijing (North)	Nanhai (South)	Shenyang (Northeast)	Xi'an (Northwest)	Wenzhou (East)
GDP (CNY bn)	8,940	217.44	30.58	101.31	61.37	73.31
Population (mn)	1,276.3 [a]	12.50	1.08	6.77	6.88	7.21
1	Land/ Office Space	Land/ Office Space	Land/ Office Space	Land/ Office Space	Roads	Land/ Office Space
2	Roads	Roads	Electricity	Roads	Electricity	Roads
3	Electricity	Electricity	Fuel, Oil, Coal, and Gas	Electricity	Land/ Office Space	Electricity
4	Environment	Telecommuni-cations	Roads	Environment	Environment	Environment
5	Water Supply	Environment	Internet	Water Supply	Telecommuni-cations	Telecommuni-cations

[a] Total population excluding special administrative regions; not the sum of the five cities.
Source: ADB. 2000. *Technical Assistance to the PRC for Private Sector Development.* Manila.

The ADB survey of foreign investors found that improved infrastructure in the central and western regions is critical to attracting FDI, especially reinvestment of profits earned by foreign firms that have already been operating in the coastal region. In response to questions regarding their business expansion plans for the next 5 years and whether investment in the western and central regions is being considered, 41% commented that they would not consider expanding into these regions because of infrastructure constraints and underdeveloped consumer market (22%), followed by little market awareness (14%), and lagging economic development (14%). These investors are involved in the general manufacturing sector producing consumer goods (15%) and financial institutions (13%), where restrictions to entry still apply.

About 59% of foreign firms responded that they would consider expanding into the central and western regions if certain conditions are met. Major reasons cited for their possible future expansion into the poor interior regions include potential markets (58%), followed by investment incentives (13%) and abundant resources (13%). General manufacturing producing industrial goods indicated the highest interest (19%), followed by metal and mining (12%), and utilities such as electricity, gas, and water (10%).

G. Impediment (5): Human Resources

Both domestic and foreign firms listed human resource problems, including the lack of managerial capacity and skilled professionals, among the top constraints on their operations. Even where skilled workers and professionals can be identified, restrictions on the portability of social benefits under the hukou system limit the relocation of workers whose skills may be in demand (Section II.A.7.a. Mobility). Some foreign investors also noted that the PRC's competitiveness in the world market is being eroded with labor-related developments such as increasing salary and benefits in the absence of a systematic legal and regulatory framework for labor and benefits.

1. Needed Managerial and Professional Skills

The survey of domestic private firms found that they need to intensify their efforts to improve managerial capacity and retain skilled professionals and workers. The ADB survey found that human resource deficiencies are severe in senior management and skilled technical workers categories. The IFC survey also found that private domestic firms have difficulty obtaining and retaining qualified workers and professionals until they become truly competent senior managers, and that new graduates opt to work for foreign companies, JVs, and government institutions. To retain qualified employees, owners of private enterprises, especially those in the knowledge intensive industries, provide an option to employees to buy the enterprise's shares. However, this incentive presumes the ability to transfer the shares. For smaller domestic firms, providing employees with this option does not work because the shares are not transferable unless listed on a stock market. The lack of financial transparency and clear asset ownership makes it difficult to value the shares or to sell them when employees leave the firm. The DRC-JBIC SME survey also revealed that a majority of the sample firms (58%) felt that they needed training in corporate strategies, an important element of managerial capacity. However, they were short of funds and instructors to arrange such training for senior managers.

Some progress is being made with assistance from bilateral funding agencies. The PRC now has management training centers and MBA programs that have been introduced into a significant number of universities and colleges across the country. Chengdu Management Training Center and Anhui Management Training School are examples. Nevertheless, the PRC still lacks a holistic approach to the development of entrepreneurship and management skills in its education system.

Aside from management-level human resources, surveys found that lower educational levels of employees constrain a firm's capacity to develop new technology and products. This will continue to be a challenge for private firms as many new businesses are established with little managerial experiences.[40] The Government should address the issue on how to systematically develop vocational and management education to help entrepreneurs better run businesses and help officials better promote and regulate them.

Foreign firms also cited managerial and professional skill development as essential for further development of their firms. The PRC needs more managers with expertise in the areas of information technology, strategic management, and reengineering business processes to guide adaptation of the business organizations to the needs of a global economy (American Chamber of Commerce 2001a). Needed technical skills include quality control experience, profit and return-on-investment orientation, soft management skills, and accounting, audit and finance skills.

2. Foreign Investors: Social Security Framework and Company Competitiveness

Despite improved labor market conditions for foreign investors, including easier access to a trained labor pool, increasing labor costs in the PRC are putting pressure on profitability and competitiveness in the world market. One study indicates that the PRC's competitiveness vis-à-vis other developed Asian counties is only evident in the unskilled labor market. In the more skilled job positions, salary increases far outpace inflation (American Chamber of Commerce 2001a). Competitiveness further erodes when other welfare benefits mandated in labor laws and regulations are inconsistently applied to employers. One survey reveals that local labor bureaus impose some guidelines on foreign firms that are not market-oriented. For instance, salary increases, which are not tied to prevailing economic conditions, are often imposed.

3. Domestic Enterprises and Social Security

Although the PRC is developing a social security program, significant regional differences exist in implementing relevant regulations. Following the enactment of economic reforms, SOEs and nonstate sector enterprises have been required to pay a percentage of their wage bill into an

[40] For instance, under the ADB survey, it was revealed that in Wenzhou and Nanhai, 46% and 41% of the sampled firms, respectively, were started by farmers with limited business experiences.

insurance pool (pension, unemployment, health care and other forms of insurance) administered by municipal and provincial governments. Based on the poor financial condition of SOEs, many are unable to pay their social insurance contribution.

These pools of funds have been vulnerable to diversion by local governments to fund development and infrastructure projects. Local officials determine the percentages that firms in their jurisdiction are required to pay into these funds. The tight fiscal condition of many local governments provides them with an incentive to set high collection rates that have become financial burdens for private firms. Nonstate sector firms are difficult to monitor and often do not pay and/or understate their work force to pay smaller amounts into the insurance pool.[41]

While the private sector should bear a portion of social welfare costs of their employees, consistency and transparency are needed in implementing the new social security system. The ADB survey reveals that the ratio of sampled domestic firms that have established social security for their employees varies among sample cities, from close to 100% in Nanhai to only about half in Xi'an. There is also an issue of unpredictable extra fees and taxes imposed on businesses under the name of social security.

H. Impediment (6): Lack of Management Skills

Shortcomings of the domestic private sector also constitute a barrier to development. Most domestic private enterprises are small and engage in labor-intensive, low-technology businesses. Most private enterprises are owned by a family or a single businessman, resulting in weak corporate governance and transparency.[42] When the capital and assets reach a certain size, this ownership structure becomes an obstacle to further growth. As a result of family ownership, nearly all key management positions are occupied by family members or relatives. This practice not only means that the best managers are not employed, but undermines motivation among company employees.

With respect to their limited access to finance, private domestic enterprises need to address certain concerns that make them undependable borrowers. For example, often they borrow for one purpose and use the money for something else, they provide unreliable (and unaudited) data on their performance, they may disguise profits, and they often have ambiguous claims on assets that might be used as security for loans.[43]

Business and marketing strategies adopted by some businessmen are sometimes shortsighted. As reflected in responses to the ADB survey of domestic private enterprises, many firms resort to illegal or immoral practices to make a profit and as a result damage consumers, competitors, employees, and suppliers of capital and material. This results in unfair competition, market disorder, and widespread doubt over the credibility of the private sector.

[41] See footnote 8 on the establishment of a Central Government insurance pool. One of the problems in establishing a central insurance pool arises from the strong reluctance of municipal and provincial governments to relinquish control over pension funds that they have collected. Provinces with surpluses are reluctant to turn over pension money to the Central Government to give to provinces with pension deficits. (Asia Society 2002).

[42] According to a 1999 study of 1,900 medium and large enterprises by the China Academy of Social Sciences and the National Association of Industry and Commerce, 48% of the relatives of entrepreneurs were employed in managing private enterprises, including 51% of their spouses and 20% of their adult children. Another study by ACFIC found that 98% of enterprises were family managed (ADB 2002c).

[43] Comments raised at the workshop on *Technical Assistance to the PRC for the Private Sector Development.*

I. Impediment (7): Access to Reliable Information and Professional Services

The availability of reliable information and professional services provided by consulting, legal, and accounting firms under the prevailing business environment is critical to PSD. In the ADB business climate survey of foreign investors, over half of the firms responded that it is difficult to obtain reliable market information. Further, 31% and 50% responded that it is not clear if the services they receive with respect to marketing and management consulting, respectively, are satisfactory (Table 13).

Table 13: Foreign Investors' Perception on Access to Reliable Information
(%)

Information		Difficult to Access	Not Difficult to Access	Not Clear
Market	N=104	54	44	2
Tax/Accounting	N=102	42	49	9
Legal Information	N=101	39	51	10
Human Resources	N= 97	42	42	15

Professional Services		Excellent	Satisfactory	Not Satisfactory	Not Clear
Human Resources-Recruitment	N=61	0	36	41	14
Human Resources-Benefits	N=49	0	32	42	31
Legal-General	N=69	6	61	25	9
Legal-IPR	N=44	0	23	39	39
Tax	N=63	3	54	33	10
Marketing	N=42	0	40	29	31
Management Consultancy	N=32	3	34	13	50
Public Relations	N=46	0	28	30	41
Information Technology	N=48	0	48	21	31

Source: *The ADB Business Climate Survey 2002.*

According to one consulting firm, access to reliable market information, particularly production information, remains challenging. Prior to 1993, the Government treated any information related to production as confidential. Only a limited number of large SOEs had access to such information. After 1993, access to market and production information became less difficult, but the quality and reliability of information remained inconsistent. Business people thus tend to rely on personal relationships for information. This poses challenges to enterprises when developing marketing strategies.[44]

1. Consulting Industry

Numerous industry associations that formally operated under the relevant ministries are becoming important sources of market information. The consulting industry is also growing

[44] One consulting firm said that special attention needs to be paid when it uses any statistical information. They have encountered a situation where export figures exceeded production figures, requiring further assessment of reliability of the statistics they had collected from government offices. In addition, the National Bureau of Statistics has uncovered more than 60,000 violations of the Statistics Law since October 2001. The Government has initiated a program to improve the accuracy of the national account by adopting sample survey methods and other appropriate statistical techniques, particularly to capture the rapidly growing private activity.

rapidly in response to the needs of enterprises and is dominated by large corporate accounts, either foreign-funded companies or large domestic firms. In 1995, ADB provided TA for fostering the development of the local consultancy industry through (i) examination of policies and the legal framework concerning the establishment, operation, accreditation, and administration of both public and private consulting agencies; (ii) preparation of a nationwide survey of consulting associations, agencies, and their services; (iii) compilation and publication of a national directory of consulting firms by sectors and types of organizations; and (iv) development of a network to share information and expertise among various centers and associations in the PRC (ADB 1995a and 1999a).

Currently, there are 40,000–80,000 marketing and consulting firms operating in the PRC, with their estimated business volume reaching about CNY10 billion ($1.22 billion) in 2000. More and more enterprises are seeking value-added knowledge and resources from consulting firms, particularly on research, development, and human resources.

With respect to domestic firms, only 7% of SMEs used services provided by consulting firms because of unaffordability of prevailing consulting fees. Based on surveys of domestic enterprises, important information channels for SMEs include (i) media such as newspapers and magazines, (ii) special exhibits or trade fairs, (iii) chambers of commerce, and (iv) business associations. Surveys also reveal that more enterprises are using the Internet to obtain information. Information concerning fiscal policies and incentives, as well as basic information on foreign companies searching for partners in the PRC, when available on the Internet, helps address some constraints faced by SMEs.[45]

2. Legal and Accounting Information

About 40% of the respondents found it difficult to obtain access to reliable legal and accounting information. Although the number of domestic law offices and full-time lawyers has also increased, a large portion of the lawyers in the PRC have no formal education. A new Lawyer's Law, which became effective in January 1997, encourages the growth of this profession and the level of qualification. This law promotes a better national qualification and licensing system, continuing legal education, a self-regulating bar, and a rule of ethics.

Foreign law firms operate only as a representative office in one of 19 cities. Their operations are limited to providing legal services to PRC clients and entrusting cases to domestic law firms on behalf of foreign clients. Foreign law firms are not permitted to practice PRC law or to issue legal opinions concerning PRC law. As of September 2002, there were 109 licensed foreign law firms and 28 Hong Kong, China law firms operating in the PRC. Although under WTO commitments, all geographic and business scope restrictions should be lifted within 1 year after WTO accession, new regulations that took affect in September of 2002 appear to limit the types of services that such firms can provide. The new rules prevent foreign law firms from acting in arbitration cases or dealing directly with any government department (Far Eastern Economic Review 2002a). The implications of such regulations are not yet clear.

An effective accounting and auditing system is crucial to the healthy development of the corporate sector. Constraints to the development of an effective system include (i) inconsistent tax policy applied by different government agencies, MOF, the Chinese Institute of Certified Public Accountants (CICPA) and CSRC on the central level, coupled with local government requirements; and (ii) different accounting standards that are applied to different types of entities. There are also restrictions in ownership and management of international accounting firms operating in the PRC.

[45] General policies on the promotion of SMEs are accessible at http://www.setc.gov.cn and http:// www.chinasmb.gov.cn.

In the ADB survey, foreign investors stated that there is a need for a national independent regulatory body that is separate from government agencies to promulgate professional accounting and auditing standards using the International Accounting Standards Committee as a model. These standards should be applied to all business enterprises. There is also a need for a comprehensive regulatory framework clarifying the role of relevant government agencies in this respect. Local government agencies should not be permitted to impose arbitrary requirements for audit and tax.

ADB has provided TA for strengthening the accountancy profession (ADB 2001i) through (i) preparation of a strategic plan for the CICPA; (ii) recommendations to improve supervisory mechanisms for the accountancy profession, reform the certified public accountant (CPA) examination system, and improve the development and delivery of CPA training materials; and (iii) training of senior officials on the implementation of the strategic plan.

J. Summary and Implications

The private sector has become an important segment of the economy. Despite operating challenges, both foreign and domestic enterprises are optimistic about future prospects of their business operations. The enabling environment would improve by removing some constraints faced by the private sector including overregulation, lack of transparency, policy bias, market distortions, limited access to finance and reliable information, and high operating costs due to rent seeking and bureaucratic procedures of some local governments. Lack of access to financing from external sources, weak corporate governance and transparency of domestic private firm operations, and human resource constraints are major obstacles faced by domestic private firms, particularly SMEs. Foreign firms feel constrained by weaknesses in the rule of law.

In spite of the rapid development of the last 2 decades, the general environment for the private sector needs to be further improved through the following proposed government actions, many of which have already been undertaken with assistance from international funding agencies, and internal actions of private sector enterprises (Table 14). These actions need to be properly sequenced to ensure effectiveness and sustainability.

Table 14: Constraints and General Actions to Promote PSD

Constraint to Private Sector Development	Government Action and Priority	Internal Action
I. Financial Intermediation Process (domestic enterprises)		
Interest rates	• Expand interest rate band, free lending rates for loans to SMEs, and liberalize lending and deposit rates.	
Credit evaluation	• Establish a regulatory agency for CGSs and monitor their performance, including scope of guarantees. • Merge or close failed CGSs. • Introduce a reguarantee facility. • Enhance program for credit bureau/information systems to apprise banks and enterprises of the credit standing and loan servicing record of prospective clients. • Minimize the use of CGSs.	• Once operational, use credit information system to investigate credit standing and loan servicing records of prospective clients.
Collateral	• Initiate pilot program for collateral guarantees and collateral information systems. • Clarify rights to real property so that they can more effectively serve as collateral. • With banks, CGSs and legal authorities, develop expedited system for recovery of collateral in the event of default. • Introduce a pilot program to handle collateral recovery quickly.	
Accounting and audit practices	• Through SETC, tax departments and SAIC, reiterate the need for appropriate standards for bookkeeping. • Comply with regulatory requirements.	• Enforce penalties for inadequate financial reporting.
Banking reforms	• Continue to improve bank portfolios by addressing nonperforming loans. • Continue to free banks to decide on loans based on sound commercial practice. • Improve bank supervision and regulation. • Introduce competition (both domestic and foreign) in accordance with WTO provisions. • Improve the quality of audits and disclosure by banks.	• Enterprises should make themselves more attractive to banks and investors; money borrowed should be used for stated purposes. • Improve the quality of disclosure and audits.
Capital market	• Continue to improve the quality of regulation and supervision of capital markets, including higher standards for disclosure. • Integrate A and B market • Promote development of active trading of government securities to establish a yield curve. • Encourage corporations with satisfactory performance and financial reporting standards to issue corporate bonds.	• Improve the quality of disclosure. • Where regulatory requirements can be met, publicly issue securities to increase public shareholder base.
VC funds	• Address gaps and impediments in current legal framework. • Introduce over-the-counter markets and markets specializing in high-tech companies.	• Enterprises should make themselves more attractive to venture capitalists.

(coninued next page)

Table 14: Constraints and General Actions to Promote PSD (continued)

Constraint to Private Sector Development	Government Action and Priority	Internal Action
II. Rule of Law		
Legal requirements and enforcement	• Make the rules of the game clear, transparent, easily accessible, and impartially enforced. • Elicit comments on policies, laws, and regulations. • Honor, not repudiate contracts. • Develop an efficient dispute resolution system that disposes of cases promptly. • Ensure consistent interpretation of regulations. • Extend the model used in the current training program that prepares government officials at all levels to comply with WTO requirements to improve their knowledge of domestic policies and regulations and how they apply to private firms. • Review penalties for infringement of property rights (including IPRs), promote changes to enhance enforcement, and enforce the law against persons who infringe these rights.	• Honor (not repudiate) contracts. • Obtain current legal and regulatory requirements where available to ensure compliance. • Become a member of a private business association to help promote laws and regulations that address business impediment.
Special privileges	• Level the playing field by removing special privileges. • Extend the benefits promised to foreign firms under the PRC's WTO accession to all domestic private enterprises and continue the process of extending equal treatment to all firms irrespective of ownership or origin.	
Corruption	• Stamp out corruption. • Revise the taxation system to convert legitimate fees and charges into transparent taxes and abolish illegal and arbitrary fees. • Revise administrative laws and regulations to reduce the red tape faced by businesses. • Simplify administrative procedures to make government services more easily accessible and reduce the scope for bureaucratic discretion. • Establish a timetable for routine inspections (health, safety, environment, etc.) of enterprises and announce them publicly. Monitor officials' performance and dismiss officials who abuse their office.	
III. Entry Constraints for Private Enterprises	• Review licensing requirements for enterprises with a view to eliminating unnecessary ones and establish a single point at which new firms can satisfy all their registration requirements (one-stop shop). • Enforce prohibition against anticompetitive practices. • Promote better integration of markets. • As needed, promulgate and enforce new laws to prohibit disruption of inter-provincial commerce and introduce penalties for local officials who impede legitimate activities of nonlocal firms. • Monitor legislative initiatives to ensure that they do not act as a restraint on interprovincial commerce.	

(coninued next page)

Table 14: Constraints and General Actions to Promote PSD (continued)

Constraint to Private Sector Development	Government Action and Priority	Internal Action
IV. Quality and Quantity of Information	• Coordinate responsibilities of different agencies to collect and distribute information to reduce inconsistencies and ambiguities in the information provided. • Improve the dissemination of information on policies and regulations, internal and external markets, access to technology, availability of training services, finances, personnel, etc.	
V. Management and Technical Skills Training	• Appoint a professional body/ies to accredit training • Certify courses offered by licensed training institutes. • Encourage organizations (e.g., ACFIC) to establish a register of reliable trainers for clients and seek feedback on the quality of training programs from participants.	• Conduct in-house training programs from commercial suppliers programs.
Labor mobility	• Increase the mobility of senior managers and technical personnel by ensuring their ability to register their families as residents where they work. • Continue measures to permit greater mobility of labor nationwide (especially rural-urban migration). • Develop pilots to increase the portability of benefits (housing, health insurance, and other benefits).	
Management decisions (independence)	• Promote the principle that all hirings by private firms are independent of the government and the party. • Extend principles to collectives. • Allow salaries/benefits to be made by managers/boards. • Enable all firms (including large SOEs) to appoint personnel on the basis of merit. • Separate all enterprise remuneration from official salaries and official influence.	• Develop job classification standards. • Pay skilled workers market rates and provide incentives to retain them.

ACFIC = All China Federation of Industry and Commerce, CGS = credit guarantee scheme, IPR=intellectual property rights, PRC = People's Republic of China, SETC=State Economic Trade Commission, SAIC = State Administration for Industry and Commerce, SOE=state-owned enterprises, WTO = World Trade Organization.

Source: Many of these recommendations are set forth in the Report on Development of Private Enterprises in China, which was discussed with ACFIC and disseminated to the Government, ADB. 2000. *Technical Assistance to the PRC for Private Sector Development.*

SECTION IV

SECTOR ASSESSMENTS

A. Financial Sector

1. Banking

In the PRC, banks account for 90% of all financial intermediation between borrowers and savers, a ratio that exceeds that found in other Asian countries. The principal source for commercial bank asset growth has been household savings.

In 1978, along with agricultural and industrial reforms, the structure of the banking system in the PRC was changed. The banking system was removed from MOF control and placed directly under the State Council. During the next 5 years, PBOC began to operate as the country's central bank and also included a commercial section that was subsequently separated from PBOC into four SOCBs. SOCBs handled commercial business within each of the sectors they represented (rural agriculture, construction, foreign exchange, urban commercial/industrial). Their clearly defined roles limited competition, which only began in 1994 when their policy function was transferred to three new policy banks (Cinar et al 2002).

At the same time, private banks as well as other financial institutions began to emerge and new commercial banks were established. Some are mutual banks of former cooperatives, and others are local credit cooperatives known as city commercial banks.

The banking system currently consists of the 4 SOCBs; 3 state-owned policy banks (State Development Bank, Export and Import Bank, and Agricultural Development Bank);[46] 10 joint stock commercial banks (other commercial banks); 111 urban credit cooperatives (known as city commercial banks); and 181 operations offices of foreign banks (PBOC 2003b) (Table 15).

The financial system continues to be almost entirely state-owned. The four SOCBs account for more than 80% of market share, more than 70% of deposits, loans and banking outlets, and almost 60% of profits (Zhang et al 2002). The PRC's priorities are to reform and restructure SOCBs to strengthen this pillar of the financial system. Their inherent weaknesses are characterized by (i) a labor force of more than 1.5 million across at least 100,000 branches (Strause 2002); (ii) many insolvent borrowers, most from the state sector; (iii) poor portfolios resulting in credit decisions influenced by political forces in local governments; and (iv) less sophisticated bank management capability.

SOCBs have largely provided state directed lending at controlled interest rates to SOEs and are burdened with an enormous buildup of nonperforming loans (NPLs) (discussed below). As many as half of the loans, held by the four large SOCBs are delinquent. SOCBs have also heavily speculated in real estate investment in massive property developments throughout the PRC whose value has significantly decreased. A recent survey by 104 senior Communist Party officials by the Central Party School found that almost two thirds said a financial crisis was the greatest danger to the PRC in the next 10 years (Bradsher 2002).

[46] Special depository institutions.

Table 15: Top 10 Domestic Banks Ranked by Assets as of End-2001
(CNY billion)

Bank	Assets	Market Share (%)	NPLs
Industrial and Commercial Bank of China	4,339.15	27.67	29.78
Bank of China	3,361.74	21.44	27.51
China Construction Bank	2,765.06	17.63	19.35
Agricultural Bank of China	2,528.08	16.12	NA
Bank of Communications	669.09	4.27	16.12
Citic Industrial Bank[48]	300.11	1.91	NA
China Merchants Bank	266.32	1.7	NA
China Everbright Bank	265.41	1.69	NA
Guangdong Development Bank	191.21	1.22	NA
Shanghai Pudong Development Bank	173.93	1.12	NA
Total (Top 10 banks)	14,860.1	94.77	NA
Others	819.33	5.22	NA
Total Market	**15,679.43**	**100.0**	**NA**

Source: People's Bank of China.
Note: "Others" in table above would account for the difference between assets of all banks in the banking industry and assets (and market share) of the top 10 banks.

The most dynamic banks are in the third category of "other" commercial banks that were set up during the mid-1990s and are relatively less burdened with NPLs. Although such banks still have a limited number of branches, they are important for PSD. These shareholder commercial banks are positioned for, and oriented toward, financing the nonstate sector of the economy, including private and collective domestic companies and FIEs, and should play a key strategic role in the PRC's development strategy (Harner 2000). In the 1990s, these banks started to raise capital by issuing shares to the public.[47] At the end of 2001, their assets reached a combined total of $291 billion, up 28% on a yearly basis (Consulate General of the PRC in New York 2002).

There are 111 city commercial banks. In contrast to the nationwide shareholding commercial banks, city commercial banks may not establish branches outside their native cities. City banks arose from approximately 2,000 former credit societies that emerged during the early reform period. For example, the Bank of Shanghai was created from the merger of 100 former credit societies and has now become one of the largest and most profitable city commercial banks.

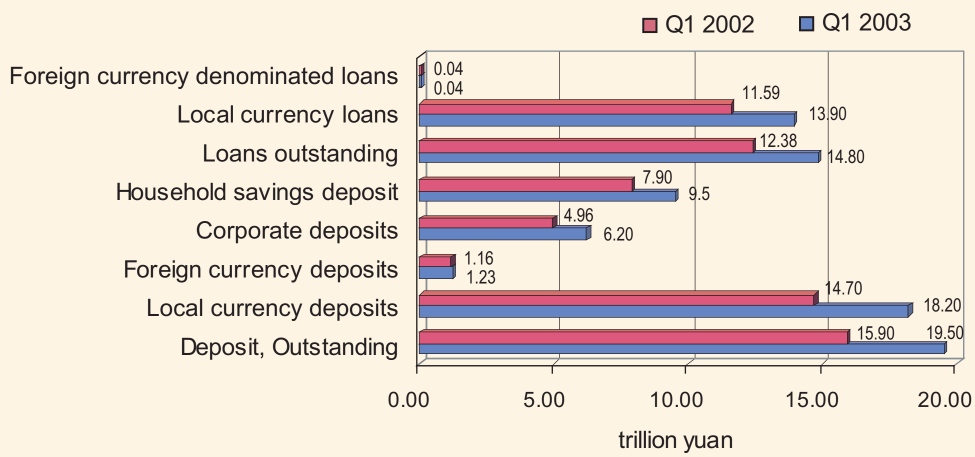
As of March 2003, outstanding deposits of both local and foreign currencies in all financial institutions increased by 22.5% year-on-year to CNY19.5 trillion ($2.4 trillion). Local currency deposits reached CNY18.2 trillion ($2.2 trillion). Outstanding foreign currency deposits increased by 5.4% to CNY1.23 trillion ($148.8 billion). Corporate deposits stood at CNY6.2 trillion ($750 million), increasing by 25% from 2002 figures. Outstanding loans in both local and foreign currencies in all financial institutions reached CNY14.8 trillion ($1.79 trillion), increasing by 19.5% from a year earlier. New loans in the first quarter alone reached CNY851.3 billion ($102 billion), a growth of CNY502.2 billion over the same period in 2002 (PBOC 2003a).

Based on various restrictions that are slowly being lifted under the WTO schedule[49] (discussed below and Box 3), foreign banks currently play only a negligible role in the banking sector, accounting for only 2% of total banking business compared with about 30% in most developing

[47] China Merchants Bank became the fourth bank to go public after Shenzhen Development Bank (1988), Shanghai Pudong Development Bank (1999), and Minsheng Banking Corp. (2000), when it sold 1.5 billion shares in the PRC's second largest initial public offering on 27 March 2002, raising CNY11 billion.
[48] Special policy bank (Table 16).
[49] See the new Rules on the Administration of Foreign-Funded Financial Institutions (PBOC No. 1 Decree of 2002), which came into effect on 1 February 2002 and included detailed requirements governing the establishment and registration of foreign financial institutions, their business scope including foreign exchange business, capital adequacy ratio requirements, and management and professional qualifications.

countries and 54% in transitional economies. The Xiamen International Bank, in which ADB has an equity stake, was the first foreign-funded financial institution to obtain a license to engage in foreign exchange business for PRC domestic residents (Chinese Securities Journal 2002).[50] Subsequently, Citibank was the first wholly foreign-owned bank that gained direct access to domestic clients for foreign exchange business (Consulate General of the PRC in New York 2002).

Figure 2: Performance of the PRC Banking Industry
1st Quarter 2002 and 1st Quarter 2003
(CNY trillion)



Source: People's Bank of China.

Since its accession to WTO, the PRC has taken significant steps to open up its banking system to foreign competition. By end–October 2002, foreign banks had established 181 operations offices in the PRC, of which 155 were branches and subbranches of foreign banks and 19 were incorporated in the PRC, with up to 7 branches. These foreign banks had $38 billion in assets and $33.8 billion in liabilities. Since the domestic currency business was introduced on a pilot basis for foreign-funded banks in Shanghai and Shenzhen in 1996, 53 foreign funded banks have been licensed to engage in this business (Consulate General of the PRC in New York 2002).

Increased interest by international financial institutions and investors in city commercial banks has also led to structural changes. In December 2001, the Hong Kong and Shanghai Banking Corporation, Ltd. (founding and principal member of the HSBC Group) became the first foreign commercial bank to buy a stake (8%) in the Bank of Shanghai, a city commercial bank. The Hong Kong-based Shanghai Commercial Bank (3%) and IFC (7%) also acquired stakes in this bank. IFC subsequently invested in the Nanjing City Commercial Bank and made a loan to Orient Group Industries, Ltd., which was used to acquire shares of the China Minsheng Banking Co., the PRC's first and only national commercial bank that has majority private sector ownership. Further changes in the ownership structure of the PRC's banking sector are expected, following the Government's recent policy pronouncement to allow foreign investors to own up to 15% of city commercial banks.

In July 2002, the Bank of China listed its Hong Kong, China subsidiary and floated 25% of its shares. The listing followed the restructuring of the bank's operations and raised $2.8 billion for its subsidiary. The bank's retail allocation was 25 times oversubscribed and the corporate tranche was three times oversubscribed. In the near future, the Government plans to publicly offer other shares of SOCBs, after substantial restructuring, to raise funds.

[50] New foreign exchange business includes individual foreign currency deposits by domestic residents and individual foreign exchange purchasing and selling.

Table 16: Top 10 Foreign Banks
Ranked by Number of Branches, 4th Quarter 2002

Bank	Origin	Branches	Rep. Offices
HSBC	United Kingdom	9	2
Bank of East Asia[a]	Hong Kong, China	7	7
Standard Chartered Bank[a]	United Kingdom	7	6
Nanyang Commercial Bank	Hong Kong, China	6	0
Sumitomo Mitsui Banking Corp	Japan	5	4
Bank of Tokyo Mitsubishi	Japan	5	3
BNP-Paribas	France	5	0
Societe Generale	France	5	1
OCBC[a]	Singapore	4	2
JP Morgan Chase	United States	4	1

[a] Banks with one sub-branch each
Source: Economist Intelligence Unit research, end–2002.

In September 2002, Shenzhen Development Bank announced that it would sell a 20% stake to US-based Newbridge Capital. Newbridge's bid is considered a breakthrough agreement, as it would mark the first time a foreign institution would gain control of a PRC bank (72% of the bank's shares are held by the public) (Business Week 2002). In November 2002, German bank Bausparkasse Schwabisch Hall and China Construction Bank received approval to form the PRC's first ever JV bank. The bank, which will be located in Tianjin, is expected to be operational in early 2003, and will be limited to mortgage business. In January 2003, Citigroup (US) announced the purchase of a 5% stake in Shanghai Pudong Development Bank.

a. Regulatory Framework

Banks in the PRC are regulated under the Central Bank Law, Commercial Banking Law, Negotiable Instruments Law, Trust Law, and subordinate legislation such as regulations, decrees, provisions, and opinions issued by PBOC.[51] The Commercial Banking Law standardized the commercial behavior of banks that were mostly stated owned. Under the law, commercial banks are required to be established under the Company Law of 1994. Banks are required to be formed as limited liability companies and acquire the status of a legal person responsible for their own liabilities and debts to the extent of their assets. The Commercial Banking Law sets out the framework for lending, personnel management, and depositor protection. PBOC has developed an outline of a banking manual to be distributed to commercial banks, which includes all relevant PBOC laws and regulations and will be updated regularly.

The Commercial Banking Law also put an end to universal banking practice by mandating a strict legal separation between commercial banking activities and nonbank financial intermediation. The only securities business that commercial banks may be engaged in is underwriting and trading government securities. This law also prohibits commercial banks from investing in real estate or trust and investment companies, or indirectly investing in any nonbank financial institution. As a result, many commercial banks have been required to divest ownership interests in nonbank financial institutions or devolve functions within the banks that are noncore commercial banking activities. The slow speed at which this process has occurred to date suggests that many banks are reluctant to do so in an environment where government policy is constantly under review and nonbank financial activities provide a better basis for revenue in the face of NPLs.

[51] Based on the establishment of CBRC, a new Banking Supervision Law is being prepared along with amendments to the Central Bank Law and Commercial Banking Law.

Regulatory segregation has not stopped conglomeration of financial services in the PRC. A number of holding companies (e.g., China International Trust and Investment Company, China Everbright Group, and China Merchant Group) are engaged in banking, insurance, and securities businesses.[52]

To further promote transparency in banking operations and enable depositors, borrowers, and investors to better protect their interests, PBOC promulgated interim guidelines on information disclosure by commercial banks on 21 May 2002. Information required to be disclosed includes financial and accounting reports, risk management, corporate governance, and important matters that occur during the fiscal year. The guidelines are applicable to all commercial banks except for city commercial banks, which have to adopt these guidelines fully by 1 January 2006 (China Daily 2002j).

b. PBOC and CBRC

When PBOC was established, it was responsible for regulating the financial sector. Concern about excessive stock market speculation and systemic risks resulted in the separation of the banking, securities, and insurance sectors. As noted above, the Commercial Banking Law, which was adopted in 1995, prohibits commercial banks from any kind of securities business. In 1998, the Government transferred oversight of the securities and insurance sectors to separate supervisory authorities to deepen financial reforms, minimize financial risks, and promote the fledgling financial services industry. Authority to regulate the insurance industry was transferred to CIRC, while authority to regulate capital markets was transferred to CSRC (Korner 2002).

The State Council appoints the governor and vice governor of PBOC. In 1999, PBOC underwent a major restructuring modeled after the Federal Reserve Board in the US. All provincial and local branches were abolished and PBOC opened 9 regional branches whose boundaries did not correspond to local administrative boundaries. The restructuring was intended to reduce the influence that local officials had on PBOC policy making. Although PBOC's role is currently being redefined, it has been responsible for formulating and implementing monetary policy, exercising supervision and administration of the financial industry, and examining and approving the establishment of PRC financial institutions, including those with foreign investment and branch offices of foreign banks. With assistance from ADB, PBOC developed an effective prudential supervision system with effective early warning and risk mitigation to monitor and control the liquidity of financial institutions, using Shanghai as a pilot (ADB 1998a). At the 10th NPC, the Government announced plans to create a new banking regulator, CBRC, in charge of banking supervision, to enable PBOC to concentrate on developing and implementing monetary policy.

The Government is currently in the process of defining the role and organization of CBRC and its relationship with PBOC in monitoring the financial stability of this sector.

c. Regulation of Interest Rates

PBOC sets interest rates on domestic currency and the spread between deposit and lending rates. Currently banks are permitted to float up to 10% of the official rate for SOEs, up to 30% for SMEs, and up to 50% for rural credit cooperatives (RCCs) (Yang 2002). PBOC has submitted to the State Council a plan permitting commercial banks to float their lending rates for all enterprises and expand the band. Although financial authorities have said they will eventually liberalize interest rates, a timetable has not been set.

Interest rates for foreign currency and foreign currency deposits of $3 million or more have been fully liberalized. Interest rates on deposits of less than $3 million are set by the China Association of Banks, a national organization established in May 2000 to promote self-discipline and cooperation in the banking sector (Shirai 2002).

[52] Amendments to the current legal framework are currently being prepared with ADB assistance to, among others, address the regulation of financial conglomerates.

d. Nonperforming Loans

SOCBs have accumulated large portfolios of NPLs based on imprudent lending to SOEs encouraged by the Government. Under banking regulations, banks may not restructure loans or transfer creditor rights to other investors. Thus borrowers have only two options: fully repay their debts or repay their debts through liquidation when they are completely insolvent (Asia Society 2002).

In 1998 and 1999, a major step was taken to address the NPL issues of the four SOCBs. For each bank an AMC was established.[53] AMCs acquire and manage NPLs transferred from each of the SOCBs. The purpose was to reduce the NPLs of the four banks from 35% of their portfolio to 25% in 2000.[54]

AMCs, which have an operational period of 10 years, are fully state–owned institutions with a paid–up capital of CNY10 billion ($1.2 billion) and are funded by issuing bonds supported by government guarantees. NPLs in the SOCBs' balance sheets are replaced by these bonds. AMCs handle debt collection and asset replacement, transfer, and sale. To support the restructuring of insolvent borrowers, AMCs may engage in direct investment, debt-equity swaps, asset securitization, and issuance, listing, and underwriting of bonds and shares within the scope of asset management and commercial lending.

In 1999, total NPLs in the PRC banking system were officially estimated at 25% of total loans ($540 billion). In 2000, the Government transferred close to CNY1.4 trillion ($169 billion) of the SOCBs' NPLs to AMCs. In 2001, AMCs were allowed to write down the value of NPLs, which SOCBs were not able to do (Oxford Analytical Asia Pacific Daily Brief 2001).

At the Government's request, ADB provided TA to Cinda Asset Management Company (Cinda), which was established to support the resolution of bad debts to the China Construction Bank and serve as a role model for other AMCs (ADB 2002e). Since April 1999, Cinda has acquired NPLs worth $52 billion (as of August 2001). The TA was designed to assist Cinda in developing its capacity to deal effectively with restructuring and disposing its NPLs based on international best practice standards. Although the TA assisted in capacity building of Cinda and in strengthening its operations, it was not able to help adequately address larger constraints that limit the ability of Cinda, as well as other AMCs, to operate effectively based upon an inadequate legal framework.[55]

Cinda became the first of the four AMCs to securitize bad loans and sell them overseas. Under a deal with Deustche Bank. Cinda agreed to create an asset pool of operations totaling CNY1.5 billion ($181.2 million), and Deustche Bank was subcontracted to dispose of the loans overseas in 3–5 years. Great Wall is in negotiations to sell CNY3.4 billion ($410.8 million) of NPLs to foreign investors, while Orient is in talks to sell NPL packages to Taipei,China investors (Hong Kong Standard 2003).

In November 2001, a consortium led by Morgan Stanley (Lehman Brothers, Salomon Smith Barney, and KTH Capital), negotiated the purchase of approximately $1.3 billion of assets from Huarong Asset Management Corporation (Huarong) for $117 billion, with the provision that they share future profits once the consortium makes a stipulated "preferred return" (20–25%) on the initial investment in 24 months (Zhang et. al 2002). In December 2002, MOFTEC approved two Sino-foreign JVs charged with selling a total of CNY12.8 billion ($1.54 billion) of bad loans. The larger of the two JVs, First United Asset Management (FUAM), is 35% owned by Huarong.

[53] China Huarong Asset Management Corp. (Huarong) for Industrial and Commercial Bank of China (ICBC); China Orient Asset Management Corp. (Orient) for Bank of China (BOC): Cinda Asset Management Corp. (Cinda) for China Construction Bank (CCB); and Great Wall Asset Management Corp. (Great Wall) for Agricultural Bank of China (ABC).

[54] In addition, to promote the need to ensure the creditworthiness of borrowers, a five-classification loan structure (pass, special mention, substandard, doubtful, and loss) was standardized (Zhang et al 2002).

[55] The current legal framework limits AMC powers to collect debt, obtain speedy justice, control shares obtained in the debt-equity swap process, supervise management, enforce bankruptcy and liquidation, end unfair or burdensome contracts between the borrower and the bank, implement disposition strategies, safeguard against fraud and corruption, or set up special purpose vehicles that can buy loan receivables and restructure them to be retailed as bonds and other commercial papers.

The remaining shares are owned by a consortium consisting of US investors Morgan Stanley, Lehman Brothers, Salomon Smith Barney, and KTH Investments. FUAM will be responsible for disposing of CNY10.8 billion ($1.3 billion) in bad loans owed by 254 PRC companies. The smaller of the two ventures, Rongsheng Asset Management, is a JV between Huarong and Goldman Sachs (US) and is charged with the disposal of CNY2 billion ($241 million) in bad loans owed by 44 companies.

The Government has instructed banks to reduce the ratio of NPLs to 15% over a 5-year period through recovery of existing NPLs and improved quality of new lending. The ratio of NPLs to total loans fell to 23.4% in June 2002 (Table 17). Although NPLs of other commercial banks are lower due to their shorter operational history and less exposure to SOEs, rural and urban credit cooperatives have NPLs that could be as high as or higher than those of the four SOCBs. In March 2002, PBOC Governor Dai Xiangliong publicly admitted that bad loans of SOCBs could be as high as 30% of total lending. Foreign analysts estimate that the figure can be high as 30–50%.[56]

Table 17: Ratio of NPLs on the Books of the Four Large SOCBs
(1999-2nd Quarter 2002)

Year	1999	2000	2001	2002
NPL Ratio	25	29	25.4	23.4%

Sources: *Asian Development Outlook 2003* and Development Research Center.

As of end–March 2003, the four AMCs had collectively disposed of more than CNY343.45 ($41.38 billion) billion of NPLs. Of this amount, CNY71.5 billion ($8.64 billion) was recovered in cash, a recovery rate of 21.82% (Table 18).

Table 18: Assets Status of Four AMCs as of End 1st Quarter 2003
(CNY billion)

Company	NPLs	Disposed	Recovered	Recovery Rate
Huarong	500.0	96.4	12.4	21.8
Great Wall	346.0	76.0	6.6	10.1
Cinda	373.0	63.5	19	25.4
Orient	350.0	32.0	7.4	30.6

Sources: *China Daily*, 2 November 2001; and PBOC web site.

Table 19 shows that the NPL ratio is higher in the PRC than in many Asian countries. However, a simple country comparison could be misleading. The large proportion of NPLs in the PRC is part of the cost of the transition from a centrally planned to a market economy, particularly SOE reforms. A complex long-term strategy is needed to solve the NPL problem.

[56] In September of 2001, the Government penalized 1,240 banks that failed to reach the reduction targets on NPLs. (Zhang 2002 and International Herald Tribune 2002).

Table 19: Comparison of NPLs between the PRC and Other Asian Developing Countries in 2001 (2002) (%)

Item	PRC	Indonesia	Republic of Korea	Malaysia	Philippines	Thailand
NPLs	26.6[a]	18.0 (10.2)	4.1 (2.4)	10.3 (7)	17.0 (16.4)	12.6
NPLs including Transfers to AMCs	37.0	55.2	19.2	16.6	NA	25.1

NA = not available.
a This percentage differs from Table 17 and reflects the difficulty in obtaining reliable statistical information.
Sources: *Asian Recovery Report*. September 2001; and *Asian Development Outlook 2003*.

2. Capital Markets

a. Background

Although the development of the stock market in the early 1990s was one of the driving forces of recent economic development, it has not functioned as a source of capital for private enterprises. Instead, it has functioned as a key instrument to provide needed capital for large SOEs.

Funds raised on the Exchanges started with CNY0.9 billion ($108.7 million) in 1991, growing at a 75% compound annual growth rate to CNY142 billion ($17.2 billion) in 2000. However in 2001, the amount of funds raised decreased by one third from 2000 to CNY100 billion ($12.08 billion) and further decreased by 4% in 2002 to CNY96 billion ($11.6 billion).

Although capital raised through initial public offerings (IPOs) increased by 3% from 2001 to 2002, from CNY45 billion to CNY46.2 billion ($5.4 billion to $5.6 billion, respectively), amounts raised were less than one third the amount raised in 2000 and one half of the amount raised in 1997 (Figure 3) (Asia Society 2002).

The number of listed companies has increased significantly from 14 in 1991 to 1,160 by 2001, and 1,224 in 2002 (Figure 3). Market capitalization has steadily increased from $2 billion (World Bank 2003a) (CNY241 million) in 1991 to CNY4.3 trillion ($525.8 billion) in 2001, but declined by nearly 12% to CNY3.8 trillion ($463.1 billion) in 2002.

The private sector has had a negligible role in the securities industry that is largely stated-owned. It includes two stock exchanges—the Shanghai Securities Exchange (SSE) and the Shenzhen Securities Exchange (SZE) (collectively Exchanges)—124 securities companies (brokerage firms) mostly owned by state-owned financial or other institutions,[57] more than 200 securities trading units controlled by trust and investment companies, 54 closed-end mutual funds and 17 open-end mutual funds managed by 17 fund management companies, 35 insurance companies, and a few leasing and financing companies.[58]

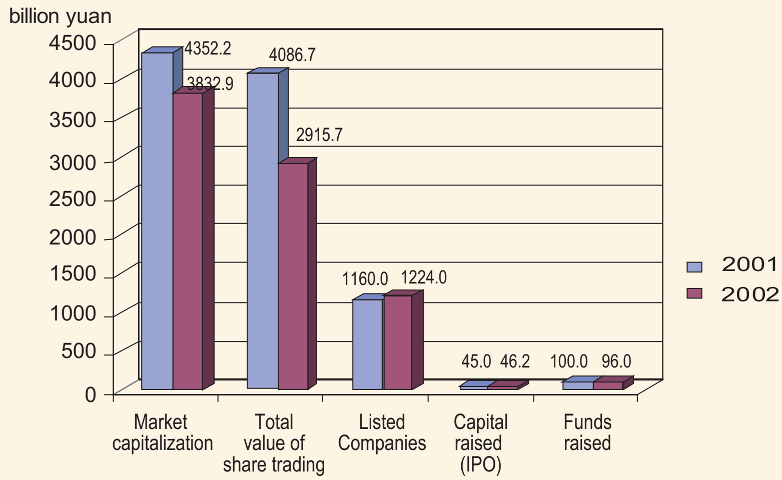
Shares are classified by reference to the status of the shareholder. State shares are purchased with state assets by government departments and usually constitute more than half of all issued shares. Legal person shares are owned by entities such as companies and institutions, generally other state enterprises. Individual shares are held by employees or individual investors from the general public. Only individual shares of listed companies can be traded on the Exchanges. Until recently, state shares and legal person shares were not transferable.[59] Based on the segregation of shares, there has been no market for corporate control.

57 The PRC's largest brokerage firm is China Galaxy Securities. Other leading brokers include Haitong Securities, China Southern Securities, China Guotai, and Jun An Securities. CITIC Securities, which went public on the SSE in January 2003, is the second listed brokerage firm in the PRC. The first was Shenzhen-based Xinjiang Securities, which listed in 1999 under its former status as a trust and investment corporation.

58 Figures are from December 2002, except for mutual funds (January 2003) and for insurance companies (2001).

59 But see discussion in Section II.A.2.b. Restructuring of State-Owned Enterprises) on recent decision to allow QFIIs to purchase non-trackable shares.

Figure 3: Stock Market Profile (2001–2002)



Source: Federation des Bourses de Valeurs or International Federation of Stock Exchanges (http://www.fibv.org).

Only shareholding companies may apply for an exchange listing. Cross–listings between the Exchanges are not permitted and CSRC determines on which exchange a company will list. Listed firms are evenly distributed between the Exchanges, with 52% listed on the SSE and the rest on the SZE. More than 95% of companies listed on the Exchanges are SOEs and more than 70% of shares issued by listed issuers are state and legal person shares.[60]

State control of a majority of listed companies has contributed to poor corporate governance. Concentration of shares in the hands of the Government enables the state to influence the composition of boards of directors and managers at the expense of small investors. The Government ends up managing and operating the company and driving and endorsing major decisions. The public, as ultimate owners of SOEs, who bear the ultimate risks, have no say in the governance of SOEs or in monitoring them. This situation contradicts the principle of separation between the Government and enterprises endorsed since the beginning of SOE reforms.[61]

Managers and boards of directors of former SOEs often continue to hold such positions even when the company has been converted to a joint stock company (JSC). Listed companies generally have about 10 members of the board of directors, of which between 70 and 99% are drawn from the original SOE. One person generally serves as both the general manager and the chairman of the board of directors of listed companies. Managers are appointed through the political system and often lack sufficient training (Cooper 2001).

To address concerns about the volatility of private capital flows, the domestic securities market is divided into two categories of shares: A shares, which are only available to PRC investors and QFIIs, and B shares which are available to both foreign investors and PRC investors with foreign currency. H shares, shares of mainland registered companies listed in Hong Kong, China and Red Chips, shares of companies registered overseas and listed abroad with having substantial mainland interests and controlled by affiliates or departments of the PRC Government, may also be purchased. A shares account for 73.3% of market capitalization, B shares account for 8.8%, and H and other shares listed on foreign exchanges account for 17.9%.[62] Once a share is issued in a certain category, it may not be converted to another share type.

[60] Ibid.
[61] See discussion in Section II.A.3. Ambiguous Private Property Rights on establishment of the SASAC, which should help address governance concerns, and Box 7.
[62] One reason that A shares dominate the market is the legal requirement that A shares account for not less than 25% of total shares issued when a company applies for listing (Shirai 2002).

An over-the-counter trading market operated by the Securities Association of China, a self-regulatory organization (SRO), provides a venue for trading unlisted securities with a positive net asset value.

Securities companies operating in the domestic securities industry take one of the following types of licenses: (i) broker/dealer, with minimum capital of CNY50 million ($6 million); (ii) "comprehensive" covering brokerage, dealer activities, and discretionary funds management with a minimum capital of CNY200 million ($24 million); and (iii) underwriting, with a minimum capital of CNY500 million ($60 million). As of October 2001, there were 16 comprehensive securities companies with CNY250 billion ($30.12 billion) in total assets and 694 branch offices, and 17 broker securities companies with CNY11 billion ($1.33 billion) of total assets and 109 branch offices. All securities companies are members of the Exchanges and the China Securities Depository and Clearing Corporation. Minsheng Securities, which has the same shareholders as Minsheng Bank, is the first securities company in the PRC with a majority of its capital from private sources (Gang 2002).

The PRC's accession to WTO enables foreign securities firms to participate in the PRC market through partnerships with domestic securities firms that will benefit from the transfer of new technology and managerial skills. New rules adopted by CSRC, which became effective in July 2002, permit foreign companies to own up to one third of domestic securities firms although the PRC party must maintain control. The new rules require CNY300 million ($36.25 million) of paid-in capital for foreign partners in fund management JVs.

As of end-January 2003, CSRC officially accepted three applications of foreign securities firms to set up a JV with a PRC partner. Credit Lyonnais Securities Asia (CLSA) and Xiangcai Securities recently became the third JV securities firm to be approved by CSRC. Morgan Stanley International Incorporated has been granted a license to form a JV with a PRC partner, the Construction Bank, and the Government of Singapore Investment Corporation and has been operating in the domestic market under the name of the China International Capital Corporation, Ltd. (CICL) for the past 6 years.[63] CICL has been used by major SOEs when they restructure and issue shares overseas and was recently appointed the lead adviser for the sale of shares of five SOEs in Shenzhen (Section II.A.2.b. Restructuring of State-Owned Enterprises). Another JV securities company, BOCI Securities Company, established in March 2002, is 49% owned by BOC International Holdings Co. Ltd. and the Hong Kong, China-based investment arm of the Bank of China. Other applications are currently under review (China Law and Practice 2003e) (Box 3 and Section IV.A.7 on Impact of WTO Accession on the Financial Sector).

The PRC securities market is retail driven. The number of retail investors with a brokerage account at securities companies has grown from 2.2 million in 1992 to 64 million at the end of 2001. Individual investors dominate the A share market. Institutional investors represent only 0.48% of all investors (Asia Society 2002). To address the retail investor bias, CSRC has embarked on the following reforms, which have been welcomed by foreign investors:

(i) creating securities investment management companies (SIMCs) that can manage securities investment funds (10 SIMCs and 33 funds were established as of March 2001);
(ii) allowing securities companies to diversify their operations into in-house private portfolio management services for their corporate clients;
(iii) allowing life insurers to invest in securities markets through SIMCs; and
(iv) introducing the QFII scheme to allow foreign investment in the domestic A share market.

[63] According to the *China Securities Journal*, the Wuhan-based Changjiang Securities Company also signed a deal with the French-based BNP Paribas to establish a JV securities firm on 7 March 2002.

b. Regulatory Framework

Four tiers of regulations govern the PRC securities market. Tier one includes relevant legislation—the Company Law, Securities Law, Trust Law, and two laws on administrative sanctions and review (Administrative Sanctions Law and Administrative Review Law)—that apply to all government agencies.[64] The second tier includes Administrative Regulations adopted by the State Council in respect of a particular area of regulation. As of February 2002, there were three regulations governing the conduct of the capital market: Regulation of Stock Offerings and Trading, Regulation on Convertible Corporate Bonds, and Regulation on Stock Investment Funds. Tier three consists of subordinate rules and orders adopted by CSRC. As of February 2002, CSRC administered 280 regulations, rules, and orders under the Securities and Companies Law. CSRC administers part of the Company Law insofar as it applies to listed issuers. All CSRC rules and orders are adopted by decision of the chairman and commissioners meeting as a collegiate body. In important cases, CSRC consults with other agencies or the State Council before adopting a particular rule. The fourth level includes rules adopted by market institutions and SROs (stock exchanges, commodity futures exchanges, Securities Association of China, Futures Association of China, and China Securities Depository and Clearing Corporation), with CSRC approval.

One of the areas in which CSRC has been actively promoting reforms is the corporate governance of listed companies. CSRC has adopted numerous regulations, codes, and guidelines in this area (Box 7). For example in 2001, CSRC adopted Interim Procedures for Former SOEs that are being Corporatized and Raising Funds through an IPO. These procedures require directors, managers and persons who own more than 5% of company shares to undergo 1 year of training prior to IPO approval to ensure that they understand their regulatory duties, including corporate governance standards. The lead underwriter for the IPO is required to provide such training, culminating in an exam to confirm such understanding. Although this may delay the IPO process, it helps ensure that control persons are aware of their regulatory duties.

To address concerns about the quality and accuracy of information disclosed by listed issuers, CSRC recently issued new disclosure requirements that include more effective sanctions and penalties for noncompliance. On 27 December 2002, CSRC issued revised guidelines on the content of annual reports that require additional disclosures concerning the definition of senior management personnel, salary distribution of senior personnel, and investment of major assets to third parties (China Law and Practice 2003d). On 6 January 2003, CSRC issued revised guidelines governing the content of annual reports that require persons at listed companies in charge of accounting work and the company's accounting firm to guarantee the truthfulness and completeness of the financial information contained in the annual report. As discussed in more detail in Box 8, as a further deterrent to fraudulent disclosure, the Government has also taken recent measures to provide for a civil compensation scheme for investors.

c. China Securities Regulatory Commission

Under the Securities Law, the securities industry is regulated by CSRC, which enfolded all provincial and local agencies dealing with securities issues. CSRC is a quasi-government agency under the State Council, with a degree of independence with respect to its budget. As a result, the salary structure of CSRC is higher than that of the regular civil service but may not be adequate to supervise the post-WTO securities and investment industry. Two CSRC vice chairmen were educated in the US, and one, who is also a US-trained lawyer, served as the former deputy chairman and executive director of the Hong Kong Securities Commission.

[64] The Government expects to release a new law on Investment Funds next year (Beijing Times 2002).

Box 7:

Regulation of Corporate Governance in the PRC

In January 2001, the China Securities Regulatory Commission (CSRC) issued a Code of Corporate Governance for Listed Companies in the PRC incorporating requirements under the Company Law, Securities Law, other relevant laws and regulations, and international best practice standards (the "Code"). Among other things, the Code requires listed companies to establish fair and transparent standards and procedures to assess the performance of directors and managers (Assessment). The board is required to report to shareholders the performance of directors and the results of the Assessment. The Code encourages listed companies to hire professional management and prohibits any individual or institution from interfering with the company's normal recruiting procedures.

The Code also requires listed companies to introduce independent directors to their board in accordance with relevant regulations, and clarifies a listed company's continuous obligation to timely disclose required information truthfully, accurately, and completely in a reasonably comprehensible way. Disclosed information is required to include, among other things (i) the attendance of independent directors at board meetings, their issuance of independent opinions and their opinions regarding related party transactions and appointment and removal of directors and senior management; (ii) the actual state of corporate governance of the company, the gap between the company's corporate governance and the Code, and the reasons for the gap; and (iii) specific plans and measures to improve corporate governance. Under the Code, the secretary of the board of directors is in charge of information disclosure, including formulating rules for information disclosure, contacting shareholders, and providing disclosure to investors. The board of directors and management are required to actively support the secretary's work and no person is allowed to interfere with such disclosure.

In August 2001, CSRC issued *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* ("Guidelines"). Among other things, the Guidelines require that at least one of the independent directors be an accounting professional. By 30 June 2002, at least two members of the board are required to be independent directors and by 30 June 2003, at least one third of the board is required to include independent directors. All independent directors and nominees for independent directors are required to take part in related training organized by CSRC and its authorized institutions in accordance with CSRC requirements. The Guidelines clarify the "independence" requirement and provide CSRC with the power, after notification, to object to the classification of a director as "independent." Independent directors are responsible for, among others, expressing an independent opinion to the board of directors on major events occurring in the listed company. The requirement for independent directors created a demand for qualified directors for listed issuers. By offering training courses on the role and responsibilities of directors, CSRC hopes to create a pool of qualified candidates. The training of such directors intensified in 2001 with ADB assistance.

On 28 April 2003, CSRC helped develop and launch the China Corporate Governance Index (CCGINX) for public companies. The CCGINX was codeveloped by Nanka University Corporate Governance Research Center, Exchanges, financial institutions, and public companies.

CSRC has 3–level regulatory structure consisting of CSRC headquarters at the top, 9 regional offices, 25 special inspection offices (local offices), and 2 other offices under the direct supervision of CSRC headquarters. An enforcement bureau has been set up in each of the 9 regional offices.

Under the current legal framework, CSRC does not appear to have adequate enforcement powers. For example, CSRC may not be able to compel cooperation from suspects or witnesses or inspect bank accounts of individuals or registration documents of companies and other enterprises that are overseen by another government institution. CSRC's task in overseeing the securities market is also influenced by the fact that in many instances central and local government units are major shareholders of listed companies and owners of securities intermediaries. Many do not know how to act as a majority shareholder and often confuse their role as stockowner and regulator, leading to heavy interference.

Box 8:

Development of a Civil Compensation System for Investors

Significant progress has been made to establish a civil compensation system to enable investors to bring to court listed companies that have been judged by the China Securities Regulatory Commission (CSRC) to have committed fraud in their disclosure of information for listing. Earlier CSRC efforts to sanction such actions did not address shareholder issues. For example, in the case of PT Chengdu Hongguang (PTCH), the first public company in the PRC that showed a loss within 6 months after listing, a CSRC investigation found that PTCH had falsely disclosed more than CNY540 million ($65.24 million) in profits for prior years to qualify for listing when in fact the company had suffered huge losses. After listing, the company used more than 80% of the proceeds raised to pay off its debts rather than in accordance with the stated purpose as disclosed in the prospectus. In another case against Yinguangxia, CSRC found that this company had provided manufactured sales revenues in its export business of nearly CNY1.5 billion ($181.2 million) from 1998 to 2001 in order to receive a listing.

These two cases gave rise to unsuccessful shareholder suits in 1998 after plummeting sale prices made investments in these companies almost worthless. Based on difficulties in proving fraud, the absence of procedures for bringing such cases to court, and the unfamiliarity of judges in this area, these cases were not successfully resolved. To clarify procedural issues, in January 2002, the Supreme People's Court (SPC) issued the "Questions Concerning the Acceptance of Civil Tort Dispute Cases Arising from Misrepresentation in the Securities Market" Circular. As a result of such circular, more than 900 shareholder suits were filed in 2002. However, based on failure of this Circular to resolve key issues (elements of proof, loss calculation), only two of these cases were resolved by way of settlement. Subsequently, to address these key issues, SPC issued a new circular on 9 January 2003 entitled "Trial of Civil Damage Cases Arising from Misrepresentation in the Securities Market Several Provisions" that became effective in February (China Law and Practice 2003d).

d. Major Impediments to Capital Market Growth

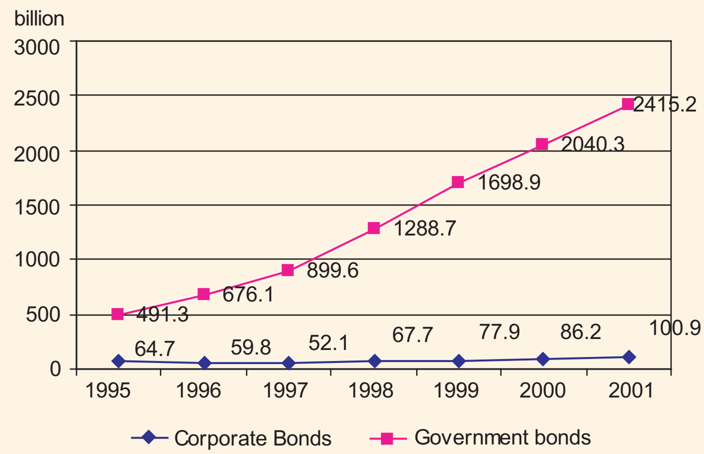
As discussed, several fundamental structural problems exist, that impede development of the capital market, including the segregation of the A and B share markets, the state's domination in market capitalization and nontradability of its SOE shares, and retail investor bias. Weakness in regulation and market compliance and surveillance, and the perception of widespread manipulation and insider trading, have encouraged a high degree of volatility and market segmentation. Market intermediaries do not have access to financing and operate without adequate safeguards and internal risk management systems. Prior to settlement, clients are exposed to risks including broker insolvency, fraud within the broker's office, and funds and securities being illegally used for other activities. Settlement systems for equity securities are not sufficiently flexible to assist the future development of markets. The Exchanges do not play a critical role in listing, surveillance, and enforcement. ADB provided TA to CSRC in 2001, which culminated in recommendations to address these concerns.[65]

[65] ADB has provided six TAs to help support capital market development (ADB 1991, 1992, 1993, 1995b, 1998b, 1999d).

e. Bond Market

Although the PRC bond market has grown enormously from about $70 billion in 1994 to $261 billion in 2000 (Fabella and Madhur 2003), bonds are the least developed part of the PRC capital market.[66] In terms of regulatory framework, market infrastructure, secondary market liquidity and the government bond market yield curve, the PRC bond market has a long way to go.

Figure 4: Outstanding Domestic Debt (1995–2001)



Sources: Hongkong Shanghai Bank of China. 2002. China Capital Markets Handbook. December 2002, citing Ministry of Finance, Center of Electronic Information of China.

Currently, government bonds (treasury and policy bonds) account for about 96% of outstanding debt. Although the PRC raises capital in the international debt market from time to time, it lacks an integrated domestic government securities market. A regular issuance program would help establish a reliable US dollar benchmark yield curve for the PRC and help other potential bond issuers, including enterprises, raise funds at a lower cost domestically. Bonds have been issued in recent years to finance infrastructure projects, pump priming, social welfare programs, and cover budgetary shortfalls (Green and Wall 2000). Domestic government bond issuance grew from CNY291 billion ($35 billion) in 1996 to CNY747 billion in 2001 ($90 billion)[67] (Figure 5).

The market for corporate bonds is very small. While equity market capitalization was about 37.4% of GDP in 2002 (FIBV 2003), corporate bonds outstanding amount to less than 1% of GDP. During 1993–2000, annual proceeds for corporate bonds averaged CNY16.93 billion ($2.45 billion). The CNY14.7 billion ($1.21 billion) issued in bonds in 2001 was insignificant compared with the CNY100 billion ($12.08 billion) raised through equities. Thirteen corporate bonds are currently listed on the Exchanges with a market capitalization of CNY22.85 billion ($2.76 billion). The total trading volume of corporate bonds in 2001 was CNY41.45 billion ($1.38 billion) compared with CNY3.32 trillion ($40.35 billion) traded in the A share market (Kaiguo 2002).

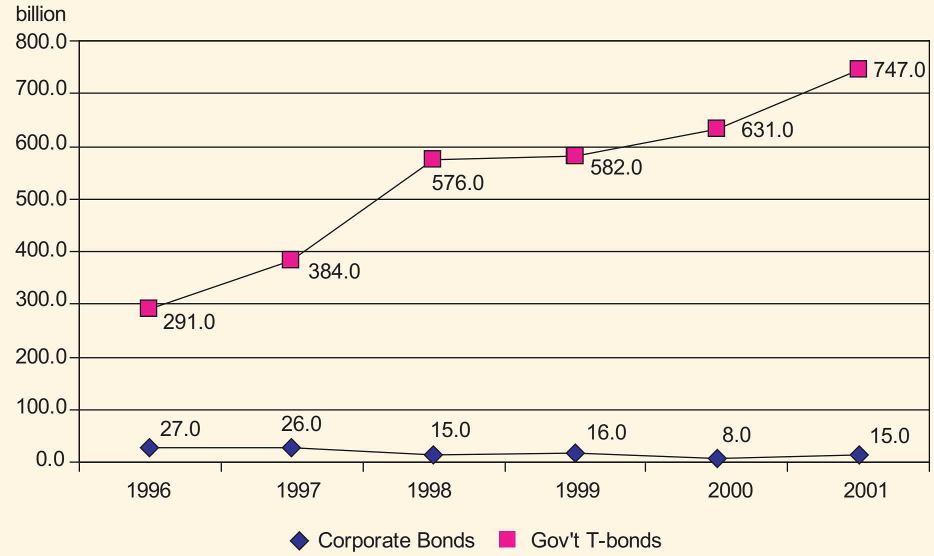
In the first 11 months of 2002, corporate bond issuance reached CNY23.5 billion, an increase of 60% over 2001. The largest corporate bond issue of the year, and a historical record in the PRC,

[66] Disaggregated data not available for 1994. In 1995, government bonds and corporate bonds comprised CNY491 billion ($59 billion) and CNY64.7billion ($8 billion), respectively, of outstanding domestic debt. In 2000, government bonds and corporate bonds accounted for CNY2040.3 billion ($246 billion) and CNY86.2 ($10 billion), respectively, of outstanding domestic debt (Figure 4).

[67] Preliminary data on Treasury bond issuance for 2002 is estimated at Y606 billion ($73 billion).

was a bond sale by telecommunications company, China Mobile (Hong Kong) in November 2002 worth CNY8 billion ($ 966.5 million). The Export-Import Bank of China sold CNY5.5 billion ($664.4 million) in 10-year bonds in the same month. In June 2002, the State Power Corp. raised CNY4 billion ($483.3 million) in an issue on the SZE, and Shenzhen Wanke raised CNY1.5 billion ($181.2 million) in convertible bonds. Some companies are also tapping the overseas debt market.

Figure 5: PRC Government and Corporate Bond Issuance (1996–2001)



Source: HSBC. 2002. China Capital Markets Handbook. December 2002, citing PBOC, CSRC, and MOF.

There are two secondary bond markets in the PRC: the exchange bond market and the interbank bond market. Up and until August 1997, when banks were prohibited from trading on the Exchanges and the interbank bond market developed, commercial banks traded repurchase contracts (repos). Trading in repos provided a way for securities firms to obtain long-term loans from banks, while formal loans were prohibited. The interbank market became the largest issuance and trading market for government bonds, as well as financial and policy bonds. In 1999, PBOC allowed qualified securities companies and incumbent management companies to participate in the interbank market. These markets currently compete with each other and are regulated by different government bodies. PBOC has been overseeing the financial bond market and the interbank bond market, the Treasury manages the treasury bond market and corporate bonds, and CSRC manages convertible bonds and exchange traded bonds.[68]

Developing the bond market is crucial to tapping into the PRC's massive domestic savings and matching savings to its large infrastructure needs (World Bank 1997). A developed corporate bond market will help mitigate currency and savings mismatches, reduce borrowing costs, and promote development of a derivatives market. In many Asian developing countries, bank loans and corporate bonds are likely to be complementary to each other for financing economic development (Yoshitomi and Shirai 2001).

[68] See discussion in Section IV.A.1.a on changes in the regulatory framework for the banking sector.

Several constraints impede development of this market. First, preferential treatment is given to the treasury bond and equity markets. The process of issuing corporate and enterprise bonds is merit based and the issuance of such bonds is closely tied to the credit allocation system previously administered by SDPC.[69] To ensure the successful issuance of treasury bonds, the Government allows only corporate bonds to be issued after the issuance of treasury bonds. Under the Regulations on Corporate Bonds adopted in 1993, SDPC worked out the annual issuance quota for corporate bonds according to the situation of the macro economy, fiscal and monetary policy, sector development, and securities market development. The quota is allocated to different ministries, local governments, and different sectors under administration and monitoring by PBOC. Since all corporate bond issuers are large key enterprises with support from the Government, which assumes the risk of default, the Government imposes rigorous restrictions on the issuer, bond rate, and quota.

Based on the multiplicity of regulators, the issuance procedures for corporate bonds are overly complex. Potential issuers are faced with a segmented regulatory structure requiring multiple approvals at the local and national levels of government. These multiple approvals may significantly delay (up to 1 year) the issuance of corporate bonds, which is not conducive to the development of a vibrant bond market.

There is no reliable credit rating system, the industry is overconcentrated, there is a weak connection between ratings and interest rates, and there is a lack of independence. Credit rating agencies are affiliated with government institutions or PBOC, making it difficult for them to provide an adequate picture of the corporate credit status and potential risks or the quality of the corporate bond. An effective rating system needs to be developed and regulation needs to be strengthened to ensure investor protection and promote the development of the bond market.

The pricing mechanism does not work well. There is no benchmark yield curve in treasury bills and government bonds. A majority of corporate bonds are priced based on treasury bonds according to different maturities. MOF issues bonds at a fixed spread above interest rates on bank deposits of similar maturity, rather than at market-determined interest rates. Credit rating, operating conditions, and debt paying ability are not reflected. Moreover, as discussed in Section IV.A.1.c, interest rates are still subject to administrative control.

There is no effective security mechanism for debt repayment in the PRC. The collateral mechanism is ineffective because most enterprises pledge fixed assets as collateral, which are illiquid. The supervisory system for the corporate bond market also needs to be strengthened. Better information disclosure by issuers, a risk alarm system for debt payment, and a trustee system where the debtor cannot pay should be incorporated into the regulatory framework. Market infrastructure for the trading, payment, and settlement system for debt securities also needs to be strengthened.

f. Asset–Backed Securities

The demand for capital in the PRC is enormous and increasing. Asset securitization, which transforms illiquid assets into freely tradable liquid assets, provides an alternative method for raising capital. The PRC has passed targeted laws and regulations to facilitate the securitization of large infrastructure projects (highways, project finance). For example, the National Highway Law facilitated the financing and development of road construction and maintenance (Kong 1998).

In April 1997, the PRC issued its first asset backed security. China Ocean Shipping Company (COSCO), an SOE, completed an asset backed securitization transaction that securitized its future shipping revenues derived from overseas operations (Kong 1998). Other securitized investment products have not quickly developed in the PRC due primarily to gaps in the legal and institutional infrastructure, tax policy, absence of credit insurance and guarantees, and administrative control of interest rates. In addition, every stage of the transaction requires approval from various government

[69] Note that convertible bonds, which are under CSRC jurisdiction, may be issued by listed companies without going through the credit allocation process.

bodies (e.g., SAFE, SDPC, MOF, MOFTEC, and PBOC). If the originator is state owned, any sale of assets to a special purpose vehicle established outside the PRC also requires approval from its governing authority or the State Asset Administration Bureau (Kothari 2003).

Although there is great potential for a mortgage-backed securities market in the PRC to provide housing finance alternatives, there are several issues, in addition to above-mentioned impediments, that need to be addressed before this market can be fully developed. The need for housing will continue to increase based on government pronouncements (in 1999) that all vacant residential housing units built after 1 January 1999 would be sold, not allocated, and the ongoing growth in the world's largest population.[70]

The housing mortgage system in the PRC is very new. On average, only 6–7%[71] of a commercial bank's portfolio is in mortgage loans in contrast to more than 30% for commercial banks in the US. In 2002, loans for individual housing were CNY825.8 billion ($99.8 billion), an increase of CNY267.1 billion ($32.3 billion) or 47.8% over the previous year (National Bureau of Statistics 2003).

Currently, the mortgage loan market in the PRC lacks standardization. Other problems relate to unclear title and ownership of property, and absence of a central registration and collateral system, secondary housing market, and mortgage insurance.

Several cities have adopted a legal framework to provide guidance for mortgage processing on real estate. In Guangzhou, the local government published regulations on mortgages and required domestic mortgage lenders to be regulated by PBOC. In 1998, the Shanghai Housing Authority announced the establishment of a mortgage-backed securities program, involving a central agency as both mortgage broker and guarantor.

g. Collective Investment Funds

As of end–January 2003, the PRC had 54 closed-end and 17 open-end mutual funds managed by 17 fund management companies that held assets of more than CNY130 billion ($15.7 billion). Current funds under management comprise only about 20% of the assets in the PRC's insurance sector, and only about 1% of the assets in the PRC's banking system (Economist Intelligence Unit 2003)

The PRC's largest fund managers, ranked by market share in total funds under management as of end–June 2002, are China Asset Management (11.3%), China Southern Fund Management (10.2%), and Hua'an Fund Management (10.1%). Large, well-known funds include the Jintai Fund, the Kaiyuan Fund, and the Xinghua Fund.

The mutual fund industry was largely unregulated until the adoption of the Investment Law in December 1997. The law requires funds to (i) have a minimum capital of CNY200 million; (ii) have no more than 10% of a fund invested in any one company, and no more than 10% of a particular company's stock held by a fund; (iii) invest at least 80% of fund assets in equities and bonds; and (iv) invest at least 20% of fund assets in treasury bonds.

In October 1999, CIRC permitted foreign-funded insurance companies in the PRC to buy units in mutual funds, thereby permitting indirect investment in the A-share market. In October 2002, CIRC approved the PRC's first JV fund management company, Guo'an Fund Management. This JV, with a registered capital of CNY100 million, is 67% owned by Guotai Junan Securities, with the balance held by Allianz of Germany. China Merchants Fund Management, a Sino-Dutch JV,[72] gained approval shortly afterward and commenced operations in December 2002.

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70 See www.ChinaBig.com, discussion on the real estate market in China.

71 Staff estimate.

72 China Merchants Securities own 10% of the venture, ING of the Netherlands owns 30%, and China Electric Financial Affairs, China Huaneng Financial Affairs and COSCO Financial Affairs each hold 10%.

3. Venture Capital

Venture capitalists provide equity financing to private companies with rapid growth potential and serve as an alternative financing vehicle for SMEs. International experience demonstrates that companies backed by VC historically have produced a disproportionate share of new jobs, particularly well-paid and highly skilled jobs (Nuechterlein 2000).

The PRC has approximately 100 domestic venture centers nationwide and 3,600 companies are currently under incubation. According to MOST, the PRC also has 92 foreign VC investment corporations, with $1.2 billion in funds, of which about $300 million has been invested in the PRC and abroad. The top five domestic VC firms by amount of funds, as of end 2002, are First Eastern Investment Group ($378 million), Asia Strategic Investments ($305 million), Shenzhen Capital Group ($250 million), BOCI Direct Investment Management ($150 million), and China Merchants China Investment Management ($134 million). The largest foreign VC firms include Walden International ($1,900 million), H&Q Asia Pacific ($1,800 million), Newbridge Capital ($1,221 million), AsiaVest Partners, TCW/YFY ($710 million), and IDG Technology Venture Investment ($500 million). Box 9 presents an overview of the VC industry in the PRC.[73]

Box 9:

Overview of the Venture Capital Industry in the PRC

- March 1985. The Communist Party releases a new policy statement, the Reform of Science and Technology Systems Decision, setting up venture capital (VC) firms to promote the high-tech industry.
- September 1985. China Venturetech, the first PRC VC company, is set up with support of the Ministry of Science and Technology (MOST).
- 1987. The Wuhan East Lake High-Tech Development Zone Venture Center is set up with the help of the UN Science and Technology Promotion and Development Fund.
- 1988: China Venturetech closed.
- Late 1990s. International VC funds enter the PRC's VC market.
- March 1999. A group to draft an investment fund law is formally established, headed by Mr. Li Yining (an economist who also drafted the Securities Law) and members including the National People's Congress, State Development Planning Commission , MOST, and China Securities Regulatory Commission (CSRC).
- March 2000. CSRC announces that the quota system for choosing listings will be abolished and underwriters will determine the pricing and timing of new issues instead of the state.
- 2001. The Provisional Regulation on Establishing Foreign-Invested VC Investment Enterprises is adopted, encouraging foreign investors to invest in high-tech industries and help develop the VC market.

Several structural obstacles, including the absence of an enabling legal and regulatory framework, hinder the development of domestic and foreign VC funds. The structural obstacles are fourfold: (i) limited availability of VC resources for both seed money and subsequent funds due in part to underdeveloped legal mechanisms to channel savings into funds and lack of long-term

[73] The Government has encouraged investment in technology-based business ventures through the establishment of 53 national high-technology zones and VC funds.

investors such as pension and mutual funds; (ii) limited pool of venture capitalists with fund management capability; (iii) lack of a reliable exit mechanism and restrictions; and (iv) legal obstacles and inconsistency of laws and regulations.

Most observers agree that the lack of a reliable exit mechanism is the biggest restraint to the development of VC in the PRC. There are no channels for a venture capitalist to cash out of its investment through an IPO or other exist mechanism after a certain period (usually 3–7 years after its initial investment), when the company has reached a sufficient level of maturity. As discussed in Section IV.A.2, the PRC capital market is underdeveloped. The Government recently dropped the much-expected establishment of the equivalent to the National Association of Securities Dealers Automated Quotation system in the PRC for SMEs with small capitalization and short operating history. This was a major blow for the VC industry.

Relevant laws impose significant limitations on a VC's ability to sell portfolio investments. Investors who are shareholders prior to an IPO are required to hold their shares for an extended lockup period following the IPO, generally 3 years. This compares with an international lockup period of 6 months and has been cited as a serious problem that forces investors to organize outside of the PRC. In addition, the Company Law does not provide the rights necessary for exit strategies (piggyback rights, demand registration rights, tag-along rights, drag-along rights, and tender rights upon change in control) (ADB 2002d). The purchase of shares by the issuing corporation and their cancellation is also subject to the consent of other shareholders and the creditors of the corporation.

Other legal obstacles include (i) weak IPRs protection that prevents high-tech start-up companies from developing (Box 6); (ii) restrictions on share transfer and issuance of bond and multiple classes of stocks such as preferred stocks, which is not clearly provided for in relevant laws; (iii) lack of certainty of the status of employee incentive schemes, such as stock options and rights issuances to retain key employees under the Company Law; and (iv) inability to establish a VC as a limited liability partnership which, through its pass-through tax treatment, usually eliminates double tax issues and reduces the liability exposure of limited partners.[74] Although new rules adopted to incorporate the WTO accession agreement allow foreign firms to take up to a 33% stake in fund management companies, high paid-up capital requirements for foreign partners ($36.25 million) may discourage investment (Section IV.A.2. Capital Markets and Box 3).

Some improvements have been made in the enabling environment for venture capitalists during the past few years, including abolition of the quota system for IPOs in 1999 and the ability of underwriters to determine the pricing and timing of new listings in 2000. This is a major step for CSRC to depart from its original role of mobilizing financing for SOEs and diversifying their ownership. However, in practice there continues to be a bias in favor of listing large-scale SOEs as a way of reforming the state-owned sector. Other obstacles cited by foreign investors include (i) high capital requirements to obtain listings; (ii) inability of foreign investors to obtain foreign currency upon the sales of their shares on the Exchanges; and (iii) the difficulty that companies face in carrying out share buybacks. Some experts have pointed out that inconsistencies in the Provisional Regulation on Establishing Foreign-Invested Venture Capital Investment Enterprises (adopted in August 2001) and existing laws, such as the Company Law, and Article 30 of the Provisional Regulation, which provides that state bodies will be the agencies responsible for the Regulation's interpretation, could lead to possible inconsistencies if different interpretations are presented by each ministry (China International Business 2002).

New Rules on Administration of Foreign Invested Venture Capital Enterprises were published on 8 February 2003. These rules require additional disclosure about fund organization and control of the investment process and impose international standards in the operation of PRC private equity funds (China Law and Practice 2003c).

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[74] Article 2 of the PRC Partnership Enterprise Law provides that the name of a partnership cannot contain the words "limited" or "unlimited," and Article 8 states that all partners shall bear unlimited liability.

4. Leasing

Leasing plays a role as alternative financing vehicle for SMEs in many emerging markets.[75] With an appropriate legal and regulatory framework in place, leasing can play a significant role in developing the SME sector.

Several factors have contributed to the development of the leasing industry in emerging markets. First, because leasing companies focus on the lessee's ability to generate cash flow for the lease payment, rather than relying on credit history, assets or capital base, a new SME can access lease financing more easily than bank loans. Also, leasing contracts can be structured more flexibly than bank loans to meet the cash flow needs of the lessee. Second, leasing has fewer formal requirements and therefore speedy processing is possible. Third, if properly regulated, SMEs can benefit from tax incentives. In many countries lessees can offset their full lease payments against income before tax, compared with just the interest on bank loans. Fourth, leasing can have a developmental impact by enabling new small companies to access financing for investment and for industries and enterprises to introduce new concepts such as cash flow-based credit analysis. Repossession is also a significant benefit of leasing. Repossession is easier than foreclosure and makes the lessor less dependent on the judicial system for restitution.

In the PRC, JV finance leasing companies had lackluster performances during the 1980s. Many JV leasing ventures turned into costly failures. The resulting bad debt write-offs reached about $800 million (Harner 2000). The performance of domestic leasing firms was even worse. In addition to the problem of rent arrears, the PRC has no leasing law, accounting standards are unclear, appropriate tax incentives are not in place, and funding is an ongoing concern.

PBOC announced the Rules for the Management of Finance Leasing Companies in July 2000 to revive the leasing industry. The new rules encourage FDI to bring in foreign leasing expertise as technical partners for JVs and also allow leasing companies to invest in marketable securities, make working capital loans to lessees, and invest in shares of financial institutions. The latter implies that foreign invested leasing companies could become specialized financing units within bank groups, and be included under financial holding companies or within group finance companies.

In September 2001, MOFTEC issued regulations for foreign-invested leasing companies. These new regulations require all foreign-funded leasing concerns to be organized as limited liability companies and classified as financial leasing or nonfinancial leasing companies. A financial leasing company is required to have a minimum registered capital of $20 million, no less than 20% of which must be contributed by a PRC partner. For nonfinancial leasing firms, the minimum amount of registered capital is $5 million, 20% of which should come from its PRC founder.

As of end–2002, there were 42 JV leasing companies, 15 domestic financial leasing companies, and some 300 nonbank financial institutions that were exclusively or partially engaged in leasing (Economist Intelligence Unit 2003). Some foreign JVs involved in leasing include China International Leasing (owned jointly by Japan's Mitsui Bussan and China Investment Bank), China Universal Leasing (co-owned by Bank of China's Orient Trust and Investment Corporation, Japan Sanwa Bank, and Germany's Dresdner Bank), and China International Non-Ferrous Metals Leasing (a JV between Industrial and Commercial Bank of China [ICBC] and several European banks).

[75] The benefits from the perspective of the lessee, leasing companies, and the Government are discussed in IFC 1996a.

5. Insurance

a. Background

In 1984, the State Council separated the state–run People's Insurance Company of China (PICC) from PBOC. From 1984 to 1998, PBOC permitted the establishment of more than 10 domestic insurance companies. In 1996, PICC was restructured into three independent insurance companies (China Life Insurance, China Property Insurance, and China Reinsurance Corp.). In 1996, foreign insurance companies were invited to assist the PRC develop the domestic insurance market by training local staff, hosting symposiums, supporting insurance education, and investing (Korner 2002).

As of 2001, 35 insurance companies were in operation, 21 of which were foreign invested insurance companies. Although there were more than 200 representative offices of foreign insurers in the PRC, such offices were not permitted to conduct business. Due to limitations on branches, along with geographical restrictions especially for foreign companies, the nonlife insurance market remained dominated by PICC (78%), followed by China Pacific (11%), Ping An (8%), and Hua Tai (1%); and the life insurance sector by China Life (70%), Ping An (Life) (20%), China Pacific (Life) (7.6%), and New China Life (1.2%).

In 2002, the three largest life insurers, China Life, Ping An, and CPIC, continued to dominate with a market share of 91.1%, down slightly from 95.2% in 2001 (Table 20). In the property segment, the top three insurers (PICC, CPIC Property, and Ping An [Property]) control a combined share of 94.8%, compared with 96.2% in 2001. The combined share of foreign and JV companies is now estimated at just 2% but is expected to grow dramatically in the years ahead, given PRC's WTO accession (Section IV.A.7. Impact of WTO Accession on the Financial Sector).

Table 20: Top Five Insurance Companies Ranked by Premium Income in 2001
(CNY billion)

Company	Premium Income	Growth %	Market Share %
Life Insurance			
China Life	81.2	26.7	57.0
Ping An	40.1	82.9	28.2
CPIC Life	14.3	82.3	10.0
New China Life	2.3	56.3	1.6
Tai Kang Life	1.7	141.2	1.2
Subtotal (Top 1-5)	**139.6**	**–**	**98.0**
Top 6-10	2.5	–	1.8
Others	0.3	–	0.2
Total Market	**142.4**	**45.1**	**100.0**
Property Insurance			
PICC	50.9	7.8	74.0
CPIC Property	8.6	25.0	12.5
Ping An (Property)	6.7	40.3	9.7
Hutai Insurance	0.6	33.1	0.9
Tianan Insurance	0.4	50.0	0.6
Subtotal (Top 1-5)	67.2	–	97.7
Top 6-10	1.4	–	2.0
Others	0.2	–	0.3
Total Market	68.8	12.8	100.0

– = Data not available.

Source: China Insurance Regulatory Commission.

As reflected in Table 21, insurance premiums rose 44.7% in 2002 to CNY305.3 billion ($36.88 billion). Life insurance premiums grew by 59.8% to CNY227.5 billion ($27.48 billion), while nonlife insurance grew by 13.6% to CNY77.8 billion ($9.4 billion).

Table 21: The PRC Insurance Market: Total Premium Paid
(CNY billion)

Item	1996	1997	1998	1999	2000	2001	2002
Life Insurance (share %)	32.5 (42)	60.2 (55)	74.8 (60)	86.4 (62)	99.8 (63)	142.4 (68)	227.5 (75)
Growth Rate (%)	—	85	24	16	16	43	60
Nonlife Insurance (share %)	45.2 (58)	48.6 (45)	50.0 (40)	52.4 (38)	59.8 (37)	68.5 (32)	77.8 (25)
Growth Rate (%)	—	8	3	5	14	15	14
Total	77.7 (100)	108.8 (100)	124.8 (100)	138.8 (100)	159.6 (100)	210.9 (100)	305.3 (100)
Growth Rate (%)	31	40	15	11	15	32	45

Sources: China Insurance Regulatory Commission, S.M. Harner and Company; *China Statistical Yearbook 2002*; http://www.stats.gov.cn

Actuarial services are developing but have a long way to go before they are equivalent to the services provided in more developed markets. Reinsurance arrangements in the PRC are not well developed nor well understood. As a result, there is only one domestic reinsurance company in the PRC, China Reinsurance Corporation.

The agreements on accession to the WTO signed in 1999 and 2000 with the US and the EU represent significant progress and have had a significant impact on market entry by foreign insurers (Box 3 and Section IV.A.7. Impact of WTO Accession on the Financial Sector). By December 2002, 33 foreign insurers including 20 JVs and 13 branches of foreign firms had been approved to operate in the PRC. CIRC approved the bid by Italy's largest insurance company, Assicurazioni Generali, and China Petroleum Finance Company, a subsidiary of China National Petroleum Corporation, to establish a 50-50 JV Generali China Life Insurance with an initial capital of about $25 million and a sales force of 500 agents (People's Daily 2003). This was the first JV that was granted an operating license after the PRC's WTO accession. In January 2003, Aon Corporation, a Chicago-based insurance company, received the first full license to operate an insurance brokerage business in the PRC. GAB Robins Group also received CIRC approval to establish a wholly foreign-owned insurance appraisal company in Shanghai (People's Daily 2003).

b. Regulatory Framework

Although the insurance industry began to develop in 1984, there was no legal framework until 1985 when the State Council issued the Provisional Stipulations of Insurance Enterprise Administration. In 1995, the Insurance Law of China was adopted. This Law reflects international standards of regulation, attempts to clarify the basic principles of insurance contracts, draws a line between social and commercial insurance, establishes the principles of minimum protection for an insured person, and defines the legal status of insurance brokers.

In February 2002, the Administrative Regulations for Foreign Invested Insurance Companies were adopted to clarify qualification requirements for foreign insurers wishing to do business in the PRC. These include at least 30 years experience abroad, operation of a representative office inside the PRC for at least 2 years, and total assets of more than $5 billion at the end of the year prior to application. These regulations include a minimum capital requirement of CNY200 million ($24.16 million) applicable to foreign-owned insurers, JV insurers, and branches of foreign insurers with headquarters overseas.

The Insurance Law was amended in October 2002 to ensure a level playing field for foreign, domestic, and JV insurance companies. The amended law, which took effect in January 2003, includes provisions that broaden the scope of insurance businesses, introduce more product designs, and promote competition.

The CIRC oversees regulation of the insurance market. The CIRC was established in 1998 out of the regulatory apparatus of PBOC and is staffed mainly with ex-PICC employees. By 2000, CIRC had established branches in more than 30 provinces, regions, and municipalities (Allison 2001). ADB provided TA to CIRC to help prepare regulations and policies covering the regulation, organization, operation, and market behavior of insurance companies and the management of insurance intermediaries (ADB 2002f). The TA also helped CIRC address issues related to WTO entry and eventual liberalization of the insurance sector.

6. Informal Sector–Microfinance[76]

a. Background

Inadequate credit to farmers and the agriculture sector has been a major problem in the PRC. Approximately 70% of the population of the PRC lives in the countryside and most commercial banks have closed down their rural branches. Rotational savings and credit associations, otherwise known as rural credit foundations (h*ui's*), developed rapidly in the 1980s to meet demands for credit in rural areas. Their loan portfolios were more than four times that of the formal financial sector in 1998, just before PBOC ordered them to close or merge with RCCs for financial prudence. Their members were farmers and small businessmen who were willing to pay interest rates that were two to three times the official interest rate.

Currently, only RCCs operate in rural areas and have been estimated by some to have NPLs as high as 60%. To enhance the quality of lending and reduce the number of NPLs, RCCs began to apply strict credit quality control systems that required loans to be collateralized. However, since the housing of farmers cannot be used as collateral, it was difficult for farmers to obtain credit from RCCs.

With the support of international financial institutions, more than 300 microcredit pilot projects have been implemented in the PRC to help convince PBOC that farmers can maintain good credit without collateral if appropriate mechanisms are applied. However, a majority of these projects have been implemented under a flawed environment with three fundamental issues influencing their sustainability. First, the vast majority of microfinance projects have no proper legal status. Other than the few that are operated through formal financial institutions (the Agricultural Bank of China [ABC] and RCCs), microfinance schemes are illegal, but tolerated by the Government because of the possible utility of these projects in poverty reduction. In the absence of a legal basis for microfinance, these projects are subject to changes in government policy and sudden closure of operations. Second, there is no liberalized interest rate regime in which microfinance projects can operate on a sustainable basis, charging interest rates based on expected costs.[77] Third, microfinance pilot projects for the most part are exclusively microcredit, which limits their ability to grow and proliferate.

Problems have also been experienced with RCCs that have been mandated by the State Council to allocate more than half of their credit to farmers. In practice, this has proven to be difficult to realize because nonfinancial transaction costs for farmers are high and RCCs prefer to make larger loans to better-off farmers and enterprises. Other issues include weak management in terms of internal policies, procedures, systems and corporate culture, and the use of joint liability groups for production lending to relatively better-off farmers, not necessarily for the poor, the intended target for microfinance.

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[76] This section is based on the ADB. 2000. *Technical Assistance to the PRC for a Study on Ways to Support Rural Poverty Reduction Projects*. Manila.

[77] See discussion in Section IV.A.1.c. Regulation of Interest Rates (China Daily 2002).

Although legally allowed to conduct microfinance operations, ABC has not proven to be effective in microfinance delivery. Due to its historical involvement in the Government's subsidized lending program for poverty reduction (except for the period 1995–1998 when such functions were transferred to the Agricultural Development Bank of China), ABC has been characterized by a lack of autonomy and poor credit discipline in its microcredit loan portfolio. As commercial orientation has been emphasized in banking sector reforms, ABC management and staff are reluctant to lend to the rural poor since microcredit is not viewed as a viable commercial business and ABC is undergoing a transformation into a regular commercial bank.

Since May 2001, PBOC has conducted a pilot project on microcredit implemented by RCCs in Wuyuan county, Jiangxi Province. By end-June 2002, more than CNY220 million ($27 million) was lent to 40,750 households (60% of farmers). The loan recovery rate was as high as 95%. The interest rate charged by the microcredit program is about 30% higher than the lending rate set by PBOC. RCCs that do not have enough money to run the microcredit program can receive funds from the PBOC window. Many provinces in the PRC are implementing such programs. The medium- to long-term objective of these programs is to reach 60% of farmers or about 110 million rural households. By end–June 2002, more than 55 million households (30% of farmers) received a microcredit loan and the total microcredit lending reached CNY70 billion ($8.4 billion).

These pilot microfinance schemes have demonstrated the relevance and viability of microfinance in the PRC and their effectiveness in reaching the poorest of the poor. However, these projects need to be provided with a legal status to be able to deliver services more effectively and sustainably. The PRC needs to decide how to implement the lessons learned from its experience of using microfinance in its poverty reduction program, particularly during the last 5 years. Institutional and policy barriers to development, identified above, need to be addressed.

7. Impact of WTO Accession on the Financial Sector

WTO commitments in the financial sector, especially those in the banking and insurance sectors, will place significant competitive pressures on domestic enterprises. Under the WTO schedule (Box 3), the PRC banking sector is gradually opening up to foreign participants. Foreign banks will be allowed to offer business in local currency to local corporate clients within 2 years after WTO accession and conduct full domestic currency operations 5 years after accession. Foreign banks may also gradually expand the number of cities where they can conduct local currency business. New licenses should be granted to foreign banks based on prudential criteria, with no limits on the number of licenses or other restrictions like economic needs tests.

Domestic banks have a 5-year adjustment period to meet WTO challenges. This requires accelerating reforms to restructure SOCBs to align reward and incentive systems for commercial management, improve corporate governance, intensify efforts to tackle NPLs, strengthen private commercial banks to support the nonstate sector, particularly SMEs, and create a conducive legal and enabling environment[78] (Appendix 8 has a more in-depth analysis on the projected impact of WTO accession on this sector).

The PRC's WTO commitments in the capital markets sector are more limited. They allow the establishment of JV fund management firms on accession to WTO. The foreign party may initially own 33% of the JV, which may rise to 49% 3 years after accession. JVs may manage domestic funds. JV securities companies may also be established. However, foreign party ownership is also limited to 33% of such companies. The agreement does not state how many licenses will be granted, a timetable of when these licenses will be granted, or make the application process transparent (Green and Wall 2000).

[78] ADB is providing technical assistance to help PBOC develop a forward-looking and comprehensive legal framework for the banking sector (ADB 2002i).

The PRC's WTO commitments in the insurance sector are broad and significant. Under the WTO schedule, foreign players will be allowed to expand into group, health, and pension lines of insurance within 5 years for the US and 2 years for the EU. Geographical limitations will be limited. As of December 2001, nonlife companies are allowed to provide master policies (if headquarters of the insured are located within the insured's licensed city) and large-scale risks without geographic restrictions. Foreign life insurance providers are limited to no more than 50% equity but can sell group products and pension products 3 years after accession. Foreign insurance brokers are allowed to form JVs now and transition to wholly owned operations by December 2006. The PRC has also agreed to award licenses solely based on prudential criteria, with no economic needs test or quantifiable limits on the number of licenses issued.

B. Infrastructure

1. General

Private sector financing for infrastructure reduces the fiscal burden on the Government, lowers the costs of providing infrastructure services by introducing competition and providing market-based incentives to encourage efficiency improvements, and helps better allocate and mitigate investment risks between the public and private sectors. The private sector brings capital, managerial expertise, and technological innovation, and thus facilitates improved infrastructure and capital market development.

Although enormous investments were channeled into infrastructure over the past 2 decades, only in the late 1980s and early 1990s did the Government begin to allow private investment. In the early 1990s, private sector infrastructure financing reached 12% of the total annual investment. However, from 1990 to 2000, investments in private infrastructure projects totaled $44 billion, accounting for less than 10% of the total annual investment.

Foreign investors tend to shy away from infrastructure projects because they find themselves negotiating with both the Central Government and the provinces and the procedures are inconsistent from one to the next (World Bank 2001c). Investors do not receive assurances on performance obligations from their PRC counterparts and are deterred by the PRC's underdeveloped legal and regulatory system, although many of these issues are being resolved and legal and regulatory frameworks are being developed. Notwithstanding these concerns, recent pricing reform, especially for utilities, has made power investments more attractive. New financing techniques have become available, often offered in conjunction with multilateral financial institutions.

So far there have only been a few competitively bid build-operate-transfer (BOT) projects that were financed on a limited recourse basis and involved no financial guarantees from either central or local governments. Under these concessional projects, the Government, as granting authority, grants rights and responsibilities of operating a public service to a private company. The BOT Chengdu Water Project is among the most prominent concessional and pilot BOT project, following BOT Circular (1995) and has been closely monitored by SDPC. This project was the first BOT water supply project awarded through competitive bidding in the PRC and was developed with ADB assistance (Box 10). One of the results is that water tariffs are lower than tariffs from publicly owned water supply companies in Chengdu. The project mobilized more than $100 million without any fiscal support from either the central or local governments.

This project shows that the private sector can provide quality infrastructure services efficiently. With experience and continued improvements in the legal and policy framework, the PRC can and should take advantage of private sector participation in infrastructure financing. If conditions are right, the private sector can help overcome infrastructure bottlenecks in the Western Region.

Box 10:

Chengdu Generale des Eaux-Marubeni (Chengdu Water Supply Project)—1999

The Chengdu Water Supply Project was designed to provide bulk supply of treated water to the capital city of Sichuan Province in the People's Republic of China (PRC) under an 18-year build-operate-transfer (BOT) contract. Chengdu is the second largest city in the southwestern part of the PRC and classified by the PRC Government as having serious water shortages. The Project involved the construction of a water treatment plant with a capacity of 400,000 cubic meters per day, two water intakes, and a 27-kilometer transmission pipeline to the city. The project sponsor is a consortium of Vivendi from France and Marubeni Corporation from Japan.

The Project was developed with the assistance of the Asian Development Bank (ADB). As the first BOT water supply project in the PRC, it would serve as a model for similar projects in other parts of the PRC. Through technical assistance support to the Chengdu Municipal Government, ADB helped ensure that the basic elements of transparent bidding were observed, the lowest feasible tariff was obtained, and that project fundamentals, such as tariff increases to enable cost recovery, were in place. The Project demonstrated that the BOT structure could be used at the municipal level and funded externally without any central government guarantee.

ADB was instrumental in structuring the finance for the Project, estimated to cost $106.5 million. In addition to its own direct loan of $26.5 million, ADB helped secure debt funding commitments from seven commercial banks under ADB's Complementary Financing Scheme ($21.5 million) and under a guarantee facility from the European Investment Bank ($26.5 million).

Following approval by ADB and financial closing, the Project won four awards for excellence in project finance in 1999 from four internationally recognized financial publications. The London-based *Project Finance International* cited the Project as the "Infrastructure Deal of the Year," while both the Hong Kong, China-based Financial Intelligence Agency and the *International Financial Law Review* voted it as the "Project Finance Deal of the Year." The awards were given in recognition of the Project's innovative and superior financing structure that allowed international lenders to take long-term municipal risk in the PRC for the first time.

a. Legal and Regulatory Framework for Private Participation in Infrastructure

Although the PRC has made substantial progress in issuing a series of laws, regulations, notices, and circulars governing the legal framework (the Bidding Law, unified Contract Law, Project Finance Measures, and the BOT Circular) for private participation in infrastructure (PPI), work still needs to be done in this area.

Relevant regulations, notices, circulars, and implementing rules are issued by agencies at both the central and local levels. Many important and routine decisions are left to administrative authorities, often with inconsistent results. For instance, ADB conducted studies on the three main regulations granting operating rights for toll roads and identified inconsistencies and contradictions.[79]

The BOT Circular of 1995, which clarified some unanswered issues concerning PPI under previous laws, such as concession terms, granting authorities, convertibility of foreign currencies and procurement, was considered a major breakthrough. The Circular was drafted as a limited experiment and requires further refinement. Despite potential benefits, it is uncertain whether the

[79] The three main regulations granting operating rights for toll roads are (i) the Highway Law issued by NPC, (ii) the Notice of Strengthening the Administration of Transfer of Infrastructure Assets issued by SDPC, and (iii) Measures of Transfer of Operating Right of Highway with Compensation issued by the Ministry of Construction.

Government will promote BOT types of projects as a major means of attracting private capital in the future based on the availability of other funding options.

The World Bank's recent report on PPI outlined possible directions that the PRC can take, including (i) tightening existing laws and procedures without passing specific legislation on PPI; (ii) codifying the BOT Circular into law; and (iii) adopting a new framework law covering a broad range of models for PPI. The framework law is recommended as the most effective way to proceed. The proposed framework law should

(i) establish a legal framework specifically for projects involving PPI and, with respect to existing requirements that might apply and new requirements as they are adopted, clarify which requirements take precedence when there is a conflict;
(ii) apply to all projects involving PPI and cover concessions, management and leasing contracts, BOT, and so on;
(iii) emphasize the development and protection of basic contract rights for projects involving PPI;
(iv) provide flexibility so that project terms are left for negotiation between the granting authority and the investors (i.e., the BOT Circular prohibits domestic financial and nonfinancial institutions from providing any guarantees for project financing);
(v) refer to model contracts to facilitate implementation, without obliging parties to use those contract terms;
(vi) grandfather all existing projects to provide protection and certainty to existing investors; and
(vii) be consistent with sector laws.

The approval process for PPI projects is cumbersome. According to the World Bank report, the official review and approval process for an infrastructure project generally has three stages: (i) project approval stage, (ii) project company approval stage, and (iii) operational approval stage. A basic project approval process for pilot BOT projects requires 8 approvals from various agencies, with each step further requiring smaller approvals, consultations, and filings with various agencies. For non-BOT projects or projects initiated by local governments, the approval process is more complex, requiring 12 approvals from various agencies, both central and local. The next step is to establish a project company that could require 18 additional approvals, followed by more than 10 other approvals at the stage of operational approvals. In total, an infrastructure project could require about 40 different approvals. The approval process continues even after the project starts, through site inspections from numerous local government agencies. International experience shows that cumbersome current approval processes can be streamlined by adopting "one-stop approval shops" under which all relevant approvals can be handled.

Capacity building of local governments is essential for successfully formulating BOT projects. Increasing PPI has put pressure on local governments to strengthen their capacity as granting authorities (World Bank 2001c). Due to the tender approach taken for BOT projects, local governments are required to do a substantial amount of preparatory work, including preparation of bidding documents, as opposed to the JV approach in which local governments can rely on foreign partners for most of the time-consuming task of formulating the project. Given the successful BOT Water Project in Chengdu (Box 10), ADB should provide further assistance to the Central Government to establish a mechanism and ways to disseminate best practice to other local governments.

2. Transport—Road and Highways[80]

In the past 5 years, the PRC has invested close to $242 billion on infrastructure projects, including 25,500 kilometers (km) of highway, of which 8,000 km are expressways. Another 4,000 km of trunk rail lines were built and 3,000 km of track were either rehabilitated, double tracked or electrified (China Daily 2002l).

Of the total investment, approximately $62 billion has been raised through treasury bonds while the rest has come from public coffers, funding agencies, private investors, and user charges. However, the share of private capital is still very small. According to the World Bank, the share of private capital investment in the road sector between 1990 and 2000 accounted for about 10%, 80% of which was invested in the coastal provinces. None of these investments involved "greenfield" (start-up) projects with higher risks than "brownfield" (expansion or rehabilitation) projects.

The planned investment in the road sector is expected to increase road assets by a further 150,000 km over the next 5 years at a cost of about $115 billion. This includes several thousand kms of high-capacity roads and expressways that form the National Trunk Highway System (NTHS), costing approximately $34 billion. Revenue from user charges on the NTHS will likely cover less than half the cost. Hence there is a need to mobilize nongovernment sources of funding to supplement public sources. A major portion of the planned investment over the next 5 years will be in the western provinces for development roads and class 1 and class 2 roads. Many of these will not be suitable for private sector financing.

Modest private participation in the road sector in the past reflects several factors: (i) the nascent development of the domestic capital market; (ii) unclear government policy on public and private financing; (iii) evolving legal and regulatory environment; (iv) lack of transparency in the approval process; (v) weak contract enforceability; and (vi) defaults on loans and bonds.

There are several models for PPI: (i) cooperative JVs, (ii) securitization, (iii) domestic bond market, and (iv) commercial loans from PRC banks. Transforming the road sector into public-private partnerships requires a more aggressive introduction of corporatization, leasing/ concessioning, and securitization (ADB 1997c). There are no BOT schemes for highway projects involving foreign investors.

Corporatization is relatively well-established in the PRC. However, the following key issues need to be carefully addressed in the corporatization process: (i) the necessity of the Provincial Communications Department (PCD)'s authorization to support the establishment of a new share limited company, while obtaining its agreement to reduced shareholding in the new company; (ii) scope of the corporatization; (iii) the need to identify five founders of a new share limited company in an innovative way (as opposed to PCD/Ministry of Construction as a single shareholder of the expressway corporation); and (iv) structuring an optimum debt/equity ratio of the new company.

Leasing is a special case of concessioning in the Leasing of Assets, also known as the Transfer of Operating Rights in the PRC. While leasing has occurred mainly through JVs, the concept of competitive leasing or concessioning is virtually precluded by the approval process, which requires that the corporate structure and details of the lease be fixed before approval for the lease is given by higher authorities. As a result, the concept of competitive leasing or concessioning has not yet been used in the PRC. Major issues include (i) how to ensure fairness in the valuation of land and resettlement of existing residents (up to 20% of the shares may be allocated against the value of the land and resettlement costs); (ii) how to secure and process the land use certificate under prevailing circumstances in which obtaining the land use certificate takes more than 2 years and many road projects are implemented under a permit for use of the land only; and (iii) how to effectively and accurately manage demand.

Securitization is popular in the PRC as a funding modality for toll roads, although listing requirements, such as 3-year profitable operations prior to listing, remain hurdles for further use of securitization.

[80] This section is based on an ADB staff report and ADB 1997c.

Privatization of roads and highways is not progressing rapidly. A number of PCDs have established separate, but 100% owned, provincial expressway companies to carry out specific highway projects under preferential treatment. Under WTO rules, such preferential treatment will need to change to an arm's-length relationship with open and competitive bidding for concessions or operating rights. If the private sector, particularly the international private sector, is to invest in these companies, they will need to be restructured so that their autonomy from the Government is evident and their internal operations and decision making becomes accountable to all owners, not just PCD.

Another issue is the absence of a coherent set of rules and standards to guide the process. For example, a detailed set of regulations setting standards has not been adopted under the amended Highway Law. In addition, both the Ministry of Construction and SDPC have issued inconsistent administrative orders and notices that impact on forming private-public partnerships.

3. Transport—Railway

The 68,000 route-km railway system in the PRC comprises 58,000 route-km of the state-owned national railway and 10,000 route-km of local railways. The 1990 Railway Law provides the framework for regulating and operating railways in the PRC. As the PRC moves toward a more dynamic, decentralized, and market-driven economy, and in the light of increasing competition from the expanding road network, structural reforms touching all aspects of railway operation and management are being implemented to modernize and improve the efficiency of the railway system. Important reform efforts include the introduction of (i) the productivity contract system in 1986; (ii) the assets operation liability system for the national railway in 1999; (iii) the management contracts system in 1999; (iv) a new commodity-based freight tariff structure and additional charges for freight loading and unloading; and (v) various restructuring measures to improve productivity and reduce operating losses after 1999. Due in part to these reform efforts, unit revenues from both freight and passenger services increased more than unit operating costs, which improved the financial performance of the national railway.

Challenges still remain. The lack of railway capacity to meet the increasing demand for transportation services is constraining economic growth. The Government's plan for railway development gives priority to (i) expanding the railway network by constructing new railway lines to provide economic transportation and catalyze growth in poor inland regions; (ii) encouraging the construction of JV railways to develop local economies; (iii) improving the efficiency of the existing system by using new technology and modern management tools; (iv) increasing cost recovery by commercializing services and adopting appropriate pricing policies; and (v) encouraging nongovernment investment in infrastructure and related services.

The Tenth Five-Year Plan envisages (i) constructing 6,000 km of new lines to provide access to unserved areas with the network length reaching a total of 74,000 route-km; (ii) providing 3,000 km of double lines and electrification of 5,000 km of key lines to increase capacity; and (iii) increasing operating speeds on 5,000 km with the total length of such lines reaching 15,000 km. The total outlay for the Plan will be CNY350 billion ($42.27 billion) for railway development, consisting of CNY270 billion ($32.61 billion) for capital construction, and CNY80 billion ($9.66 billion) for rolling stock. About one third of this investment will be internally generated. The remaining investment will be arranged from domestic markets and foreign sources. The Ministry of Railways (MOR) is channeling 30% of its funds for railway construction into the western regions to spur economic development. The total length of railways in the western region will reach 27,500 km by 2005, accounting for 37% of the country's total length of railways open to traffic, up from 23,700 km (35% of the national total) in 2000. Total investment is expected to amount to CNY127 billion ($15.3 million) for 2001–2005 to connect provinces, municipalities, and autonomous regions in the western region with the eastern part of the country.

The PRC's entry to WTO has opened up railway transport services to foreign investors and operators. MOR is no longer a monopoly. Reforms in the railway sector include further implementation of the asset management responsibility system, separation of the accounting of freight transport and railway network operations, and acceleration of the restructuring of non-transportation enterprises. The sector is currently taking measures to attract more foreign capital into railway construction and is making use of foreign loans. The railway freight transport market has been opened by allowing foreign investors to establish JVs. MOR will grant more independent decision-making power to railway bureaus, including the power to examine and approve enterprise investment. Efforts are being made to review projects for administrative approval, revise outdated rules and regulations, and reduce administrative interference in enterprises. The 14 railway bureaus will complete the grouping of internal passenger transport companies next year.

A wider role for the private sector is envisaged in the railway sector through investments in railway project facilities and services from nongovernment and private sector sources, such as construction of industrial sidings, tourism, and containers and luggage-related businesses. An enabling environment conducive to such investments is needed.

ADB has supported commercialization of railway operations with full cost recovery to ensure financial sustainability. In 1996, ADB supported the Guan-Shen Railway Company—the first PRC railway entity to raise $510 billion in international markets through an IPO. ADB continues to assist the commercialization process, particularly in tariff setting to ensure full cost recovery, strengthened marketing, and improved services.

4. Water and Sanitation[81]

Private sector participation in the water supply industry is at an early stage of development. The major source of financing continues to be government equity and grants, supplemented by domestic loans and official development assistance. Between 1991 and 1997, local governments spent CNY50 billion ($6.08 billion) on water supply. The investment required for urban water supply is estimated to be more than CNY74 billion ($9 billion) between 2000 and 2004, a 48% increase over expenditures in the 1991–1997 period. To mobilize necessary domestic resources, the Government created a water resources fund financed mainly from two sources: (i) an allocation equivalent to 3% of national and provincial taxes on transport infrastructure; and (ii) an allocation of not less than 15% of taxes for urban infrastructure maintenance in cities with high flood risk. The Government is considering including in the water resources fund part of the taxes paid on fixed investments. The Government recognizes that because of large investments needed, greater efforts are required to mobilize private sector funding. In 1991, the Government adopted a policy to allow and encourage foreign investment in this sector and is experimenting with the BOT model.[82]

A key factor for success in developing a viable private sector participation package is to balance potential risks and rewards for private sector operators in a manner that is acceptable to the public sector. The Government's main objectives in promoting private sector participation in the PRC water sector are to (i) improve access to capital funds; (ii) gain access to advanced technology and equipment; (iii) introduce new approaches to management that will increase production efficiency and financial performance; (iv) upgrade the technical skills of water supply company (WSC) employees; and (v) create opportunities to reform water tariffs.

The objective of the private sector partner is a reasonable return on investment at an acceptable level of risk. The principal elements of risk for the private sector partner are (i) changes in the fiscal, legal, and regulatory regime; (ii) failure to achieve performance standards for construction or operations; and (iii) failure to realize revenue requirements due to factors such as low sales

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81 This section is based on an ADB staff report.

82 A construction agreement on the first urban water infrastructure project for Chengdu City, approved by the Government to investigate the use of foreign funds under the BOT scheme, was signed in July 1998, and was the result of ADB assistance in structuring and partially financing the project. Construction started in early 1999 and the plant began operations in 2002 (Box 10).

volumes, low tariffs, and exchange rate movements. Water tariffs have been low in the PRC, even lower than water production costs, and although tariffs increased by 18% per annum from 1986 to 1998, they are still not high enough to ensure the financial viability of water companies.

Tariff policies have a key role in managing risk when private sector participation is introduced. This is particularly true when a private sector partner assumes direct responsibility for the water tariff, but it is also the case when the municipal government and the WSC retain responsibility for tariffs. In either case, revenue risk is minimized if clear policies requiring tariffs that recover the full cost of the water supply exist, while establishing an independent and transparent regulatory process to safeguard the customer from excessive profit taking. Important policy milestones include (i) the Regulation on Management of Pricing of Urban Water Supply (1998) that was the first national guideline on water tariffs and includes the principle of full cost recovery through tariffs; and (ii) the Circular on Strengthening the Collection of Wastewater Treatment Tariffs that came into effect in 1999. The ability to attract private sector partners in the PRC water sector will depend on the future prospects for cost recovery, including a reasonable return on capital investment. ADB's two water tariff study TAs implemented over a 4-year period have contributed significantly to water tariff reforms in the PRC. Also, ADB's Chengdu Water Supply Project, the first internationally bid BOT water supply project in the PRC, contributed to the reform of the water sector (Box 10).

5. Power

The PRC is the world's second largest installed base of electric power generation capacity at over 300 gigawatts. Power generation is open to foreign investors. Over the past 2 decades, electricity demand grew by nearly 9% per annum, except from late 1997 to early 1999. The slower-than-expected growth in demand led to a series of contractual disputes between the off-takers and the independent power producers. A recent decline in FDI reflects the impact of disputes in this sector, the high liquidity of domestic banks that are very interested in lending for power generation projects, and current overcapacity in power generation.

Future demand should grow at an annual average rate of 5% over the next decade. Based on required demand, by 2010 capital cost for power generation will be $700 a kilowatt for a typical coal-fired power station.[83] The Government expects that 25–30% of the investment will be mobilized through private sector participation in power generation.

a. Independent Power Projects

The independent power generation sector has experienced mixed results over the past few years. About one third of all projects have proceeded without problems, another third have had minor delays or misunderstandings, and the remaining third remain at an impasse. The most serious cases involve abrupt project cancellations and changes in tariff rates following initial negotiation and signing of contracts which threatens the willingness of foreign companies to invest in, and commercial banks to provide, project financing in the PRC. It is usually the provincial and municipal governments that are deemed hindrances to this process. Corruption, uncertainty over prices, ambiguity over decision-making authority, fall in power demand in 1997, and ensuing government renegotiations of power purchase agreements (PPAs), have deterred investors. While excess supply of energy exists in some regions and inhibits the development of some independent power projects (IPPs), other regions have insufficient supply.

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[83] ADB staff estimate.

The source of many disputes over IPPs derives from contracts. The Government and foreign companies retain diverging views on the degree of sanctity of contracts. The Government sometimes appears to regard contracts only as a means of initiating a project before moving to a second stage of cooperation where the project commences and all variables are again negotiable. Investors and lenders reject this concept of a “flexible” contract. The contract is a further source of strain, especially in “take-or-pay contracts,” since the Government may not interpret the wording with the same level of rigidity as do sponsors and lenders.

Another lingering problem in the power sector is ambiguity over project planning authority. While the SDPC approves new plants, existing projects are under the authority of SETC and the State Power Corporation. Confidence in power planning has been further hampered by excessive revisions of energy planning that have contributed to oversupply where demand was overestimated.

In addition to contract and planning process problems, the larger issue of power deregulation is a crucial one currently facing independent power purchasers. The stage of deregulation in the PRC today makes negotiations especially sensitive. The transition from a contract-based determination of prices to market-based determination leaves room for uncertainty from both negotiating parties. When the US passed through this stage, it was necessary to buy out projects to terminate the corresponding PPAs. However, PRC authorities are unwilling to pay such transition costs. Uncertainty also arises with regard to what level electricity tariffs will be set at. Ambiguity on what tariff rate power producers will face in both the near and long term is not conducive to a climate that encourages private investment.

Plans to standardize electricity tariffs for relevant government bodies have been adopted by SDPC. Further assurances to investors that such guidelines will be honored would help allay investor apprehensions. The separation between generation and transmission assets remains ambiguous in many provinces. Completion of electricity sector restructuring would reduce uncertainty over grid access, ensure a shift away from the monopolistic structure toward competition, and help reduce uncertainty and restore investor confidence. The announcement of the Power Sector Restructuring Plan in 2002 (PSRP), discussed below, is a major step in the right direction.

While some companies may cite negotiating difficulties as exclusive justification for leaving the PRC power sector, their choices are directly linked to other international market forces and strategic business decisions. Specifically, with the market for power strengthening in both the US and Europe, the market in the PRC becomes relatively less attractive, especially given the aforementioned complicating factors for IPPs.

With the PRC having achieved parity in power demand supply, the availability of cheaper domestic funds and concerns among sponsors and lenders about the enforceability of contracts on which project finance decisions are based, FDI in the power generation sector could slow. However, there are areas where large investments are required such as in high voltage transmission and city distribution modernization schemes. There are no foreign investments in these areas.

Foreign investors will need to monitor developments that arise from the introduction of competitive power markets. Six pilot areas[84] have been selected for separating generation from transmission and introducing an embryonic form of a power market by the end of 2000. A full power market system, including retail competition, is to be developed by 2010. Although there has been some delay in the implementation plan, future foreign investors will need to participate as investors in merchant plants and sell power in a competitive market. Most likely there will no longer be any plant set up on the basis of selling power on a take-or-pay contract with agreed tariff levels. BOT projects may not be the most appropriate for channeling future private investments in power generation.

[84] Shandong, Zhejiang, the northeastern region provinces of Heilongjiang, Jilin and Liaoning, and Shanghai Municipality.

Foreign investors believe that the following further improvements are required in the reform process:

(i) a clear statement on the future of existing take-or-pay PPAs and clarification on the status of existing contracts (will they be honored or bought out?);
(ii) separation of the operation and ownership of the transmission and distribution system from generation assets to remove conflicts of interest and guarantee fair access to dispatch and transmission functions;
(iii) legal support for fair access to the transmission and distribution network for all generation companies;
(iv) foreign investor access to the transmission and distribution network; and
(v) access to local capital markets.

b. Power Sector Restructuring Plan

On 9 January 2002, the State Council passed the PSRP, which was drafted by SDPC and discussed extensively among government agencies, key economists, and other experts in the PRC. ADB supported the development of this plan. Among the key issues debated in the process of drafting the PSRP was whether or not an integrated nationwide transmission network should remain after restructuring. The PSRP is known as the "1 plus 6" plan, which suggests that the current transmission operations be restructured as one "new" state power grid corporation plus six other regional power grid corporations. Previous plans including "0 plus 4", "1 plus X," and "0 plus 6" were also considered. Key elements of the proposed PSRP and related implementation issues include the following.

Transmission. The PSRP recommends that the State Power Corporation be dismantled both horizontally and vertically. A State Power Grid Corporation (SPGC) will be responsible for interregional transmission lines and construction and operation of the Three Gorges Transmission networks for a short period. Five regional power grid corporations, namely, (i) North (including Shandong); (ii) Northeast (including Inner Mongolia); (iii) Northwest; (iv) Central (including Sichuan and Chongqing); (v) East (inclusive of Fujian Province); and (vi) South (consisting of Yunnan, Guizhou, Guangdong and Hainan Provinces) will be legally independent from SPGC and from each other. However, SPGC may be a shareholder of the five regional power grid corporations. The PSRP also suggests that the Northwest and North PRC, as well as Central PRC and East PRC, be merged in the future to realize the nationwide power grid interconnection by four regional power grids.

Some experts believe that the five regional power grid corporations should be subsidiaries of SPGC to ensure an integrated power network across the country. There is some debate whether the State Power Corporation should take a majority share in SPGC to ensure that the thermal power supply is supplemented during the dry season in the southern areas of the PRC and surplus power in Fujian Province can be transmitted to Guangdong when there is a shortage of electricity.

Generation. The PSRP suggests restructuring state-owned power generation assets. According to the Plan, SPGC would hold the total generation capacity, except 20%, as a peak-regulating tool and four to five generation companies will manage remaining generation capacity to ensure that the market share of each generation company does not exceed 20%. Each generation company would have about 40 gigawatts (GW) of generating capacity. The existing Huaneng Group Corporation would also be restructured as an IPP.

There are tremendous challenges in restructuring the generation subsector, given the complexity of the ownership structure of existing power plants. Some power plants are old without any loan repayment obligations, and others are new with long-term liabilities, PPAs, and much higher tariffs. There will also be long negotiations between the provinces and the Central Government to determine the ownership of equity in many plants (Section II.A.3. Ambiguous Private Property Rights). Possible power generation giants include Huaneng International, Datang Generation Company, Shandong Power International, Guohua Generation, and State Power Generation.

Distribution. There would be no change in the distribution subsector. Power grid companies will manage the distribution operations.

Formulating a New Tariff-setting Mechanism. The PSRP shed little light on a new tariff-setting mechanism, market incentives to promote environmental protection, and ways to resolve existing long-term PPA issues. Many questions regarding the future power market framework, energy efficiency, and conservation remain unanswered.

Establishing a State Electricity Regulating Commission. A new commission, which will report directly to the State Council, will be established to implement the PSRP.[85] The Plan suggests that SPGC and regional power grid corporations be established within 1 year. Electricity trading centers will also be set up for regional power grids and all power generation companies will compete to sell electricity to the grids.

Refining the Regulatory and Legal Framework. This will include (i) revising the current Electricity Law and related sector regulations; (ii) formulating regulations on environmental protection; and (iii) implementing these regulations in conjunction with the competition scheme for power selling.

Implementation Timetable. The PSRP was approved by the State Council in January 2002, but is still awaiting formal issuance. The Plan suggests that it should be substantially implemented within 1 year.

C. Oil, Gas, and Coal

1. Oil

The PRC is the world's third largest oil consumer after the US and Japan and will be the world's fastest growing regional oil market, with an average annual demand growth of 4.7% between 2000 and 2010. Since becoming a net oil importer in 1993,[86] the PRC's petroleum industry has focused on meeting domestic demand. In 2000, total crude oil production reached 160 billion tons and 70 million tons of petroleum was imported. About 90% of production is located onshore. Government priorities for oil production focus on stabilizing production in the eastern regions of the country at current levels, increasing production from new fields in the western regions, and developing the infrastructure required to deliver western oil and gas to consumers in the east (Energy Information Administration 2001). The Government expects that additional oil production from the Bohai Sea and the Pearl River delta could be developed in the east. In the west, production from the Xinjiang Uygur Autonomous Region could reach 1 million barrels per day by 2008.

[85] In February 2003, the State Council approved the functions of the new State Electricity Regulatory Commission that include (i) regulating the electricity industry and establishing a nationwide unified regulatory system; (ii) proposing the drafting and revision of the laws and related regulations in relation to the supervision and administration of electricity industry; (iii) determining the development program for national and regional power markets, and reviewing and approving the market models and establishing power trading entities; and (iv) participating in formulating technical, safety, and quality control specifications and issuing business licenses; (v) proposing adjustment to electricity prices; and (v) implementing power sector reform in accordance with the State Council's instructions.

[86] The PRC's dependence on oil imports is increasing and one of the major oil national producers, the China National Petroleum Corporation (CNPC), has acquired oil concessions in Iran, Iraq, Kazakhstan, Peru, Sudan, and Venezuela.

In 1998, the Government reorganized most state-owned oil and gas assets into two vertically integrated firms, CNPC and the China Petrochemical Corporation (Sinopec). CNPC and its affiliates predominantly operate in the northern and western parts of the country while Sinopec operates mainly in the southern and coastal regions of the country. Other domestic companies involved in development of the oil and gas sector are the China National Offshore Oil Corporation (CNOOC), which has exclusive responsibility for the development of offshore oil and gas resources, and the China National Star Petroleum Corporation, which was the fourth major state-owned oil and gas corporation and is now a subsidiary of Sinopec operating under the name Sinopec Star Petroleum.

The years 1998–2001 witnessed dramatic reforms in PRC's energy industries, particularly in the oil and gas sector. Major reforms were implemented in the upstream and downstream segments of this sector. Reforms implemented in the upstream segment include (i) the adoption of market-based pricing mechanisms for crude oil and linkage of PRC crude oil prices to international markets; and (ii) IPOs of the three major oil companies. In June 1998, the SDPC promulgated the oil pricing reform scheme that abolished government controls over the price of crude oil. The new scheme required SDPC to publish monthly benchmark prices for various types of crude oil based on the same prices in Singapore. The sale of crude oil will take place based on these benchmark prices (plus surcharges or less discounts to reflect duties, transportation costs, oil quality, etc. in accordance with the relevant contract). In March 2001, SDPC promulgated the Crude Oil Price Circular, which abolished the benchmark-pricing scheme and allowed oil companies to set their own crude oil prices based on Singapore prices and in accordance with the principles established in the Oil Pricing Reform Scheme. Shares in CNPC were listed on the New York and Hong Kong, China stock exchanges in April 2000 through a company named PetroChina. Shares in Sinopec were listed on the New York; Hong Kong, China; the PRC; and London stock exchanges in October 2000. Shares in CNOOC Limited (a subsidiary of CNOOC that has been given the exclusive right to exercise CNOOC's offshore oil and gas exploration and production rights) were listed on the New York and Hong Kong, China stock exchanges in February 2001. The privatization of Sinopec contributed to a revitalization of several foreign JV petrochemical projects and three major partnerships with foreign companies in the retail petroleum sector.

Regarding the downstream segment of the oil and gas sector, the oil pricing reform scheme requires that SDPC promulgate standard retail prices for gasoline and diesel fuel for each province, which will be adjusted monthly by SDPC. CNPC and Sinopec are required to set their prices within 5% of SDPC's standard prices, adjust the prices at least every 2 months, and register their prices with SDPC. CNPC and Sinopec are free to set their own ex-refinery and wholesale prices for gasoline and diesel fuel, provided they register the same with SDPC. Prices for jet fuel and heavy oil for fertilizer production are still determined by SDPC. CNPC and Sinopec set prices for kerosene, heavy oil, and liquefied natural gas (LNG) in line with SDPC's pricing measures. Natural gas prices for producers and consumers and gas transmission tariffs are determined by SDPC and other relevant government departments.

Foreign participation in exploration and production of oil and gas, onshore and offshore, is generally carried out under a petroleum contract. This form of production-sharing contract has been subject to MOFTEC approval. The foreign contractor is responsible for financing and performing all exploration operations and required to carry all associated risks. If a commercially viable discovery is made, the contractor may recover its costs while the PRC partner takes up 51% of the participating interest in the field and may also take over field development operations. Onshore oil and gas exploration and production activities are carried out in accordance with the 1993 Regulations for Foreign Cooperation in the Extraction of Onshore Petroleum Resources, while offshore oil and gas exploration activities are carried out in accordance with the 1982 Regulations for Foreign Cooperation in the Extraction of Offshore Petroleum Resources. Under both regulations, CNPC, Sinopec, and CNOOC may enter into petroleum contracts with foreign partners through invitation of competitive bids for certain concession areas and selection of the best bidder or occasionally through direct negotiations. Offshore oil and gas exploration and production concession areas that were opened for foreign participation have been successful in attracting international oil companies (about 150 petroleum contracts with 70 foreign companies as of the end of 2000). However, mobilizing international oil companies for oil and gas exploration and production has been less successful onshore. This seems to be based on the poor oil and gas prospects of some of the concession areas that have been offered.

With the exception of the planned Nanhai petrochemical complex that will be built and operated by Shell International in Huizhou, Guangdong Province, all refineries are operated by CNPC and Sinopec. The Government is planning to upgrade existing refineries to be able to process increasing imports of heavier crude oil from the Middle East. Foreign companies can only establish directly owned retail gasoline stations if they have invested in the concerned highway. British Petroleum, Shell International, and Exxon Mobil have agreed to form JVs with Sinopec that would allow each to establish some 500 gasoline stations in three provinces (British Petroleum in Zhejiang Province, Shell International in Jiangsu Province, Exxon Mobil in Fujian Province).

During WTO negotiations, the PRC agreed to reduce its state monopoly on the oil trade by releasing the imports of 4 million tons of petroleum products and 7.2 million tons of crude oil each year to the private sector (China Daily 2002p and China International Business 2002), with SOEs such as Sinochem retaining exclusive trading rights for the remainder. Foreign firms will be able to participate in oil distribution 3 years after WTO accession and fully own a minimum of 30 gasoline stations each. The wholesale oil market will become fully market-based by 2006.

2. Natural Gas

Given the PRC's significant natural gas reserves and the environmental benefits of using gas, expanding the natural gas infrastructure has become one of the highest priorities for the Government. Gas currently accounts for only 3% of total energy consumption, but consumption is expected to more than triple by 2010. Natural gas demand is expected to increase considerably in the near future, growing 9% per annum to 2010. However, even if this growth in gas demand materializes, the share of natural gas in total energy consumption would increase to only about 7% by 2010.

Adequate gas infrastructure is lacking and the largest reserves of natural gas are located in the western part of the country. Significant investments are required in gas infrastructure to supply natural gas to potential markets that are predominantly located in the coastal areas. The largest gas infrastructure projects under consideration include the 4,000 km east-west natural gas pipeline which, together with the required investments in development of the gas fields and the downstream distribution facilities in Shanghai, would require investments of at least $17 billion. An LNG receiving terminal in the Shenzhen Special Economic Region in Guangdong Province will cost about $600 million. Shell International will be involved in financing and constructing the pipeline. The Shanghai municipal government is seeking foreign partners with experience in natural gas distribution to undertake the required expansion of the gas distribution network. British Petroleum has won a share of 30% in the JV company that will own and operate the LNG terminal. Nine major gas transmission pipelines and three additional LNG terminals (in Fujian, Shandong, and Shanghai provinces) are planned over the next decade.

Although foreign investors are now encouraged to participate in several major domestic pipeline projects linking gas deposits in central and western regions and consumers mainly in eastern cities (Shanxi-Beijing, Hebei-Shandong, Sichuan-Hubei, and Hunan), foreign investments in the oil and gas sector are not regulated by a single law or subject to supervision by one organization. SDPC made regulatory changes in July 2000 to ease foreign participation in gas projects, including opening up the possibility of foreign firms taking majority stakes. However, the regulatory framework is deficient. It does not promote competition and lacks transparency. Obstacles to foreign investment—such as uncertainty about SDPC's and other relevant departments' responsibilities and methodologies to be used for determining gas transmission tariffs and prices for gas producers and consumers—remain.

The PRC has agreed to increase foreign access to its energy markets by adopting a phased series of reforms that will be implemented over a 5-year period after WTO accession.

Other issues remain. First, access to markets for distribution and retail of petroleum products currently remains restricted. Implementation and enforcement of the WTO agreement and the Government's commitment to newly emerging regulations that support the liberalization of the sector will be essential. Nontariff barriers should be avoided. Requirements for storage capacity and environmental protection at new downstream wholesale and retail projects should be implemented on a fair and equal basis for both foreign and domestic companies. Second, regulatory reform needs to be strengthened, including the development and implementation of streamlined approval procedures and a clear and complete separation of regulatory and commercial functions. Third, a clear and coherent natural gas policy is necessary. For example, it is unclear whether recent reforms allowing majority foreign stakes in the large west-east natural gas pipeline are applicable to other projects. Investments in local distribution networks also appear to be subject to local, nontransparent conditions. Fourth, gas pricing should also be reformed to reflect the right market signals to downstream gas distribution companies and consumers.

3. Coal

The PRC is the world's largest producer and consumer of coal. Coal accounts for two thirds of primary energy consumption. In 2000, total coal production was about 1.17 billion tons, which represented 32% of total global coal production. The demand for coal is projected to more than double by the year 2020. About 40% of the increased demand for coal will come from the power sector as the PRC is planning to add 100 GW of new coal-fired power generating capacity up to 2020. The remaining 60% is expected to occur in the industrial sector for steam and heat generation in the chemical, cement, and pulp and paper industries and for the manufacturing of coal coke for steel production. Because of the abundance of coal reserves and the PRC's limited reserves of oil and natural gas, coal will remain the dominant source of energy.

Traditionally, the coal sector was supervised by the Ministry of Coal Industry. However, this ministry was abolished in 1998. All coal mines are currently supervised by the respective provincial governments, with the exception of safety aspects, which are supervised by the State Administration of Coal Mine Safety Supervision. Recently the coal industry experienced serious oversupply problems. Large coal stockpiles appeared at large coal mines, and at small, sometimes unlicensed, mines. Coal mining productivity in terms of coal production per miner per year ranks as one of the lowest in the world and mines are usually gaseous and pose considerable safety and health risks for miners. Emissions of coal bed methane, which is a greenhouse gas, from PRC coal mines are estimated at 8 billion cubic meters a year. Mine accidents result in thousands of casualties each year. In 2001 about 4,500 people were killed in about 2,300 accidents. In 1998, because of the excess capacity in coal production and the relatively unsafe operations of small, often village-run, coal mines, the Government embarked on a program to close such mines. By end-2001, about 11,000 small coal mines had been closed, either for operating illegally or because of inadequate safety. The Government estimates that about 80% of the approximately 23,000 remaining small coal mines are illegal or have inadequate or nonexistent safety precautions and therefore need to be closed.

By end-2005, the Government plans to restructure large state coal mines into seven corporations in a process similar to the establishment of CNPC and Sinopec in the oil and gas sector. At present, some larger coal mines have finalized agreements for joint coal development with foreign partners while FDI in coal mining operations have also materialized. The Government is encouraging FDI in coal mining to promote the introduction of new technologies and/or reduce the environmental impact of coal mining and handling. The areas that require the introduction of foreign technologies include coal mine development, coal washing, coal liquefaction, coal bed methane drainage and production, and transportation of coal as slurry by pipeline (as opposed to increased coal transportation by rail, which has physical limitations).

D. Social Sector

1. Education

Private participation in higher education through JVs is encouraged by the Government and the Ministry of Education (MOE).[86] There were about 30 JV educational programs approved by MOE in 2000. However, two constraints have hindered top-level private educational institutions from entering the PRC market. First, a JV educational program is prohibited by law from making a profit. Second, foreign higher educational institutions (universities) need to have a local university host to enter the market. Some foreign universities believe that their program content would be under scrutiny, which may compromise their academic integrity.

Distance learning has the potential to facilitate human resource development cost-effectively and efficiently through the provision of higher and continuing education to a larger number of students than could be covered under a traditional education system. Although valued by MOE as an effective and efficient means to address deficiencies in the current higher education system, foreign players cannot participate in the distance learning market. In April 2000, MOE banned foreign companies and organizations. This reflects two concerns: (i) the need to control substandard educational service providers; and (ii) cultural and national issues related to control over the educational and social system.

Training is another potentially important but unregulated and fragmented education subsector. There are about 38,000 training organizations, of which 20,000 are private consulting firms that also provide training. The remaining 18,000 are government training organizations (American Chamber of Commerce 2001a). Services delivered through these training institutions include language programs, computer skills training, and ISO 9000 certification training. However, a wide range of corporate training that can facilitate corporate governance, and vocational and management training tailored for new entrants and displaced labor, is lacking.

2. Health

The health sector is going through structural changes as the PRC transforms into a market-oriented economy and from a society with high fertility and mortality rates to one with low fertility and mortality rates.

Government spending as a percentage of total health expenditure fell from 25% to 15% during the 1990s. Out-of-pocket spending as percentage of total health expenditure increased from 37% in 1990 to 59% in 1999. Health expenditure per capita in urban areas is about three times that in rural areas. Pressure on public spending on the health sector has resulted in an increased role for private medical practice.

According to the results of a recent World Health Organization (WHO) survey, the health sector is facing major challenges, including increasing medical costs and the need for quality regulation of private medical practice. There is a general concern with high medical costs among the population. About 70% of the WHO survey respondents felt that health care costs were too high and unaffordable. Public clinics are not affordable and are not responsive to patients' needs. Health care utilization by certain segments of population, particularly lower income households and the uninsured, has decreased due to the increased costs of health care.

Private medical practice is now playing an increasing role, but needs to be regulated for quality and unchecked proliferation. There is weak monitoring and enforcement of rules. About one third of the WHO survey respondents stated that their last medical visit was to a private clinic.

[86] Foreign investment in basic education remains prohibited.

Decisions to visit a private clinic are made primarily based on seriousness of the illness. For minor ailments, an increasing number of respondents go to private clinics. However, for serious medical problems people tend to go to public hospitals. Reasons cited for opting for private clinics include their responsive services, accessibility, and affordability.

Joint efforts are under way between the Ministry of Health (MOH) and WHO to create monitoring tools to measure WTO policy effects on the health sector. Since WTO policy implementation is independent of health policy implementation, it may or may not conflict with overall public health policy. Health system performance involves multiple factors and is affected by governance, policies on fairness and equity, system responsiveness, training and human resource capacities of the system, and overall elements of service delivery. To measure health/trade impact on system performance, an attempt is being made to assess the impact of WTO on FDI in the health sector, including long-term capital investment, capital investment in advanced medical equipment, and household expenditures at facilities developed because of WTO mandated trade liberalization.

a. Medical JVs

Foreign investors are allowed to establish for-profit medical JVs. MOH has already approved more than 200 JV medical institutions, including 23 in 2001 (China International Business 2002). Approval criteria for both parties applying for a JV license include (i) their direct and indirect investment in, and administration of, medical and health services; (ii) provision of internationally advanced medical services and management; and (iii) provision of internationally advanced medical technology and equipment. The total funds invested must not be lower than CNY20 million ($2.42 million), and the PRC share must not be lower than 30%, with a cooperation period not exceeding 20 years.[87]

b. Medical Equipment and Pharmaceuticals

The medical market is growing rapidly. In 1999, over $1.5 billion was spent on medical equipment, more than half of which was imported. One of the PRC's WTO commitments is to allow direct foreign distribution of pharmaceuticals within 3 years of WTO accession. This should allow hospital pharmacies to provide a wider range of services. Some critical issues cited by foreign medical investors and companies include (i) high import duties and a value-added tax on most imported medical equipment (this issue is addressed by WTO commitments);[88] (ii) counterfeiting of pharmaceutical products; and (iii) a lengthy approval process (exceeding 30 months) for new pharmaceutical imports.

c. HIV/AIDS[89]

AIDS is a major disease and a high priority for disease control in the PRC. The Government reports that there were about 850,000 people infected with HIV in 2001. Some international HIV/AIDS experts, however, estimate that there may be over 1 million HIV-positive cases. In 1998, the State Council approved a report entitled the PRC National Medium and Long-Term Strategic Plan for HIV/AIDS Prevention and Control (1998–2010) (the Plan) jointly drafted by MOF, MOH, MOST, and SDPC. This plan requires every region and sector to formulate and implement their own plans and strategies according to local conditions, and incorporate their local strategic plan into their overall socioeconomic development programs. However, implementation of the Plan has been uneven. There has not been enough coordination to prevent HIV/

88 China International Business 2002. See also discussion in Section II.A.6.b. on Unemployment.
89 Import duties on most medical equipment are 10% (in addition to a value-added tax of 17%), which is expected to be reduced to an average of 5% in 8 years.
90 HIV/AIDS = human immunodeficiency virus/acquired immunodeficiency syndrome.

AIDS and sexually transmitted diseases, especially to address the spread of HIV among intravenous drug users and through illegal blood collection and/or blood transfusion, despite repeated prohibitions. To ensure that the objectives and tasks set forth in the Plan will be achieved on schedule, the State Council in 2001 formulated the PRC's Action Plan for Reducing and Preventing the Spread of HIV/AIDS (2001–2005).

d. Public Health Emergencies

The recent emergence of the Severe Acute Respiratory Syndrome (SARS) in the PRC and the potential economic impact highlight the urgent need for a coordinated, effective, and timely government response to public health emergencies. The warm humid climate of the southern region of the PRC, with millions of people living in close proximity to animals, makes it a breeding ground for new viruses. The growth in air travel and globalization enables diseases originating in this region, the manufacturing hub for exported products, to rapidly spread throughout the world (Business Week 2003 and Far Eastern Economic Review 2003).

SARS required the government to spend more on health care to screen and quarantine suspected SARS carriers and hospitalize SARS patients. In response to SARS, the Government established a national SARS task force, known as the SARS Control and Prevention Headquarters of the State Council, headed by Vice-Premier Wu Yi, and a national fund of CNY2 billion ($243 million) for SARS prevention and control (Embassy of the People's Republic of China in the United States of America. 2003.). In April 2003, the PRC invited WHO to review the way that local health authorities were working to contain SARS and began to provide its citizens with more information than it had previously provided about other public health issues.[90]

[90] ADB plans to provide a $2 million TA to the PRC to help contain the outbreak of SARS by strengthening local capacities for SARS prevention, surveillance, management, and mitigation with a particular emphasis on quick action to protect front-line medical workers, the poor, and other at-risk groups.

PRIVATE SECTOR DEVELOPMENT ACTIVITIES OF OTHER FUNDING AGENCIES

Multilateral and bilateral funding agencies have directly or indirectly addressed impediments faced by the private sector in the PRC. Assistance generally takes the form of policy dialogue, experts financed by TA or trust funds, and direct investment in private sector companies without government guarantees (Appendixes 11 and 12).

Three observations are noteworthy. First, most funding agencies share a common development assistance goal in supporting the PRC's reform process in line with government policy and initiatives, such as assistance in SOE reforms, SME development for job creation, social security reform, and WTO accession. Some funding agencies provide a wide range of assistance directly addressing impediments cited by private sector players, while others have a narrower and indirect scope through, for example, the provision of WTO-related training to government officials. Table 22 summarizes the areas of bilateral and multilateral aid interventions to help address impediments faced by the private sector.

Table 22: Funding Agencies' Efforts to Address Impediments to Private Sector Development

Item	Policy		Legal					Financing				Human Resources				
	Taxation/Audit	Market Entry	Rule of Law	Drafting Laws	Accessibility	IPR	Exit (Bankruptcy)	Financial Sector	SOE Reform	SME (supply)	SME (demand)	Infrastructure	Training	Social Security	Corporate Governance	Access to Information
ADB	x	x	x	x			x	x	x	IX	IX	IX	x	x	x	x
AusAID		x						x		x	x		x	x		
CIDA	x	x	x							x	x	x	x			
EU	x	x	x	x	x	x		x	x	x	x		x	x	x	x
Ford Foundation											x		x		x	
GTZ	x	x	x	x			x	x	x	x	x		x	x	x	
IFC		x		x			x	IX	x	I X	IX	IX	x	x	x	
JBIC/JICA		x						x		x	x					
OECD	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
UK DFID	x								x	x	x	I		x	x	
UNDP		x	x			x		x	x	x	x		x	x	x	x
UNIDO		x						x		x	x		x		x	x
World Bank	x	x	x	x			x	x	x	x	x	IX	x	x	x	x

I: Investments and guarantees; X: Policy dialogue, TA, and research.

ADB = Asian Development Bank, AusAID = Australian Agency for International Development, CIDA = Canadian International Development Agency, EU = European Union, GTZ = German Agency for Technical Cooperation, IFC = International Finance Corporation, JBIC = Japan Bank for International Cooperation, JICA = Japan International Cooperation Agency, OECD = Organisation for Economic Co-operation and Development, UNDP = United Nations Development Programme, UNIDO = United Nations Industrial Development Organization, UK DFID = United Kingdom's Department for International Development.

Second, given the size of the PRC, each aid intervention has inevitably been limited in magnitude and geographical coverage. Most interventions have served as pilot projects and programs. The replication of successful interventions continues to be a major challenge for the funding community.

Third, some funding agencies have started to forge partnerships and arrange joint projects and programs in an attempt to increase their impact on PSD. Examples include the China Project Development Facility (CPDF), which is a multidonor TA facility set up by IFC in 2000 to develop private SMEs in Sichuan Province. Major bilateral funding agencies participating are Australia, Switzerland, and the UK. The Public-Private Infrastructure Advisory Facility (PPIAF) is a World Bank-led TA facility aimed at helping developing countries improve the quality of their infrastructure through private sector involvement. PPIAF's major funding agencies are Japan and the UK.

The CPDF is structured to address impediments faced by SMEs from both the supply and demand sides. The CPDF has four components: (i) an enterprise-level support program to help local SMEs prepare bankable business plans to be presented to financial institutions; (ii) a financial institution strengthening program to help local partner financial institutions lend to SMEs in Sichuan; (iii) a training and capacity-building program to help develop local SME support services; and (iv) business environment assistance program to help identify and relieve key constraints that small companies face in the local business environment.

The PPIAF supports three projects in the PRC for a total amount of $1.295 million: (i) regulatory and institutional reform in the telecommunication sector; (ii) privatization strategy for competitive electricity generation at the provincial level; and (iii) options for private participation in water and sanitation services in Chongqing.

The World Bank and IFC share development goals that are similar to ADB's, including poverty reduction through PSD, and their assistance addresses issues and impediments faced by the private sector. As of 30 June 2002, World Bank (World Bank 2003b) commitments to the PRC stood at $346.1 billion for a total of 2,349 projects. About half of these projects are still being implemented, making the PRC's portfolio the largest in the World Bank. Infrastructure (transport, energy, industry, urban development) accounts for more than half of the total portfolio. Agriculture, social sector, environment, and water supply and sanitation comprise the remainder.

The World Bank's assistance for PSD is designed to help countries develop needed legal and regulatory frameworks and institutions in a way that protects the interest of poor people (World Bank 2002a). The World Bank's operations encompass lending, guarantees, and stipulating private provision of infrastructure. As for enterprise reform, the World Bank is involved in the PRC's important corporate reform agenda through policy advice, technical analysis, and policy seminars, often in conjunction with IFC. The study, *Bankcruptcy of State-Owned Enterprises in China—An Agenda for Reforming the Insolvency System*, is assisting the PRC to build an improved insolvency system with an appropriate legal framework for both state and nonstate enterprises. A corporate governance study, one of the World Bank's focal areas, is expected to assist the PRC in dealing with issues that arise in connection with the ownership transformation of state enterprises. Training in corporate governance issues by the World Bank Institute has already been provided in the PRC through the Global Development Learning Network.

The World Bank and IFC have taken an integrated approach to address issues faced by the private sector through joint programs such as a World Bank-IFC Private Sector Advisory Service, the SME program, and the creation of global product groups. Major World Bank activities to support PSD include (i) assessment of the PRC's knowledge economy and requirements for technological innovation in collaboration with the Organisation for Economic Co-operation and Development (OECD); (ii) the Economic Law Reform Project, which is financing the preparation of economic laws; and (iii) the Accounting Reform Project, which is helping government auditors curb waste and other misuse of resources and strengthen public sector financial management.

IFC is mandated to make direct loan and equity investments in private sector companined without government guarantees and provide advisory services jointly with the World Bank through the Foreign Investment Advisory Services. The PRC is one of IFC's fastest growing recipient countries and ranks ninth in terms of portfolio. As of 30 June 2002, IFC had supported 54 enterprises in the PRC with total gross IFC financing of about $1.3 billion (including $522 million syndications) (IFC 2002). Recent IFC operations in the PRC include (i) equity investment in the finance and insurance sectors, and (ii) support to SMEs through loans and equity investment. Other ongoing activities include (i) policy dialogue with PBOC regarding a regulatory framework on leasing, in general, and a relevant chapter in the Contract Law, in particular; (ii) cooperation with CSRC to provide training for directors of listed companies (as of March 2002, 120 directors had received training); (iii) advisory services to the Shanxi provincial government on FDI promotion; (iv) a study on revising the prevailing BOT circular that was submitted to SDPC in November 2001 and is currently under review; and (v) a study on bankruptcy, and another on corporate governance.

UNDP has undertaken public-private partnership initiatives to address issues faced by the private sector. Ongoing programs include (i) the Small Credit Guarantee Fund with a total amount of $300,000, (ii) Capacity Development of Chinese Business on IPR Compliance, and (iii) Strategic Sustainable Development Planning Training for Chinese Business Executives. The Small Credit Guarantee Fund was set up in collaboration with SETC in Jiangsu Province to provide SMEs with better access to credit and improve the services provided to large multinational companies. The IPR Compliance project is intended to address counterfeiting issues, one of the key challenges in IPR protection, through the Chamber of Commerce in Fujian. UNDP, the Government, and the Quality Brands Protection Committee of over 70 multinational companies operating in the PRC conducted a survey on counterfeiting hot spots in Fujian province. Consensus was reached to forge partnerships to support the development of business associations to replicate the project model in other parts of the PRC. The objective of the project is to promote members' products and deepen IPR compliance awareness by setting up regulations to be followed by members. To address human resources constraints, particularly managerial skills in the western region, UNDP announced in early 2002 that it would launch a program to train professionals in the western region.

The United Nations Industrial Development Organization launched a new joint initiative to address development of SMEs in Shaanxi Province during 2002–2004, with total funding of $10 million. The intervention includes (i) industrial investment promotion by establishing and strengthening VC mechanisms and FDIs; (ii) development of competitive SMEs; (iii) information technology and e-commerce for SMEs; and (iv) food and agro-industrial development.

Other active funding agencies that are engaged in activities supporting the private sector include EU, UK Department for International Development (DFID), and Germany through the German Agency for Technical Cooperation (GTZ) (Appendix 11). EU's assistance programs encompass (i) the rule of law and good governance initiatives, including an IPR cooperation project and a legal and judicial cooperation program; and (ii) an economic and social reform initiative, including a WTO accession project, financial services cooperation project, and enterprise reform to contribute to the development of the SME sector. DFID's development assistance priorities include support for PSD, particularly the encouragement of greater investment and development of the micro- and small enterprise sector to contribute to poverty reduction. DFID's activities include (i) an SOE reform project that addresses enterprise restructuring and development in Sichuan and Liaoning; (ii) contribution to IFC's Project Development Facility; (iii) a WTO accession project; and (iv) policy support for fiscal reforms. In addition to SME development assistance, GTZ provides assistance to the PRC's economic and structural reforms through the Sino-German Cooperation in Economic Law and other initiatives, which support the transformation of the PRC's legal system to facilitate the move toward a market economy.

Japan International Cooperation Agency's PSD activities in 2000–2002 include housing finance reform support research and a study on SME development in the model cities of Hanzhou and Shengyang. JBIC's primary support for private activity in the PRC is to assist Japanese companies investing in the PRC through the Private Sector Investment Finance program. Two investments were made in 1992 and 1995 in an industrial zone management company and a property management company, respectively.

OECD addresses issues faced by the private sector through research and policy dialogue with the Government. The policy dialogue has centered on the establishment of the institutional framework for effective governance of enterprises, development of the capital market, the role of regulatory reform in a state of transition, and competition policy.

There are some NGOs providing support for PSD. The World Resources Institute (WRI) is an environmental NGO that has already established its unique position in Latin America by helping SMEs in the environment sector fill the gap between potential investors and investees. In October 2002, WRI launched its New Ventures Program in the PRC in collaboration with the PRC Chapter of the Leadership for Environment and Development, a global network of individuals and NGOs committed to sustainable development. Its mandate is threefold: (i) to provide free consulting services to selected SMEs that are promising in terms of their business concept but which require more sophisticated business plans, strategies, and governance in order to be considered by potential investors; (ii) to offer cost and time saving avenues for potential investors that have constraints on "investable" deal flow; and (iii) to provide an investors forum where both potential investors and already "trained" investees can meet. WRI is funded to recruit volunteer "coaches" (professors, business people, and MBA students from prominent business schools). The Ford Foundation has funded Phase I of the program under which over 400 SME managers have been trained in seven provinces. The first investor forum in the PRC is planned for September 2003.

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SECTION VI

ASSESSMENT OF ADB'S PRIVATE SECTOR ACTIVITIES

A. Private Sector Development, Poverty Reduction, and Governance

ADB views PSD as an effective means to achieve its overarching objective of poverty reduction. Sustainable economic growth, based on increased productivity, is the key to winning the war against poverty. The private sector will be the engine for economic growth, creating jobs and increasing incomes necessary to lift people out of poverty. Recent studies have revealed strong empirical evidence of the links between growth and private investment, job creation in the private sector, and poverty reduction (IFC 2000c).

A study on the relationship between job creation and poverty reduction in 80 countries from 1987 to 1998 concluded that private firms created 4–80 times as many jobs as public sector firms, depending on the country (Table 23). One survey tracking specific poor individuals over time shows that finding a job (or a family member finding a job) is a major path out of poverty (Pferffermann 2001). Most people escaping poverty find jobs in private firms, not in the public sector. In this sense, PSD has a sustainable effect on poverty reduction.

Table 23: Private Firms as a Source of Job Creation
(selected developing countries)

Country	Period	Job Creation ('000)		Job Creation Ratio
		Private	Public	Private to Public
PRC	1996-2001	27,139.0	0	87:1
Mexico	1989-1998	12,431.0	143.0	16:1
Turkey	1987-1992	1,490.0	91.0	13:1
Kenya	1993-1998	173.0	13.0	10:1
Bolivia	1994-1997	181.0	18.0	3.6:1
Gabon	1992-1996	4.7	1.3	

Sources: *China Statistical Yearbook*. 2002. Pfeffermann, 2000. Private Sector Development Strategy – Directions for the World Bank Group. 2002.

The PRC's experience is more complex due to its size and nature of the country. However, the above hypothesis is applicable. PSD has had a significant impact on poverty reduction. A recent unpublished ADB study shows that provinces and cities that have a high share of private sector activity usually have a much lower level of poverty (ADB 2001a). The relationship between per capita GDP and the share of private sector employment to total employment in 30 provinces clearly indicates a relationship between the contribution of private sector employment to the level of income. On average among provinces, for every 1% increase in the share of private employment, there is a corresponding increase of CNY164 ($20) in per capita GDP.

Good governance is also essential for PSD and poverty reduction. Good governance establishes the rules of the game for the private sector in a clear and transparent manner. Good governance improves transparency, predictability, accountability, and participation. These dimensions are all needed for the private sector to be able to make sound business decisions, reduce risk, and operate efficiently. The poor are most vulnerable to public sector inefficiencies, corruption, and waste (ADB 2002c).

B. ADB's Support to Private Sector Development

ADB has provided assistance to promote PSD in the PRC within a framework that has three strategic thrusts (i) to help establish an enabling environment for the private sector; (ii) to generate business opportunities in which the private sector can participate; and (iii) to catalyze private investments by mobilizing additional resources through direct financing, credit enhancements, and risk mitigation instruments. The first 2 have been pursued through ADB's public sector window, mainly with TA operations and loans to help address infrastructure constraints. The third has been operationalized through investments in, and loans to, private individual companies by ADB.

1. TA Operations

As of 31 October 2002, ADB has provided 46 TAs totaling $25.6 million in support of PSD in the PRC.[92] Support can be broadly classified into four categories: (i) financial sector support (15 TAs—$6.64 million); (ii) an enabling environment for private participation in infrastructure (16 TAs—$10.20 million); (iii) laws to promote PSD (3 TAs—2.25 million); and (iv) enterprise support including TAs to assist SMEs (12 TAs—$6.47 million).

ADB's TA operations reflect three trends in response to emerging needs in the private sector: (i) a shift from a broader industry study in the financial sector to more focused enterprises support such as capacity building; (ii) focused topics to address specific constraints on participation by the private sector in infrastructure, such as water tariffs studies; and (iii) studies in response to emerging challenges of supporting the rule of law (Appendix 13).

a. Financial Sector

Over the past 14 years, ADB has provided TA in the financial sector to help develop the emerging nonstate sector. In the early 1990s, TA projects centered on broad industry studies such as leasing, VC, and securities market development, to identify policy and legal constraints. In the late 1990s, the focus shifted to capacity building of particular financial institutions and regulatory organizations (e.g., capacity building of the financial markets' regulatory systems, institutional strengthening of Cinda). Additional TA studies that address the need for enterprise reform are discussed below.

[92] The figure does not include the *Technical Assistance to the PRC for the Jiangsu Highway BOT Project*, which was suspended to change the scope and concept of the project. Negotiations with the Government are under way.

b. Enterprise Support

ADB's TA for enterprise reform in the early 1990s encompassed a wide range of topics: (i) restructuring of SOEs; (ii) study on social welfare and labor adjustments for enterprises; (iii) TVE development; (iv) enterprise accounting system reform; and (v) a study of the local consulting industry. In the late 1990s, the focus shifted to development of SMEs and PSD.

Currently, ADB is helping the Government develop a policy and regulatory framework to promote SME development and address the lack of access to financing. At the national level, ADB has worked with SETC to (i) provide advice on suitable SME financing policies and mechanisms; (ii) survey and review existing SME credit guarantee fund operations to help prepare a strengthened policy framework for SME schemes; (iii) identify suitable strategies and conditions to facilitate the provision of capital for SMEs from nongovernment sources, including VC funds, specialized commercial SME investment funds, and domestic capital markets; and (iv) design a financially viable pilot equity support scheme and assist in its establishment. This includes advice on creating a supportive legal, regulatory, policy, and institutional environment for their operation. This TA helped prepare the SME Promotion Law that was adopted by the NPC on 8 June 2002. A subsequent TA was provided to help design the SME Development Fund, as provided in the SME Promotion Law (ADB 2002g).

ADB's work in helping to develop SMEs in Shanghai includes (ADB 2000b) (i) advising on best practices for SME credit and credit guarantee scheme (CGS); (ii) developing policies, procedures, and systems for the Shanghai branch of the China Economic Technological Investment Guarantee Corporation (CETIGC); (iii) advising on the supervision of local guarantee funds; (iv) providing assistance to three selected banks (Bank of Shanghai, local branches of Minsheng Bank, and ICBC) in the development and implementation of SME credit risk assessment and management systems; (v) supporting a training program for CETIGC and local bank staff in SME lending; (vi) undertaking a needs assessment for complementary business support services; and (vii) identifying information and data required to assess SME creditworthiness and developing a strategy for collecting, analyzing, and disseminating such information to interested parties in a cost efficient manner.

ADB worked with ACFIC (ADB 2000a) to identify and promote appropriate policies and conditions for private enterprise development and strengthen ACFIC's business support services. ADB supported an enterprise-level study to assess the status of PSD, identify impediments to future development, and assess the need for finance and business support services. A strategy for developing ACFIC's business support and information services at central and local levels was prepared and basic business courses were developed for private entrepreneurs (Box 4). Domestic and overseas training programs were also provided to ACFIC staff and selected local chambers of commerce that provide business advisory services.

c. Creating an Enabling Environment for Private Participation in Infrastructure

ADB has provided assistance to facilitate PPI. In recent years the TAs took a more focused and targeted approach, directly addressing issues and constraints to such participation. Examples include corporatization in the road sector and water tariffs studies.

Power Sector. ADB TA operations in support of private participation in the power sector cover seven TAs totaling $3.8 million during 1993–2002. ADB's strategic agenda for policy reform in the power sector includes (i) pricing and tariff reforms; (ii) sector restructuring and enterprise reform; (iii) increasing private sector participation; and (iv) promoting the corporatization and commercialization of power utilities and the development of competitive markets in electricity. These ADB–supported reforms will help create an enabling environment for the private sector in the power sector.

Road Sector. ADB provided five TAs in the transport sector in support of the private sector totaling $4.175 million. Since 1995, ADB has provided TAs aimed at creating a market-enabling environment in this sector. Each of these studies identified policy deficiencies and suggested corrective measures. The measures recommended include

(i) adoption of new legislation assuring the legality of the transfer of rights to assets or asset usage and enforceability of these rights;
(ii) clarification and revision of regulations and administrative procedures;
(iii) improvement of levels of transparency and accountability in decisionmaking;
(iv) expansion of the scope of corporations;
(v) inclusion of more shareholders in joint stock companies by capitalizing the value of land and resettlement costs and offering shares to municipalities, through which the road passes, banks (in exchange for debt), and heavy users of the road such as mines, refineries, or shipping companies;
(vi) revision of the approval process (which currently precludes broader international bidding, delays land use certificates, etc.) to encourage competitive leasing or concessioning; and
(vii) identification of the need to address insufficient traffic level volumes to support investment.

Wastewater and Water Supply Sector.[93] Four TAs in the water sector are relevant to PSD. Among them, the two water tariff study TAs implemented over a 4-year period were particularly important to help create an enabling market-oriented environment for private sector participation, thus contributing significantly to water tariff reforms in the PRC.

In line with market reforms, WSCs are being encouraged to recover their operation and maintenance costs and some depreciation. Having appropriate mechanisms for tariff setting will be critical in attracting private investment. ADB provided a TA (ADB 1997b) to study water tariffs and develop appropriate tariff mechanisms to ensure full cost recovery. A major output of this TA was the preparation of the National Guidelines on Water Tariffs (NGWT), which were subsequently promulgated by SDPC and the Ministry of Construction in September 1998. Major features in the NGWT that reflect specific recommendations of the TA include (i) selecting a tariff structure based on local conditions and priorities; (ii) considering a two-part tariff with a volumetric charge and fixed demand charge; (iii) adopting full cost recovery as the main objective in setting and approving tariff levels; (iv) using the public hearings mechanism to disseminate tariff increase plans to the public and obtain their feedback; and (v) adopting a simplified process for tariff regulation by requiring evaluation and approval at the local municipal government level, supported by review and monitoring at the provincial and national levels. The NGWT is expected to improve the long-term financial viability of WSCs and provide for operations and maintenance, and service expansion, which in turn should help increase private sector participation in this sector.

A second water tariff study (ADB 1999b) focused on providing assistance to the Government in developing institutional and methodological capacities to implement the NGWT. The TA assisted in preparing the draft local implementing regulations of the NGWT for Zhangjiakou, Fuzhou, and Chengdu, which were accepted by the relevant local governments. Enactment of local tariff regulations provides a legal basis for regulating water tariffs and ensures transparency and efficiency. The Zhangjiakou Implementation Regulations (ZIRs) were approved by the Zhangjiakou Municipal Government in September 2000. The ZIRs were the first local water tariff regulation under the NGWT. The Chengdu Implementation Regulations was expected to be issued in 2002.

[93] Since 1989, ADB has supported 55 TA studies for approximately $28 million to address issues relating to water resource management, environment, and water supply.

Public hearings are a mandatory requirement of the NGWT. The TA advocates the use of hearings to obtain the views of the public on water supply and promote public understanding of WSCs, policies, and efforts to develop improved water supply services. Based on the first public hearing, Zhangjiakou increased its water tariffs by 75%.

The NGWT also promotes social programs targeted at the urban poor to mitigate the impact of tariff adjustments. The ZIRs include cash rebates for poor families, laid-off workers, and social aid families under the administration of the Labor Union and Civil Affairs Bureau. The NGWT also requires the tariff structure to include lifeline tariffs for the poor. The TA recommendations, including the achievements in Zhangjiakou, have been acknowledged by the State Council as a good example for tariff reforms. SDPC issued a notice to local governments nationwide recognizing the Zhangjiakou water tariff reforms as a good example for undertaking tariff reforms required by the NGWT. Upon completion of the study, SDPC, the Ministry of Construction, MOF, and other relevant government bodies officially issued a notice on further strengthening of urban water tariff reforms on 1 April 2002, followed by a nationwide videoconference to discuss the Zhangjiakou experience on water tariff reforms on 9 April. Subsequently, SDPC and the Ministry of Construction issued another notice on the national auditing of water tariffs and conducted a related training seminar in April 2002.

Specific impacts of the overall package of reforms are best illustrated by the benefits in Zhangjiakou. The benefits include (i) establishment of the Price Bureau's lead role in tariff administration; (ii) a streamlined water supply administration of the Public Utility Bureau; (iii) a financial plan which is in place for the Zhangjiakou WSC to service the debt within a reasonable time frame while recovering other costs and earning profits; (iv) funds for the municipal government of Zhangjiakou to repay international and domestic loans within 6 years and for future development; (v) funds for the Construction Commission, which is responsible for Zhangjiakou's new water treatment plant, to finish its work; (vi) proposed tariffs that are affordable for domestic customers and a new program for poor households to provide relief from their water bills; (vii) transparency of the tariff approval process through public hearings that will encourage cost control and service improvements, promote understanding of the importance of tariff increases, and support tariff adjustments; (viii) strengthened institutional capacity to control costs and tariff increases; and (ix) improved water conservation by imposition of tariff increases and an appropriate tariff structure. Multiyear tariff adjustment proposals such as the one developed for Zhangjiakou will result in other benefits. First, the underlying financial plan for the proposal provides the basis of a service contract between the municipality and the WSC, which can serve as a tool to control costs. Second, long-term financial planning provides a framework within which to attract private investors.

In the water sector, ADB is focusing on (i) improving the efficiency of water supply and distribution systems through investment in physical infrastructure; (ii) promoting improved corporate governance and commercial management to enhance the potential for future private sector involvement; (iii) improving cost recovery by strengthening tariff systems and structures for raw water and treated water; and (iv) ensuring water resources conservation and environmental protection through the continuing support of legislative and regulatory provisions governing water pollution and natural resources management. ADB water policy encourages the funding of new water supply projects directly through water tariff increases (e.g., Harbin).

d. Better Laws to Support Private Sector Development

Helping the Government formulate laws to support PSD is an important feature of ADB's TA operations. ADB has provided $2.25 million for three TAs that will help formulate key laws and regulations that are necessary for the efficient functioning of a market economy. The TA for the Development of Economic Laws approved in 1999 for $1.4 million has provided assistance to the Legislative Affairs Commission, Standing Committee of the NPC and Office of Legislative Affairs of the State Council in drafting work for the following new laws or amending existing laws:

(i) Company Law, (ii) Bankruptcy Law, (iii) Trust Law, (iv) Social Security Law, (v) Administrative Licensing Law, (vi) Law on Registration of Enterprises, and (vii) Regulation of Legal Aid. ADB also provided assistance for drafting the government procurement law, the securities law, land administration law, and clean production law.

In 2001, ADB provided assistance to help identify changes to laws and regulations required for the PRC's WTO membership. Required changes include codifying existing administrative practices into written laws and regulations to increase predictability and transparency. This demanding task includes around 200 laws and regulations that need to be reviewed, revised, repealed, and/or incorporated into new laws or regulations. The adoption of the WTO's rules–based system will have widespread benefits for the private sector. The objectives of ADB's assistance in this area are to (i) help the Government make its foreign trade laws and regulations compatible with WTO principles, rules, and obligations; (ii) help the Government determine the institutional setup for regulating foreign trade and investment; and (iii) support the Government's efforts to increase transparency by making legal information public and clarifying laws and regulations on foreign trade and investment.

As the PRC's private sector has emerged, ADB's TA operations in support of PSD have also evolved over time to focus on specific issues and constraints on development. Given ADB's resource constraints and the size of the country, ADB needs to intensify its efforts to identify proper TA topics and issues to respond to the critical needs of the private sector.

2. Lending Activities

Through its public sector lending program, ADB has helped create an enabling environment for the private sector by addressing infrastructure constraints. Public sector loans have been provided to finance construction of highways and roads, power plants and transmission lines, and water treatment facilities.

3. Private Sector Operations

To catalyze investment in the private sector, ADB employs various instruments such as loans without government guarantees, equity investments, commercial cofinancing, and credit enhancement mechanisms. Administration of existing portfolio projects is also an important aspect of private sector operations.

Other objectives of ADB's private sector operations in the PRC's capital markets include support of PRC efforts to raise corporate governance standards, catalyze transfer of capital and knowledge in capital market institutions, and support PRC efforts in raising the efficiency and competitiveness of capital market institutions in anticipation of WTO reforms. ADB is seeking high quality and creditworthy opportunities in the banking sector, other savings institutions such as mutual funds and pension funds, and capital market institutions such as credit rating agencies, and resolution of the NPL problem.

ADB made its first equity investment in the PRC in 1991, taking a 10% equity in the Xiamen International Bank, the PRC's first Sino-foreign JV bank based in Fujian Province. ADB's involvement catalyzed subscriptions from other foreign investors. As of October 2002, ADB had approved $151.5 million in loans and $79.3 million in equity investments in private sector projects. ADB had a portfolio of nine private sector projects consisting of 5 equity investments of $79.3 million and 4 loans of $151.5 million, respectively (Table 24). These projects can be organized into two categories: (i) $126.5 million for three infrastructure projects, and (ii) $104.3 million for financial sector operations. All these investments confirmed the important role of ADB in mitigating perceived risks and encouraging capital flows. With a funding commitment of more than $230 million, ADB was able to facilitate investments in development projects worth over $2.14 billion. On average every dollar of ADB's participation catalyzes $7 of total investment.

Table 24: ADB Private Sector Loan and Equity Investments in the PRC

Project Name (Year Approved)	Amount Approved ($ million) Loan	Equity	Total	Estimated Project Cost/ Fund Size	Leverage Ratio (times)
Xiamen International Bank (1991)	–	10.3	10.3		
China Assets Holdings (1991)	–	4.0	4.0	74.1	18.5
Guangzhou Pearl River Power Company (1992)	50.0	–	50.0	352.4	7.0
China Everbright Bank (1996)	–	20.0	20.0		
Fujian Pacific Electric Co., Ltd. (1998) (Meizhouwan Power Project)	40.0	10.0	50.0	740.0	14.8
Chengdu Generale des Eaux-Marubeni (GEM) Waterworks (1999) (Chengdu Water Supply Project)	26.5	–	26.5	106.5	40.2
Liberty New World China Enterprises (2000)	–	25.0	25.0	150.0	5.0
Water Infrastructure Development Facility	35.0	–	35.0	150.0	4.3
China Environment Fund 2002 Limited Partnership	–	10.0	10.0	40.0	4.0
Total Approvals (as of October 2002)	**151.5**	**79.3**	**230.8**	**1,613**	**7.0**

Below are notable catalytic achievements of ADB's private sector operations in the PRC:

(i) *Xiamen International Bank* was the PRC's first Sino-foreign JV bank;
(ii) *Guangzhou Pearl River Power Company* is one of the PRC's first JV independent power producers that has been operating profitably;
(iii) *China Everbright Bank* is the first domestic bank that was allowed to have foreign equity participation;
(iv) *Fujian Pacific Electric Company* is the first 100% foreign owned independent power producer in the PRC that was approved by the State Council. Because of ADB's involvement, this deal was closed during the height of the Asian financial crisis. This project received two prestigious "deals of the year" awards from international trade magazines; and
(v) *Chengdu Generale des Eaux-Marubeni Waterworks*: ADB played an essential role in structuring transparent international bidding for the PRC's first BOT water supply project. This project received four international awards for excellence (Box 10).

A recent private sector project in the PRC was a $25 million investment made in 2000 in a $150 million equity fund aimed at SMEs. ADB's partners in the fund, the New World Development Company Limited of Hong Kong, China, and the Liberty Mutual Insurance Company of the US, are well known for their investment expertise and networks. This fund is designed to identify high growth SMEs and help increase their competitiveness by initiating the best corporate governance and management practices. The fund is focusing on four core business sectors: health care, consumer products, building materials, and automotive midstream and downstream services.

The fund plays an active role throughout the investment process by identifying prospective investments, actively managing and building products, and ensuring business efficiency and profitability at all levels. Due diligence and a critical examination of operational strategies and financial soundness are conducted to identify potential investee enterprises, and appropriate international strategic partners are selected to make contributions in technology, market expansion, management skills, and capital. To ensure that each project achieves excellent results, the fund's investees are provided with management support by a team of more than 40 marketing, financial, and management professionals in Hong Kong, China and the PRC. This team also monitors the entire process of the Fund's investment management. In addition to investment screening and negotiating contracts, the team maintains board representation and ensures implementation of financial control over each project. Upon proven success, the fund replicates and extends the project platform across the country. ADB's main objectives in supporting this fund include (i) strengthening private sector enterprises by adopting best practices and corporate governance; and (ii) strengthening foreign investors' confidence in investing in the PRC's private sector.

As of 31 December 2002, the fund invested in eight companies in industrial sectors such as electronic/mechanical components, ceramic glass, pharmaceutical, food and beverage, automobile dealership and services, and security products/systems/services.

The PRC is also among the countries targeted by three regional investment funds supported by ADB investments (Table 25). ADB has invested $75 million in these regional funds that support primarily private sector investments in infrastructure projects.

Table 25: Regional Funds Investment/Loans in the PRC
($ million)

Name of Fund	ADB Investment	Fund Size
Asian Infrastructure Fund	20.0	780
Asian Infrastructure Development Co. Ltd.	30.0	400
Asian Infrastructure Mezzanine Capital Fund	25.0	245

As of 31 December 2001, Asian Infrastructure Fund invested in four companies: (i) a toll road operator for its investments in five provinces; (ii) a port operator; (iii) a power venture; and (iv) a paging operator. Asian Infrastructure Development Company invested in two companies in the road and telecommunications sectors. Asian Infrastructure Mezzanine Capital Fund invested in one company in the telecommunications/internet sector.

Recently, ADB approved a new $10 million investment in the China Environment Fund, which aims to raise $40 million of equity capital. The China Environment Fund is the first private sector fund in the PRC dedicated to addressing environmental issues. The PRC faces mounting environmental challenges and, based on the huge costs involved, cannot afford to clean up the environment without private sector assistance. The fund has made an investment in industrial and hazardous waste treatment companies in Shenzhen.[94] ADB also approved a $35 million loan in a $150 million water infrastructure development facility.

Lessons Learned. ADB's experience in these projects, specifically in infrastructure projects, confirms the need for closer ADB involvement at early stages of project development to ensure a bankable contract structure. Clear provisions on setting and adjusting tariffs for offtake agreements would mitigate investor and lender risk. Projects will need to be scrutinized to ensure that returns are dependent on optimization of operations based on the Central Government's recent guidance that discouraged government entities from entering into fixed return deals (Box 11 and Box 12).

[94] Protecting the environment and promoting sustainable development is one of the main objectives of ADB in the PRC. ADB has provided substantial assistance in addressing the PRC's environmental conditions. By end–2001, ADB had provided more than $2.4 billion in loans and 93 TA grants totaling more than $71 million for environmental improvements in the PRC.

Box 11:

Lessons Learned from Private Sector Investment in the PRC

Fair Deal. "At times, negotiating a balanced deal with local partners was not possible. There are often disputes about the rights of each party. Even when a negotiated agreement has been reached with local partners, enforcement as well as renegotiation has been difficult. The judicial process in the PRC is cumbersome and time consuming."

Operational and Financial Risks. "Small and medium enterprises (SMEs) lack operational and financial management skills. Due to the existence of a myriad of receivables among businesses, the ability to collect receivables has been limited. In the absence of collateral that banks can foreclose on, accessing banks for needed credit has been extremely difficult for SMEs. The capital market is not sufficiently developed to provide alternative financing for SMEs. Therefore, joint venture SMEs tend to rely solely on foreign investors to provide cash."

Divestment Risks. "Exit avenues may exist in the form of exercising a put option to local partners, trade sales to existing and other investors, and public listing at a stock exchange. Stock exchange listing is not easy for small size corporations, and even if allowed, listing in the "A" share markets has constraints for divestment by foreign shareholders. In addition, existence of adequate liquidity of the shares being traded is critical for divestment of a relatively large number of shares."

Information Disclosure. "Obtaining "full" disclosure of information is difficult and the accuracy of information obtained is suspect. In addition to fraudulent practices in some business and financial sectors, full disclosure and transparency sometimes take a backseat to a notion of effectiveness."

Budget and Control. "Business and budget plans are often set too aggressively to be achievable. There are lapses in the control function."

Inactive Board. "Board documents are usually distributed late, and board discussions are not active. Often the board minutes are not complete and timely for effective reviews by board members."

Box 12:

Fujian Pacific Electronic Company Ltd. (Meizouwan) Project

As part of the restructuring of the power sector, the State Power Corporation (SPC) was formed in 1996 to, among others, place power assets previously owned by the Government into provincial subsidiaries, including the Fujian Power Company (the off-taker). The State Economic Trade Commission (SETC) gradually took over the regulatory and oversight functions of the Ministry of Electric Power.

The State Development Planning Commission (SDPC) cleared the Meizhouwan Power Project as a wholly owned project and in February 1998 ADB approved a loan for the 724 megawatt (MW), coal–fired project. Construction began immediately thereafter. The borrower and the equity and loan participants signed the financing agreements in May and loans were drawn beginning in October 1998. That a project of this size managed these milestones during the Asian financial crisis is due to what all agreed in 1997–1998 were solid economic fundamentals. The Project received two awards from international finance magazines and became a case study at Stanford University and Columbia University business schools.

Sponsors approached ADB in 1995. ADB led the due diligence and negotiations and participated in detailed project and loan document reviews. The power purchase agreement (PPA) was negotiated primarily during 1996–1997. Under the PPA, the Fujian Province assumed the risk should the power demand of Fujian not materialize. The PPA provides for a minimum off-take of the borrower of 5,000 hours. The Province wanted a short depreciation period (7 years) for the plant, which is partly responsible for the high tariff. SDPC approved the project twice during the 1990s. The second SDPC approval, required by ADB, states that the Project budget is $655.3 million and that the average tariff during the debt service period is CNY0.517, and thereafter CNY0.464.

ADB was uncertain about the effect of the 1996 PRC Electric Power Law, which requires the tariff to be finally approved upon commercial operation by the department in charge of price control under the State Council. Just before going to the Board, ADB checked on the tariff clearance mechanism one last time with SDPC, but although some oral assurances were provided, SDPC declined to formally review the matter.

In 2001, the power situation in the Province changed from a power shortage to oversupply. During 1997–2000, while the economic growth in the Province slowed, the installed generation capacity in the Province increased following the Province's aggressive power expansive plan that included the 3,600 MW Hou Shi Power Project. The power oversupply is currently projected to last until 2005. Due to the oversupply, the Province became concerned about the economic impact of purchasing power from Meizhouwan, which would be the most expensive in the Province. The Province insisted that the borrower lower the tariff by reducing operational and capital costs and returns on investors' investments and challenged operations on technical grounds. Although initial discussions to resolve the technical disagreements failed and the Province made a decision to shut down the second unit in September 2001, ADB facilitated further discussions that led to the Province's decision to bring the second unit back into operation in January 2002. Technical disagreements have not yet been resolved.

SECTION VII

PROPOSED ADB PRIVATE SECTOR DEVELOPMENT STRATEGY

A. Major Findings and Recommendations

General findings. The rapid development of the private sector has become one of the most significant features of the PRC's transition to a market-oriented economy. Private sector enterprises are legally positioned as an integral part of the economy and will continue to play an increasingly important role in job creation. Based on ADB's surveys with both foreign and domestic private enterprises, the business community is generally sanguine about the prospects for doing business in the PRC.

Nevertheless, investors have emphasized that much remains to be done for the private sector to develop to its full potential, thereby fully contributing to the growth of the PRC economy. As reflected in the enterprise surveys discussed in Section III, impediments to further development of the private sector, which include a policy bias in favor of SOEs, weak implementation of the rule of law, constraints on financing options particularly for domestic private enterprises, weak corporate governance, infrastructure constraints, human resource constraints, and difficulty in accessing reliable information, need to be addressed. The private sector could grow even faster if these impediments were removed and an environment that is more supportive of business is developed.

Overall Approach and Recommendations. The objectives of ADB's PSD interventions are to (i) help establish the right conditions for business and a policy environment conducive to pro-poor growth; (ii) generate business opportunities in which the private sector can participate; and (iii) catalyze private investments by mobilizing additional resources through cofinancing and guarantee operations.

ADB's private sector strategy in the PRC should reflect the two lessons learned from the direct and indirect financing of private enterprises. First, the right policy environment is key to the long-term vitality of these businesses. Second, ADB assistance, if combined with the public and private sector windows to address development challenges, can provide synergistic solutions resulting in greater benefits for the host developing member country. In other words, ADB's interventions should focus on sectors requiring further impetus to reforms as well as catalytic private investments. Thus, the manufacturing and industrial sectors with over 60% of the PRC's FDI inflow would fall outside ADB's operational scope. Major findings of the PSA and recommendations are presented in the framework of the strategic thrust and public-private linkages (Table 26).

The private sector is the main engine for job creation in the PRC and an essential ingredient of any successful poverty reduction strategy. ADB private sector interventions in the PRC need to meet the following challenges: (i) how effectively ADB can play a risk-mitigating role in creating an enabling environment for private business and catalyze further investments; (ii) how effectively ADB can increase the probability that the poor will benefit from ADB's PSD interventions; and (iii) how institutionally ADB can realize the PSD strategic goals.

Table 26: ADB Strategic Thrust for PSD in the PRC

Creating Enabling Environment	Generating Business Opportunities	Catalyzing Private Investment (PSO's input)
Financial Sector Reform Support for SMEs both from supply and demand sides through policy dialogue: • expand credit guarantees models, introduce pilot program for collateral guarantees; • strengthen the commercial banking sector; • develop alternative financing for SMEs through capital markets, leasing, investment funds; and • support capacity building of central and local governments and local chambers of commerce to be service providers to SMEs. Support to develop social security system (legal and regulatory framework), governance (support for capacity building for financial market supervisors), and policy dialogue on microfinance (support for policy dialogue to support a legal framework, deregulate interest rates, and refocus program)	**Information Services** Generate business opportunities (training, advisory services) by facilitating capacity building of local chambers of commerce and partnerships between foreign and local chambers of commerce.	**Capital Markets** Investment in funds to support the development of SMEs, infrastructure projects, energy conservation and environment safekeeping, disposal of nonperforming loans, and other themes in line with PRC and ADB's development strategies. Restructure loan and equity investments in specific companies in commercial banking, insurance, and asset management industries.
Public-Private Partnership in Infrastructure Continued assistance in financial management and corporate governance for regulators and operators Policy dialogue on sector-specific laws, regulations, and administrative orders affecting private participation in infrastructure	**Project Contractors** Improve access of domestic and foreign contractors to ADB and publicly funded projects. Increase fair business opportunities through public-private partnership infrastructure projects (BOT).	**Private Participation in Infrastructure** Demonstration projects involving public-private partnerships in the infrastructure sector Projects that test the enabling environment and provide opportunities for continuing policy dialogue in the sector
Private Participation in Social Sector Policy dialogue for creating a better regulatory framework for private medical practice in the PRC Policy dialogue for facilitating private participation in higher business education and corporate training for domestic business managers **Regulatory and Legal Environment** Creating a rule-based business environment (WTO) by helping further modify existing laws, and improving transparency by assisting in establishing a system that facilitates public consultation, accessibility, and enforcement. **Knowledge Dissemination** Findings of TA projects, best practices, and lessons learned from ADB projects and TAs to facilitate creation of an enabling environment for the private sector		**Pilot Projects in Innovative Areas** A pilot project in health (medical JVs such as hospitals and pharmaceuticals) A pilot education project (i.e., for-profit educational institutions)

ADB = Asian Development Bank, BOT = build-operate-transfer, JV = joint venture, PRC = People's Republic of China, PSO = private sector operations, SME = small and medium enterprise, TA = technical assistance, WTO = World Trade Organization.

ADB has attempted to respond to these strategic challenges in the framework of the PSD strategic thrusts, taking into consideration poverty, job creation, and the geographical focus on western regions. ADB needs to make further efforts to strengthen an integrated public-private approach. Each intervention should be put into a cohesive and strategic context. ADB should intensify its efforts to further refine and determine strategic criteria for PSD interventions. For instance, ADB can sharpen its strategic criteria by responding to varying needs among the provinces in the western region. It is also necessary to reevaluate whether the ADB's current institutional setup at the PRC Resident Mission is sufficient to implement the PSD strategy and respond to increasing demands from the private sector.

B. Creating an Enabling Environment

1. Financial Sector Reform and SME Support

Major Findings. A sound financial sector is critical to sustainable private sector–led economic growth. Market-based growth requires the adoption of market-based practices by the financial system. However, the development of this sector has lagged behind the overall pace of growth and reform of the real economy. The financial sector is dominated by SOEs and is beset with old practices and a legacy of NPLs, as well as new NPLs. The PRC's accession to the WTO should help spur the development and reform of this sector.

The Government has intensified its efforts to create a policy environment conducive to PSD, particularly for SMEs. However, SMEs continue to face constraints on access to financing due to (i) the absence of a diversified financial sector capable of serving SMEs; (ii) lack of capacity of the state banking sector that is now going through restructuring; (iii) strong state-sector bias and prevailing perceptions among domestic financiers that SMEs are not credit-worthy borrowers; (iv) lack of SME capacity in marketing and corporate strategy; and (v) lack of SME access to capital markets.

Recommendations. ADB should engage in policy dialogue concerning the restructuring of the financial sector, including resolution of the NPL problem.

ADB's interventions should improve the financial environment for SMEs and increase private sector activity both from the supply and demand sides. ADB should support the formulation of policies and design of mechanisms that will facilitate SME access to financing (i.e., bank finance, capital markets, private equity, VC). Specific recommendations include the following.

(i) ADB is already committed to influence the enabling environment for development of SMEs from the supply side through the two recent TA projects. TA 3493-PRC: *Development of Small and Medium-sized Enterprise Credit Support System* introduces best international practices on credit guarantee mechanisms and identifies constraints faced by SMEs in the PRC. TA 3534-PRC*: Development of Financing Policies and Mechanisms for Small and Medium-Sized Enterprises* identifies policy and regulatory constraints faced by SMEs and alternative financing schemes for SMEs. Efforts should be further intensified to disseminate best international practices on credit guarantees systems, including replication of the Shanghai pilot project to other cities in the western region.

(ii) Strengthening the commercial banking sector should facilitate further development of private sector SMEs. ADB should address related policy and regulatory issues as well as capacity building of the commercial banking sector through their newly created SME departments.

(iii) In addition to bank financing and guarantee schemes, ADB should further explore alternative financing options for SMEs (i.e., capital markets, leasing, VC) and identify what policy and regulatory changes are needed to make alternative financing options available to SMEs.

(iii) As for capital markets, ADB's policy dialogue with CSRC on how to improve the functioning of the capital markets as a source of funding for private enterprises, including SMEs, will be important.

(iv) Regarding leasing, there is a need for a legal and regulatory framework for the leasing industry to revive. Strengthening the Contract Law would help create a pro-leasing business environment.

(v) VC funds have the potential to play a bigger role as a source of funds for SMEs, particularly startups and technology SMEs. The prevailing legal framework is inadequate for VCs to function fully and effectively reach SMEs in need of seed money and a subsequent injection of capital. Revisions to the Company Law could facilitate the further development of VCs.

(vi) ADB should work with the Government in building the capacity of central and local government agencies and local chambers of commerce to enable them to play a better role as service and information providers to SMEs.

2. Financial Sector Reform: Social Security

Major Findings. As SOE reforms deepened in the second half of the 1990s, urban unemployment and urban poverty increased. Among domestic private firms, the provision of social security for employees is uneven. Given future trends in urbanization and the Government's plans to allow more labor mobility by liberalizing the hukou (resident permit) system, policies and programs need to be put in place to ensure that urban poverty does not increase substantially.

Recommendations. ADB should help the Government establish a comprehensive social security system and social safety net. In addition to being a pro-poor initiative, developing a sound social security system will also facilitate SOE reform and capital market development. The private sector is the engine for creating jobs necessary to ensure that the urban poor do not become permanently poor. Social security reform should broaden its coverage so that pensioners do not fall into poverty. ADB should support the legal/regulatory framework and encourage the development of supplementary pension schemes to provide alternative means of retirement provision for low-income workers or workers with intermittent earnings, for whom participation in contributory social insurance schemes may not be feasible. This would encourage labor mobility and economic efficiency.

3. Financial Sector Reform: Governance

Major Findings. ADB surveys found that both domestic and foreign firms experience market entry constraints due to policy bias against the private sector. Lack of transparency and weak implementation of the rule of law were among the biggest impediments to doing business. The PRC's accession to WTO should help address these issues. However, unlike market opening obligations in the industrial sector, there is no specific timetable in terms of WTO transparency obligations. ADB survey and other surveys found that shortcomings in the private sector, such as weak corporate governance, are serious constraints for further development.

Recommendations. ADB should support capacity building for financial market supervisors to function as transparent regulators. ADB should encourage government agencies concerned to adopt sound corporate governance standards in harmony with international best practice. Initiatives should include amending the Company Law, strengthening financial market supervisors—such as CIRC, CSRC, PBOC, and industry associations—and setting and implementing minimum corporate governance standards for market participants. ADB should continue to serve as the secretariat for the APEC Financial Regulators Training Initiative, thereby strengthening the capacity of training programs for financial regulators.

4. Financial Sector Reform: Microfinance

Major Findings. There are three fundamental issues influencing the sustainability of microfinance projects operating in the PRC. First, they have no proper legal status, but have been "tolerated" by the Government during the last 15 years to serve as an experiment in poverty reduction. There is a prevailing view among NGOs and the funding community that microfinance schemes should be granted legal status so they can operate in an enabling environment. Second, the interest rate regime has not been liberalized so microcredit providers cannot set interest rates at levels that reflect commercial risks and cover operating costs. Because of these factors, microfinance projects cannot operate on a sustainable basis. In addition, microfinance institutions are not allowed to accept deposits. This power is needed to generate sustainable sources of funds for lending.

Recommendations. Policy dialogue should center on (i) creating a policy, legal, regulatory, and supervisory framework for microfinance, with an initial focus on granting legal status to existing microfinance projects; and (ii) deregulating interest rates, providing deposit acceptance for microfinance programs, and refocusing microfinance on providing financial services to the bankable poor rather than using it as a method for disbursing funds for poverty reduction. Most microcredit in the PRC has been provided in rural areas. Efforts should be made to develop assistance that generates income and provides microcredits for laid- off workers and the urban poor.

5. Public-Private Partnership in Infrastructure

Major Findings. ADB surveys found that the private sector needs better physical infrastructure (such as land and buildings, road connections, power supply, and environment and hygiene) to expand markets and operate more efficiently. Infrastructure constraints vary depending on location. Transportation is the most serious constraint for firms operating in the western region, while land and office space are cited by companies in other regions. Foreign investors cite infrastructure constraints, together with underdeveloped consumer markets, as major reasons for not entering the western and central regions. Thus, infrastructure constraints will need to be addressed to support PSD, particularly in the poor western and central regions.

Investments for the next 5 years in road/highway, power generation, and water sectors are estimated to be about $115 billion, $80 billion, and $9 billion, respectively. Without private participation in infrastructure, these plans will not be realized. A public-private partnership in infrastructure is needed. An enabling policy, legal, and regulatory environment for private participation in infrastructure is also needed.

Recommendation (1). Continued efforts are needed to select issues and topics that are critical to private participation in infrastructure in each subsector. In the roads and highway sector, ADB should continue policy dialogue on the transfer of highway asset rights and assistance in financial management and corporate governance. Building on the findings of TA PRC-2952: *Corporatization, Leasing and Securitization in the Road Sector Project*, efforts should be intensified to create an enabling environment and apply the recommendations to ongoing and future projects. In the railway sector, ADB should continue to support the ongoing reform process, particularly commercialization of railway operations with full cost recovery, to ensure financial sustainability. In the water sector, tariff policies have a key role in managing risk when private sector participation is introduced. ADB should continue to assist in creating an improved enabling environment for the private sector to participate in water projects by facilitating (i) corporatization of public water companies, holding them accountable for profitable operations; and (ii) associated tariff reforms to achieve full cost recovery of operations. In the power sector, ADB should continue to assist in ongoing restructuring plans to help create an enabling environment for the private sector. ADB should continue negotiations with central and local governments regarding the Meizhouwan project (Box 12).

Recommendation (2). ADB has the potential to act as a risk-mitigating agent to induce foreign investments into the poor interior west, which can have a developmental impact in terms of poverty reduction.

Recommendation (3). ADB operations in the oil and gas sector should focus on improving the regulatory and policy framework to create an environment that is conducive to private sector participation. Where required, selective catalytic ADB investment may be justified to attract private sector investments. Particular areas include natural gas distribution and the use of natural gas in vehicles such as compressed natural gas, which usually generate relatively modest rates of return. With regard to the coal sector, ADB assistance should likewise focus on promoting private sector investments in coal related activities that will have a direct impact on improving the efficiency of coal mining operations and reducing related environmental costs and occupational hazards. This may be done by providing support for suitable demonstration projects and policy advice.

6. Private Participation in the Social Sector

Major Findings for the Health Sector. The health system in the PRC is going through structural changes as the economy shifts from a centrally planned to a market-oriented system. Health care utilization by lower-income households and the uninsured has decreased recently due to increasing costs in public medical services. Private medical practice is increasingly becoming important for the poor because of accessibility and affordability, as well as the provision of more responsive services. Health system performance assessment is also becoming important as WTO policy may have unintended effects on the health sector.

AIDS is a high priority for disease control in the PRC. It is estimated that there are at least 850,000 HIV-positive cases in the PRC. The Government has taken a major step to address this increasingly important issue by approving the Chinese National Medium- and Long-Term Strategic Plan for HIV/AIDS Prevention and Control (1998–2010).

Recommendations. ADB should initiate policy dialogue for creating a better regulatory framework for private medical practice in the PRC by addressing, among other issues, HIV/AIDS prevention and control. Given that other funding agencies (i.e., UNAIDS and the UN Theme Group and the World Bank) are already active in the health sector in general, and in HIV/AIDS prevention and control in particular, close aid coordination is highly recommended if ADB decides to intervene in this sector.

Major Findings for the Education Sector. ADB surveys and other sources highlight the need for intensified efforts to improve managerial capacity and retain skilled professionals and workers. The SME survey also reveals that a majority of firms sampled believe that they need training in corporate strategies and marketing. Foreign firms consider that better managerial and professional skills are essential for further development of their firms and that the PRC needs more managers with expertise in information technology, strategic management, and reengineering business processes. The education sector has not been able to serve and respond to such increasing needs. The training subsector is an unregulated and fragmented market, which lacks sophisticated topics such as corporate strategy and governance. Foreign investors are not allowed to operate in the distance learning (e-learning) subsector.

Recommendations. ADB can initiate policy dialogue on private participation in the education sector, in general, and how best the PRC can create an enabling environment for delivery of needed educational services for businesses, such as corporate strategy, governance, and marketing for business managers.

7. Legal and Regulatory Environment

Major Findings. The year 2001 marked the beginning of a new phase of reforms as the first year of the Tenth-Five Year Plan and the PRC's accession to WTO. WTO entry should encourage PSD by (i) creating additional business opportunities because of more trade and investment; (ii) increasing transparency in the legal and regulatory framework and improving governance; and (iii) increasing the supply of goods and lowering costs because of reduced tariffs. However, WTO accession also poses challenges particularly on human resources of government agencies concerned due to the volume of laws and regulations that need to be reviewed, amended, and codified. Because there will be private participation in a wider range of business sectors in accordance with the new *Catalogue for Sectoral Guidance of Foreign Investment,* more inconsistencies among existing laws, regulations, and administrative orders will surface. Although some progress is being made, public consultation and accessibility to laws and regulations remain problems.

Recommendations. ADB should intensify its efforts to assist the Government in creating a rule-based business environment by helping to draft forward-looking legal frameworks, assisting in drafting and modifying laws that affect the private sector, and creating a pilot mechanism for public consultation and accessibility of laws and regulations. ADB should closely coordinate with OECD and World Bank who are active in this field. If designed properly, an integrated approach with other funding agencies will be an efficient and effective way of creating a pro-business environment.

Major Findings on IPR Protection. Weak and inconsistent law enforcement is prevalent due to (i) decentralized and multiple layers of administration; (ii) local protectionism; (iii) inadequate checks and balances on enforcement actions; (iv) ineffective sanctions and penalties to deter violations; and (v) intrusive and excessive regulation. IPR infringements are cited by both foreign and domestic enterprises as serious impediments to their operations. Clear evidence of the Government's commitment to fight against IPR infringements is exemplified in the establishment of a National Anti-Counterfeiting Coordinating Committee at the State Council and related enforcement campaigns.

Recommendations. ADB can help the Government strengthen its anticounterfeiting campaign. The assistance can be at the national level through a TA to advise on (i) necessary administrative reforms to strengthen enforcement mechanisms; and (ii) international best practices on enforcement. Also, ADB may consider providing assistance in public education at the local government and the firm level utilizing local chambers of commerce and foreign and local chamber partnerships. Close coordination with the State Intellectual Property Office and the Quality Brands Protection Committee is needed. Lessons learned from the UNDP pilot project and EU's ongoing efforts should be considered.

8. Knowledge Dissemination

Findings. One of the major comparative advantages of ADB is the availability of TA funds for policy studies and institution building. Recent advisory technical assistance (ADTA) helped create a market-oriented enabling environment in (i) social security reforms; (ii) capital market sector reforms; (iii) insurance sector reforms; (iv) SME policy; (v) water tariffs setting; (vi) power sector reforms; and (vii) corporatization, leasing, and securitization in the road sector project.

Recommendations. ADB should create a better mechanism to disseminate knowledge, best practices, and lessons learned through ADB projects and ADTA. Such an attempt is currently being made for the recently completed TA 2952-PRC: *Corporatization, Leasing and Securitization in the Road Sector Project*. ADB plans to distribute 1,500 copies of the publication not only to central and local government offices, but also to top research institutions and major city and university libraries. The aim is to reach the public and potential future decision makers and leaders. The publication discusses relatively new financing concepts. A progressive local government official suggested that dissemination of "innovative" ideas to younger personnel would accelerate the reform process.

C. Generating Business Opportunities

1. Information Services

Major Findings. Access to reliable information is sometimes difficult in the PRC. Chambers of commerce and business associations can play an important role in this area. More and more enterprises are using the Internet to obtain information. Information concerning fiscal policies and incentives, as well as basic information on foreign companies searching for partners in the PRC, if available on the Internet, would address constraints faced by SMEs.

Recommendations. ADB can generate business opportunities for private sector service providers that may offer training to chambers of commerce and their member enterprises.

2. Project Contractors

Major Findings. About 57% of respondents to the ADB business climate survey were not aware that ADB can generate business opportunities for the private sector through procurement under publicly funded projects or that ADB makes loans and equity investments in private sector projects. Some respondents also expressed an interest in learning more about ADB's private sector operations (Box 13).

Recommendations. ADB should conduct outreach programs/meetings more regularly and frequently with private sector companies, both domestic and foreign. One possible way is to continue to have a dialogue with both foreign and local chambers of commerce, using their channels to reach private companies. Regular meetings could provide ADB with information on issues and impediments that private firms face. ADB could reach out to the private sector and catalyze investments through regular road shows, seminars, and workshops that disseminate information about ADB's role in generating business opportunities through procurement under publicly funded projects.

Box 13:

Level of Awareness of ADB's Private Sector Operations

Q. Are you aware that ADB supports PSD through loans and equity investments? Please make comments on your knowledge about ADB.

Answer (1): Yes. (43% of the respondents)

"We are aware of ADB and its mandates. We have also participated in some of its projects in the PRC and elsewhere."

"Yes, we are aware. However, we wonder why private sector activities have been so limited in the PRC."

Answer (2): Yes, but we do not know the details. (17% of respondents)

"Yes, I only have general information."

"I am broadly aware of ADB's activities but not in any detail. In general, I would comment that their involvement tends to have a positive impact on economies, projects, and markets."

"Yes, but we don't know the way to take advantage of it."

"We have little knowledge about your services and scope. Our main business limitation is not related to funding or capital availability, but to market size and customer development."

"Heard of ADB, but do not know what they do specifically, especially in the PRC. We will be willing to talk to ADB if they are interested in oil and gas exploration and production."

Answer (3): No, I am not aware of it at all. (40% of respondents)

Source: *ADB Business Climate Survey 2002.*

Given ADB's private sector operation's resource constraints and strategic focus on a few sectors, a focused marketing approach will be necessary. Hosting a forum aligning investors, investees, and government officials to directly reach potential clients for ADB is one possible way. ADB should take full advantage of existing forums such as the one being planned by an NGO, the World Resources Institute, where investors with lack of "investable" deal flow and already "trained" potential investee companies can meet.

D. Catalyzing Private Investment

Major Findings. ADB's private sector operations, which require a focused strategy with a strong emphasis on development and demonstration effects, have had an indirect impact on poverty reduction. The PRC has attracted more than $45 billion of FDI inflow annually in recent years. ADB's private sector investments without government guarantees account for much less than 1% of this FDI. About 60% of FDI inflow was targeted at the manufacturing sector. The western and central regions accounted for only about 5% and 9% of FDI inflow for the past 5 years, respectively.

Recommendations. ADB should continue to use equity investments and loans to finance investments. Where applicable, ADB should use its guarantee products as credit enhancement tools to mobilize commercial cofinancing, including local currency debt financing. By so doing, ADB needs to play a risk-mitigating role to catalyze investments, particularly to the poor interior regions.

ADB should work with private sector partners to establish and maintain good corporate governance and management practices. These will enable ADB-supported projects to serve as good practice models.

ADB should not provide direct support for stand-alone industrial or manufacturing projects. Such projects should have access to commercial sources or financing. Most of the PRC's large inflows of FDI have been used for that purpose.

ADB's private sector operations should focus on effective interventions to enable ADB to (i) signal opportunities, (ii) demonstrate success, (iii) identify impediments, (iv) refine ADB's PSD techniques, and (v) test the market. ADB's PRC private sector operations strategy should be positioned to support poverty reduction.

ADB's private sector operations in the PRC should focus on: (i) effective and innovative public-private partnerships to allow sharing of risks and costs in the development process, especially in the provision of infrastructure; and (ii) development of the domestic private sector, including SMEs that are a major source of employment and income, to anchor development more firmly in domestic capacity and promote wider participation. In addition, ADB should consider exploring possible interventions through private participation in social sectors such as health and higher education.

1. Capital Markets

Major Findings. There is a need for continued restructuring of financial intermediaries to enable them to function effectively in transforming savings into productive investments, particularly in the private sector. Domestic SMEs have faced both internal and external constraints, particularly financing. Alternative financing through capital markets will facilitate further development.

Recommendations. ADB should explore opportunities to provide support for (i) investment funds that target SMEs; (ii) infrastructure investments; and (iii) projects involving energy conservation, pollution abatement, development of the central and western regions, and the disposal of NPLs.

ADB should also consider taking equity positions in existing and new commercial banks, insurance companies, fund management companies, and other domestic financial institutions to broaden ownership, improve corporate governance, and introduce international best practice standards. ADB should consider making loan and equity investments in companies in fledgling and nascent industries, such as leasing and VC, under a new legal framework and enabling environment. By so doing, ADB can play a catalytic role in mobilizing investors to follow suit and provide a wide range of financing services to SMEs.

Such bottom-up investment funds can test a new policy environment. Some international case studies indicate that investing in the first or second pioneering leasing companies in a region (or in a country) after an adequate enabling environment is in place can make both substantial financial and development impacts. Margins earned by the early investments were roughly twice as much as those earned by private investors following in later years when there is more competition. ADB's private sector operations should focus on recouping profits while playing a catalytic role in inviting other investors and making a substantial development impact in the nascent industry.

2. Infrastructure

Major Findings. Infrastructure constraints are one of the main reasons why foreign investors do not consider entering the central and western regions. Both foreign and domestic investors face varying infrastructure constraints, depending on geographical locations (e.g., transportation is cited as a major constraint by enterprises in the west). Private participation can help the PRC finance its infrastructure needs.

Recommendations. Enormous investments in infrastructure are envisaged during the Tenth Five-Year Plan. Funding these projects cannot be done by the public sector alone. The involvement of the private sector is another way to mobilize the necessary financing.

ADB's private sector operations should focus on its existing strengths to mobilize capital for large and medium-scale infrastructure projects. Multiproject financing schemes such as the World Bank's Public–Private Infrastructure Advisory Facility could be used to enable ADB to reach out to smaller projects. ADB will consider financing infrastructure projects that involve private sector participation in power generation, gas transmission, roads, ports, telecommunications, water supply, wastewater treatment, and solid waste management. Additional investments in the power sector, however, will depend on ongoing negotiations on the Meizhouwan project (Box 12) with central and local governments. Priority will be given to pioneering projects and those that can serve as models for structuring private sector investments. While private sector operations will mostly be in the coastal region, efforts will be made to encourage projects in the central and western parts of the country. ADB's infrastructure financing will be for both "greenfield" projects and "brownfield" projects.

ADB will support private participation in projects that operate within a regulatory framework that protects the interests of the poor. Experience has shown that efficiency gains from privatizing infrastructure services can benefit all income levels. But with effective regulation that ensures appropriate tariff policies, lower-income groups tend to gain relatively more than higher income groups, improving the distribution of income. ADB's private and public sector departments will ensure effective regulation of infrastructure projects that are not subject to market competition. Pro-poor growth from infrastructure projects that extend essential services to the poor at affordable tariffs requires a close partnership with the Government. Such projects can include concessions that require bidders to provide service to poorer areas (for example, low-tariff public standpipes or loss-making transport systems), with the associated cost to be borne by the Government in the form of lower concession revenues.

3. Social Sector

Major Findings. The health sector is currently going through structural changes. Private medical practice in rural areas is increasingly important for the poor. For-profit medical JVs have been allowed to operate to bring in advanced medical technology and equipment, making up the shortage of local funds, and improving techniques and facilities. WTO accession will also bring about new opportunities in direct distribution of pharmaceutical products. The education sector is still highly regulated. For-profit JVs for higher education are not allowed. Distance learning and training, however, may offer investment opportunities. Both subsectors are very fragmented markets and training programs for corporate staff are an unexploited niche.

Recommendations. ADB's private sector operations may wish to pursue investment opportunities in the health sector. Selection criteria for private sector operations potential investments based on rigorous market research are necessary. One possibility is to make investments in a JV hospital in a high-end market segment targeting expatriates or a growing segment of the upper-middle class in cities, with a view to filling the gap in public fund shortages that should be used for the poor. Rural private medical practice is becoming increasingly important, and an area for consideration and further research. Investment opportunities in the education sector remain limited for private sector operations. However, training and domestic distance learning (e-learning) subsectors can be tapped through an investment fund. It is unlikely that there will be walk-in "investable" proposals for private sector operations unless ADB conducts active outreach marketing in the social sector. ADB should utilize TA funds for private sector operations to further research the sectors and identify potential investment opportunities.

E. Institutional Response to Private Sector Development in the PRC

ADB should reevaluate whether or not its current institutional setup is appropriate to respond to increasing opportunities in the PRC' s private sector. The recent reorganization is definitely a step forward in responding to the challenges ahead. However, much remains to be done to further improve the current institutional setup, especially to strengthen public-private partnerships and private sector operations at the PRC Resident Mission and mainstream private sector operations in the PRC operational strategy. For the period from July 2000 to December 2001, the PRC Resident Mission received 124 private sector-related inquiries and speech requests. The Private Sector Operations Strategic Directions and Review (ADB 2001) states the following.

> *The Private Sector Group's experience, especially in the recent past, has demonstrated the critical importance to private sector operations of an effective local presence through the ADB's resident missions (RMs). There is simply no substitute for reliable, accurate, and timely local information and response when identifying, processing, and administering private sector projects. On this basis, and in line with ADB's policy on RMs, local inputs for private sector operations must be bolstered by more appropriate arrangements to promote private sector operations in local markets, to assist with the processing of new projects, to undertake on-the-ground portfolio administration, and to address risk management issues. — The need for substantial RM support is critical in at least four DMCs: PRC, India, Indonesia, and Pakistan.*

There is substantial interest in ADB operations in the PRC. The ADB business climate survey shows that much remains to be done to promote ADB's efforts in PSD (Box 13). A local presence of PSD/operations personnel in the PRC Resident Mission would enable ADB to conduct an active outreach marketing response to growing demands for financial sector and infrastructure operations and identify potential investment opportunities.

DEFINITIONS OF PRIVATE SECTOR ENTERPRISES

1. Individual-employed or self-employed (*geti gongshang hu,* widely known as *geti hu*) is the first new business category that the People's Republic of China (PRC) State Council defined as "private sector" in 1981. These individual businesses were the pioneer members of the private sector, following the completion of collectivization in the 1950s (ADB 2000a). Only sole proprietorships employing up to eight people can be registered as geti hu.

2. Private enterprises (*siying qiye)* were officially introduced as a new business category in 1988 under the "Tentative Stipulations on Private Enterprises." They were defined as "for- profit" organizations that are owned by individuals and employ more than eight people. Siying qiye can be privately owned by 2–50 shareholders, with a minimum registered capital requirement at only $1 in 2000. Siying qiye can be registered as sole proprietorships, partnerships, or limited liability corporations. During the past decade or so, however, their status as private enterprises kept them at a disadvantage compared with state-owned enterprises (SOEs) and collectives, owing to heavy restrictions on their freedom to operate and limited access to finance.

3. "Private" collectives and "private" town and village enterprises (TVEs) have played a significant role in the development of the PRC's private sector. Collective enterprises are defined as firms that share ownership with local governments. TVEs are defined as firms that share ownership with township and village governments. In PRC data, collectives and TVEs are classified outside the state sector, yet they cannot be considered as part of the private sector in a legal sense. However, experts estimate that over 50% of collectives and TVEs are in practice purely privately owned companies, controlled or owned by individuals. Often called as "red hat firms," many privately owned companies with the collusion of local officials adopt the form of a collectively owned enterprise to secure a protective umbrella for themselves, obtaining the security and privileges extended by local governments that would not have been available if they were defined as geti hu or siying qiye (Asia Law and Practice 1999). This phenomenon is still prevalent as seen in recent surveys conducted by the International Finance Corporation and Asian Development Bank (Box5).

4. Shareholding cooperative enterprises are defined as firms that are employee-owned, with equal voting rights independent of asset ownership. These enterprises are considered to be an intermediate stage for former collectives being transformed into privately held firms. Also, another variation of companies in transition is joint-ownership (*lian ying),* although this class of firms was larger in the 1950s when many private firms were gradually transformed into state-owned or collectively owned enterprises after the Chinese Communist Party took power. Currently, both categories are considered when describing enterprises going through transition toward private ownership.

5. Wholly owned foreign enterprises are owned by foreign parties with 100% equity stakes, and are thus considered "private sector enterprises." Foreign–funded enterprises (PRC-foreign joint equity ventures), on the other hand, can be considered either private enterprises or SOEs, depending on their ownership structure. PRC-foreign equity joint ventures (JVs) can take two forms, equity JVs or contractual JVs. Equity JVs have three characteristics. First, profits are shared depending on each party's equity shares. Second, JV contract periods can range from 20 years up to 70 years. Third, exit or withdrawal

from JVs requires consent from all board members, which makes exit far more difficult for equity JVs than for contractual JVs. Thus, long-term commitment is expected. Profit allocation for contractual JVs is predetermined by contract and can thus be flexible (typically, for the first 5 years 60% of profits for foreigners and 40% for PRC parties, with a gradually increased profit allocation to PRC parties). Also, the PRC partners are expected to provide land and buildings, while foreign partners provide equipment and technology. The biggest difference between these two forms of JVs is the fact that upon the expiration of contractual JVs, the PRC parties are entitled to receive the assets. Contractual JVs are often undertaken by investors in service industries such as hotels.

APPENDIX 2

Selected Historical Data on Private Enterprises

Foreign Direct Investment: Composition by Industry: 1997–2001
($ million)

Item	1997	1998	1999	2000	2001
National Total	**45,257**	**45,463**	**40,319**	**40,715**	**46,878**
Farming, Forestry, Animal Husbandry, and Fishery	628	624	710	676	899
share (%)	1.4	1.4	1.8	1.7	1.9
Mining and Quarrying	940	578	557	583	811
share (%)	2.1	1.3	1.4	1.4	1.7
Manufacturing	28,120	25,582	22,603	25,844	30,907
share (%)	62.1	56.3	56.1	63.5	65.9
Electric Power, Gas and Water Production and Supply	2,072	3,103	3,703	2,242	2,273
share (%)	4.6	6.8	9.2	5.5	4.8
Construction	1,438	2,064	917	905	807
share (%)	3.2	4.5	2.3	2.2	1.7
Transportation, Storage, Postal and Telecom Services	1,655	1,645	1,551	1,012	909
share (%)	3.7	3.6	3.8	2.5	1.9
Wholesales & Retail Trade and Catering Services	1,402	1,181	965	858	1169
share (%)	3.1	2.6	2.4	2.1	2.5
Real Estate Management	5,169	6,410	5,588	4,658	5,137
share (%)	11.4	14.1	13.9	11.4	11.0
Social Services	1,988	2,963	2,551	2,185	2,595
share (%)	4.4	6.5	6.3	5.4	5.5
Health Care, Sports, and Social Welfare	195	97	148	106	119
share (%)	0.4	0.2	0.4	0.3	0.3
Education, Culture and Arts, Radio, Film, and Television	74	68	61	54	36
share (%)	0.2	0.2	0.2	0.1	0.1
Other Sectors	1,576	1,146	965	1,591	1,216
share (%)	3.5	2.5	2.4	3.9	2.6

Source: *China Statistical Yearbook* 1999, p.600; 2001, p.608; 2002, p. 634

APPENDIX 3

HISTORICAL OVERVIEW AND POLICY MILESTONES OF PRIVATE SECTOR DEVELOPMENT IN THE PRC

Item	Phase I (1978–1985)	Phase II (1986–1991)	Phase III (1992–2000)	Phase IV (2001–Present)
Features	• Official revival of private business, individual enterprises (*geti hu*)	• Rise of privately run enterprises • Many "red hat firms"	• Rapid private firm development	
Reform strategy	• Gradual experimentation • Dual–track approach	• Expanded experimentation	• A more coherent strategy	• A more coherent strategy
Government perception of the private sector	• "Supplement to the state and collective sectors • "Filling the gap" in the economy	• "Necessary supplement" to the socialist public economy • Inconsistent administrative treatment	• Important changes in the PRC's overall approach to reforms and its official attitude to the role of private sector • A market system based on the rule of law, in which the private sector is an important component	• The private sector as an integral part of the economy and society
Political events, laws, and circulars relevant to private sector development	• 1978. Third Plenary of CCP's 11th Central Committee marked the beginning of market-oriented reforms. • 1979. State Administration for Industry and Commerce National Conference decided to encourage self- employment. • 1981. State Council defined a new business category, *geti gongshang hu*, or single industrial and commercial proprietor.	• 1987. The 13th Communist Party Congress officially recognized the "private economy" and regarded it as a necessary supplement. • 1988. The 9th National People's Congress (NPC) passed an amendment to Article 11 of the Constitution to add that the State "permits" the existence and development of the private economy and protects legitimate rights and interests.	• 1992. The 14th Communist Party Congress endorsed the socialist market economy as the PRC's goal of reform. • 1993. A "grand strategy" of transition to a market economy, with an emphasis on a rule-based system and on building market-supporting institutions • 1997. The 15th Communist Party Congress recognizes private enterprise as an important component of the economy. • 1999. Private ownership and the rule of law are incorporated into the Constitution.	• 2001. Streamlined registration of private firms. • 2001. Premier Jiang Zemin announced that private entrepreneurs are qualified to become CCP members.

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(Appendix 3 table continued)

Item	**Phase I (1978–1985)**	**Phase II (1986–1991)**	**Phase III (1992–2000)**	**Phase IV (2001–Present)**
	• 1982. The 12th National Congress designated the individual economy as a "necessary supplement" to the public sector. • 1983. A series of central and local regulations for licensing and control of individual businesses, taxes, product quality, hygiene, and free markets.	• 1988. *Siying qiye* is under an official categorization. • 1988. State Council issued the Tentative Stipulations on Private Enterprises, defining a private firm as "a for-profit organization that is owned by individuals and employs more than eight people," and identified three types of private firms: (i) sole ownership, (ii) partnerships, and (iii) limited liability companies.	• 2000. A new law on sole proprietorship becomes effective.	• 2001. The PRC's official entry into WTO
FDI Policy milestones	• 1979. Sino-Foreign Equity JV Law, the first FDI Law, promulgated • 1980. Special economic zones established • 1984. Open-door policy expanded to 14 coastal cities	• 1986. The JV Equity Law modified (2nd version) • 1986. Decree (22 tiao) to further encourage FDI announced by the State Council; two categories for preferential treatment announced: (i) advanced technology, and (ii) export-oriented • 1987. SDPC internal document drafted concerning the list of industrial sectors to which FDI was encouraged, restricted and prohibited • 1990. A special economic zone established in Pudong, Shanghai.	• 1992. Deng Xiaoping's speech to further stimulate economic reform • 1992. Tax–free zones established • 1995. Provisions for direction of foreign investment and master list for FDI announced • 1997-1999. Responses to the Asian crises • Introduction of BOT projects and concession rights • 1997. Master list of FDI reviewed to broaden the scope of FDI (internal document and, therefore, not disclosed to the public); custom duty policy • 1999. Decree 73 to further encourage FDI adopted by the State Council and eight related ministries • 2000. Go west policy	• 2001. Issuance of import/export permits to 450 privately owned companies • 1st year of the 10th Five-Year Plan • 2001. Record high for the PRC's FDI in 2001 • 2002. SDPC announced the new FDI catalogue in March, which became effective on 1 April.

BOT = build-operate-transfer, CCP = Chinese Communist Party, FDI = foreign direct investment, JV = joint venture, NPC = National People's Congress, PRC = People's Republic of China, SDPC = State Development Planning Commission, WTO = World Trade Organization.

APPENDIX 4

CATALOGUE FOR SECTORAL GUIDANCE OF FOREIGN INVESTMENT

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
13 encouraged foreign investment categories	**13 restricted foreign investment categories**	**10 prohibited foreign investment categories**
I. Agriculture, Forestry, Animal Husbandry, Fishery 1. Improvement of low- and medium-yield field 2. Development and production of public hazard-free cultivation technology and serialized products and production of vegetables (including edible mushrooms and melons), fruits, and tea 3. Development and production of new varieties (excluding genetically modified varieties) of fine quality, high-yielding crops such as sugar-yielding crops, fruit trees, flowers and plants, forage grass, and related new techniques 4. Production of flowers and plants, construction and operation of nursery gardens 5. Recycling and multipurpose utilization of straw, and development and production of organic fertilizer 6. Cultivation and breeding of Chinese medicinal crops (limited to cooperative JVs or CJVs and equity JVs or EJVs) 7. Planting of forest trees (bamboo) and introduction of fine strains of forest trees 8. Planting of rubber trees, sisal hemp, and coffee 9. Breeding of good strains of domestic animals, fowls, and aquatic fingerlings (not including the PRC's special, precious, good strains) 10. Breeding of famous, special, and fine aquatic products and deepwater net cage culture 11. Construction and operation of ecology and environment protection projects, such as planting of trees and grass to prevent and rectify desertification and water and soil erosion	**I. Agriculture, Forestry, Animal Husbandry, Fishery** 1. Development and production of food (including potatoes), cotton, and oil seed (PRC side must have majority stake) 2. Processing of the logs of precious varieties of trees (limited to CJVs and EJVs)	**I. Agriculture, Forestry, Animal Husbandry, Fishery** 1. Planting and breeding of the PRC's rare precious varieties (including fine genes in plants industry, husbandry, and aquatic products industry) 2. Production and development of genetically modified seeds 3. Fishing in inland rivers and areas under the PRC's administration
II. Mining 1. Risk exploration and development of oil and gas 2. Development of low-permeation oil and gas fields (deposits) (WTO Note) 3. Development and application of new technology to improve crude oil extraction ratio	**II. Mining** 1. Survey and mining of metals such as wolfram, tin, antimony, molybdenum, barite, fluorite (limited to CJVs and EJVs) 2. Survey and mining of noble metal (gold, silver, and platinum)	**II. Mining** 1. Survey, exploration, and extraction of radioactive mineral products 2. Survey, exploration, and extraction of rare earth mineral products

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
4. Formulation and application of new technology in oil exploration and development, such as exploring, drilling, well logging and underpit operations 5. Exploration and development of coal and associated resources 6. Exploration and development of coal-seam gas 7. Mining and extraction of low-grade metallurgical mine that is difficult to extract (CJVs and EJVs only, but WFOEs are allowed in western regions) 8. Exploration, mining, and extraction of iron and manganese ores 9. Exploration and mining of copper, lead, and zinc ores (CJVs and EJVs only, but WFOEs are allowed in western regions) 10. Exploration and mining of aluminum ores (CJVs and EJVs only, but WFOEs are allowed in western regions) 11. Mining and extraction of chemical minerals such as sulfur, phosphorus, and potassium	3. Survey and mining of noble nonmetals such as diamonds 4. Survey and exploitation of special types of, and rare, coal (PRC side must have majority stake) 5. Mining of boron, magnesium, and iron ore 6. Mining of celestite	
III. Manufacturing (A) Food Processing 1. Storage and processing of grain, vegetables, fruits, poultry, and livestock products 2 Processing of aquatic products, cleanup and processing of shellfish, development of seaweed nutritional food 3. Development and production of fruit and vegetable beverages, protein beverages, tea beverages, and coffee beverages 4. Development and production of food for babies and seniors and nutritional food 5. Dairy products 6. Development and production of biological feed and protein feed (B) Tobacco Processing 1. Secondary cellulose acetate and strip processing 2. Production of tobacco flakes with papermaking method (C) Textiles 1. Special textiles for engineering use 2. Printing and dyeing as well as final processing of superior fabric (D) Leather and Fur Processing 1. New-technology processing of swine, cattle, and lamb wet skins 2. New-technology polishing processing of skins	**III. Manufacturing** (A) Food Processing 1. Manufacture of yellow wine and famous and high-quality distilled spirits 2. Manufacture of carbonic acid beverages with foreign trademarks 3. Manufacture of compound sweetening such as glucide 4. Processing of lipin (B) Tobacco Processing 1. Manufacture of cigarettes and filter tips (C) Textiles 1. Wool spinning, cotton spinning 2. Filature (D) Printing and Copying 1. Printing of publications (PRC side must have majority stake except for enterprises that print only packaging and decorations) (E) Oil Processing and Coking 1. Construction and operation of refinery factories	**III. Manufacturing** (A) Food Processing 1. Processing of green tea and special teas (famous teas, black tea, and others) (B) Pharmaceuticals 1. Traditional Chinese medicines listed as state-protected resources (musk, licorice root, jute, etc.) 2. Preparation techniques for traditional Chinese medicine in small pieces ready for decoction and products of secret recipe of traditional Chinese medicine already prepared (C) Smelting or Processing of Ferrous Mineral Products 1. Smelting or processing of radioactive mineral products (D) Weapons and Ammunition Manufacture (E) Other Manufacturing 1. Ivory carving 2. Tiger-bone processing 3. Bodiless lacquerware 4. Enamel products

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(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
(E) Timber Processing, Bamboo, Rattan, and Grass Products Manufacturing 1. Development of new technology and manufacture of new products for the comprehensive use of “subquality, small, and firewood” lumber and bamboo in the forest area (F) Papermaking and Paper Product Industry 1. Chemical wood pulp with annual production of 300,000 tons or more, chemical mechanical wood pulp with annual production of 100,000 tons or above (CTMP, BCTMP, APMP) and construction and operation of raw material forest base, forest wood pulp integration project (CJVs and EJVs only) 2. Slap-up paper and cardboard production (with the exception of newsprint) (G) Petroleum Processing and Coking Industry 1. Deep-processing of needle coke and coal tar 2. Tamp tar and dry cooling tar processing 3. Heavy construction access road pitch production (H) Chemical Feedstock and Chemical Manufacture 1. Heavy oil catalyzing and cracking oil refining manufacturing 2. Ethane manufacturing with annual production of 600,000 tons and mor (PRC side must be the largest shareholder) 3. Multi-purpose use of ethylene by-products—C5-C9 products 4. Large-scale PVC resin manufacturing (ethene method) 5. Organochlorine series chemical product manufacturing (with the exception of those with high residues of organochlorine products) 6. Basic organic industrial chemicals: multipurpose use of ramification of benzene, toluene, xylene (opposite, adjacent, among) 7. Material that forms a complete set of composite material: bisphenol A,4.4' diphenylmethane vulcabond, toluene disocynate manufacturing 8. Synthetic fiber material, purified terephthalic acid, acrylonitrile, caprolactam, adipic acidhexamethylene diamine salt manufacturing 9. Synthetic rubber: liquid styrene-butadiene rubber, butyl rubber, isoprene, butadiene method, neoprene, den flex, acrylic rubber, chlorohydrine rubber manufacturing	(F) Manufacture of Chemical Raw Materials and Goods 1. Manufacture of ionic membrane caustic soda 2. Manufacture of sensitization materials 3. Manufacture of biphenyl amine 4. Manufacture of medical goods that can be readily used to manufacture drugs (ephedrine, 3, 4-methylenedioxythenyl-2-propanono, benzene acetic acid, 1- phenyl –2- acetone, heliotropin, yellow camphor, other yellowish camphors, acetic acid anhydride) 5. Manufacture of sulphuric acid basic titanium white 6. Manufacture of boron and magnesium iron ore 7. Manufacture of barium salt (G) Medicine Production 1. Manufacture of chloramphenicol, penicillin G, lincomycin, gentamicin, dihydrostreptomycin, anicacin, tetracycline hydrochloride, oxytetracyline, medemycin, kitasamycin, norfloxacinum, ciprofloxacin, and ofloxacin. 2. Manufacture of Analgin, aspirin, paracetamol, vitamin B1, B2, C, and E 3. Immunity vaccinums included in the state plan, bacterins, antitoxins, and anatoxin (BCG vaccine, poliomyelitis, DPT vaccine, measles vaccine, Type-B encephalitis, epidemic cerebrospinal meningitis vaccine) 4. Manufacture of addictive narcotic and psychoactive drugs (PRC side must have majority stake) 5. Manufacture of blood products 6. Manufacture of nonself-destructive single-use syringes, blood transfusion devices, and blood bags (H) Chemical Fiber Manufacturing 1. Manufacture of chemical fiber conventional chipper	5. Xuan paper, and ingot-shaped tablets of Chinese ink 6. Production of carcinogens or other products that cause deformity or mutation, and production of permanent organic pollutants

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
10. Plastics engineering and plastic alloy manufacturing 11. Fine chemical industry: Catalyzers, aids, and new product of petroleum additives, new technology, dyestuff (pigment) commercialization processing, high-tech chemicals for electronic and papermaking use, food additives, fodder additives, leather chemicals, oil field aids, surface activators, water treatment compounds, cement, inorganic fibers, and inorganic powder filling manufacturing 12. Aids, finish oil, variegate material manufacturing for spinning and chemical fiber reeling use 13. Manufacture of clarifiers, catalytic converters, and other auto exhaust systems 14. Manufacture of natural spice, synthetic spice, and single spice 15. Manufacture of high-performance paint 16. White titanium pigment manufacturing with chlorination route 17. Manufacture of fluorochlorohydrocarbon substitutes 18. Large-scale coal and chemical product manufacturing 19. Exploration and development of forestry chemical product, new technology, and new product 20. Ion membrane manufacturing for caustic soda use 21. Manufacture of bio fertilizer, heavy concentration fertilizer (potash fertilizer, phosphate fertilizer), compound fertilizer. 22. Exploration and development of high-efficiency, low-toxic, low-residues chemical pesticide and technical grade's new species 23. Exploration and development of biopesticide 24. Exploration and development of organic, inorganic, and biomembrane for environmental protection 25. Multipurpose use, disposal, and treatment of exhaust gas, exhaust liquid, and exhaust residue (I) Medicine Manufacture 1. Manufacture of material medicine protected by the PRC's patent or administration and chemical material medicine needing to be imported 2. Vitamin: manufacture of nicotonic acid 3. Aminophenol: Manufacture of serine, tryptophan, and histidine 4. Analgesic manufacturing using new technology equipment	2. Manufacture of viscose staple fiber with single-thread output capacity of less than 20,000 tons per year 3. Manufacture of fiber and nonfiber polyester, urethane elastic fiber of less than 400 tons per day (I) Rubber Product Manufacturing 1. Cross-ply and old tire reconditioning (not including radial tire) and production of low-function industrial rubber accessories (J) Nonferrous Metal Smelting and Processing Manufacturing 1. Rare earth metal smelting and separation (limited to EJVs and CJVs) (K) Common Machinery Manufacturing 1. Production of containers 2. Medium-sized and small common bearings manufacturing 3. Manufacture of auto cranes less than 50 tons (limited to EJVs and CJVs) (L) Special-Use Equipment Manufacturing 1. Manufacture of low- or medium-class B-type ultrasonic displays 2. Manufacture of common long-thread terylene and short-fiber devices 3. Manufacture of track bulldozers less than 320 horsepower, wheel loading machines less than 3 cubic meters (limited to CJVs and EJVs) (M) Electronics and Telecommunication Appliance Manufacturing 1. Production of satellite navigation receiving equipment and key parts	

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
5. New type anticancer medicine and new type heart blood vessel and brain blood vessel medicine manufacturing 6. New type, high-efficiency, economical contraceptive medicine and equipment manufacturing 7 New type medicine manufacturing using biology engineering technology 8. Gene engineering bacterin manufacturing (AIDS bacterin, the third type of hepatitis bacterin, contraception bacterin, etc.) 9. Development and production of oceanic medicine 10. AIDS and radiation and immunity type diagnosis reagent manufacturing 11. Pharmaceutical: new forms of prepared drugs and product manufacturing that use new technology such as slow release, controlled release, targeting, absorbing through surface, etc. 12. Exploration and application of new types of pharmaceutical adjuvant 13. Processing and manufacture of Chinese traditional medicinal crops, Chinese traditional medicine extracts, and prepared Chinese medicine 14. Biomedicine material and product manufacturing 15. Manufacture of new type of material for antibacterial medicine for animal use (antibiotics and chemically synthesized medicines inclusive) 16. Development and manufacture of new products or new types of antibiotics, anthelmintic, insecticide, anticoccidiosis medicine used for animals (J) Chemical Fiber Manufacture 1. Manufacture of differentiated chemical fibers and new tech fibers such as aramid fiber, urethane elastic fiber, carbon fiber 2. Manufacture of environmental protection types of fiber such as pectic and nontoxic spin 3. Manufacture of fiber and nonfiber polyester with daily production of 400 tons or more (K) Plastics 1. Manufacture of polyamide keep-fresh membrane 2 Exploration and manufacture of agricultural film new technology and product 3. Cleaning up and recycling of disposed plastic		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
(L) Nonmetal Mineral Product Manufacture 1. Manufacture of high-quality float glass with daily melting of 500 tons or above (central and western regions only) 2. New type of dry processing cement manufacturing using cement clinker, with daily production of 2,000 tons or above (central and western regions only) 3. Manufacture of glass fiber (through direct melting process) and glass fiber reinforced plastic (GFRP) products with annual production of 10,000 tons or more 4. Manufacture of high-level sanitation porcelain with an annual production of 500,000 pieces 5. Standard, refined porcelain using high grade decoration material manufacturing, with raw material of porcelain 6. Production of high-class refractory material used in furnaces for glass, ceramics, and glass fiber 7. Manufacture of nonorganic, nonmetal material and products (artificial crystal, high powered compound material, special type glass, special type porcelain, special type airproof material, special type cement material) 8. New type building materials manufacturing (light, multipurpose materials for wall, high powered environment-protection decorating and finishing materials, high-level water-proof materials and high effective thermal insulation materials) 9. Deep-processing of nonmetal mine (superfine grinding, super pure, and refined modification) (M) Nonferrous Metal Smelting and Rolling Processing Industry 1. Manufacture of wide and thick board 2. Manufacture of galvanized and corrosion-enduring zinc board 3. Production of direct reduced iron and retailored iron 4. Processing and treatment of steel scrap (N) Ferrous Metal Smelting and Rolling Processing 1. Manufacture of alumina with annual production of 300,000 tons or more 2. Metal smelting of low grade, difficult to extract metallurgy mine (CJVs and EJVs only, WFOEs permitted in western areas) 3. Production of hard alloys, tin compounds, and antimony compounds		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
4. Production of nonferrous composite materials, new-type alloy materials 5. Rare-earth applications (O) Metal Products 1. Design and manufacture of nonmetal product molds 2. Design and manufacture of car and motorcar molds (including die, jet molds, mod pressing molds etc.), jigs (including solder jigs, inspection jigs, etc.) 3. High-grade building, hardware, water-warming equipment and exploration and development of hardware (P) Ordinary Machinery Manufacture 1. Manufacture of linked digital control machine tool (more than 3 bearings) and digital control system and waiting equipment 2. Manufacture of high-performance welding robot and effective welding and assembling production lines 3. High-temperature resistant insulation material (with F, H insulation class) and mold casting insulation products 4. Development of proportional, servo-hydraulic technology and production of low-power pneumatic control valve and stuffing static seal 5. Production of precision trimming dies, precision cavity modes, and matrix standard components 6. Manufacture of precision bearings and all kinds of bearings used especially for main engines 7. Production of casts and forged semifinished products for cars and motorcycles (Q) Specialized Equipment Manufacture 1. New technology and new equipment exploration and manufacture of storage keeping fresh, grading, packing, drying, transporting, and processing of foodstuff, cotton, vegetable oils, vegetables, fruits, flowers and plants, forage grass, meat, aquatic products 2. Manufacture of installing agriculture equipment 3. New technology equipment manufacturing of agricultural and forest equipment 4. Design and manufacture of farm engines such as tractors and combine harvesters 5. Equipment manufacturing for recycling and multipurpose use of straw 6. Equipment manufacturing for multipurpose use of farm waste and animal- and bird-breeding waste on a large scale 7. Manufacture of new technical water-saving irrigation equipment		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
8. Manufacture of machinery used for wetland earthwork and sludge cleaning 9. Technology and equipment used for protection of aquatic ecological environment 10. Manufacture of controlling system equipment for long-distance water transfer projects 11. Manufacture of special equipment used for flood control and emergency rescue 12. Manufacture of key equipment for food industry, such as high-speed sterile canning and packaging equipment and label machines 13. Production technology and key equipment for amino acids, enzymes, and food additives 14. Manufacture of complete sets or key parts of 10 tons/hour or more feed-processing equipment 15. Manufacture of multicolor offset printing machine for web and folio or larger size sheet 16. Manufacture of new-technology polishing processing equipment for skins 17. Manufacture of special high-tech industrial sewing machines 18. Manufacture of complete sets of new-type weaving machinery and paper (including pulp) machinery 19. Design and manufacture of new-type road and harbor machinery 20. Manufacture of equipment for road and bridge maintenance and automatic detection 21. Manufacture of equipment for road and tunnel operation control, ventilation, natural calamity prevention, and rescue systems 22. Design and manufacture of equipment for large-scale railroad 23. Manufacture of new-technology garden machine and tools 24. Manufacture of special urban environmental sanitation equipment 25. Manufacture of road milling and repairing equipment 26. Manufacture of tunnel digging machine and underground metro excavating machinery 27. Manufacture of 80,000 tons/day and more urban sewage-disposal equipment, membrane processing machinery for industrial waste water, up-flow anaerobic fluid-bed, and other biological wastewater disposal equipment; recycling equipment for waste plastics; desulfuring and de-nitrifying equipment for industrial boilers; large, high-temperature resistant and acid-resistant sack dust-cleaning apparatus and garbage-burning equipment		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
28. Manufacture of turbine compressors and combined granulating devices in the complete set of equipment annually yielding 300,000 and more tons of synthetic ammonia, 480,000 and more tons of urea, or 450,000 and more tons of ethylene 29. Desulfuring technology and related equipment for thermal power station 30. Continuous plate casting machine 31. Flat plate glass deep-processing technology and related equipment 32. Under-pit nonrail mining, loading and transporting equipment, 100 tons and more mechanic-transmission self-dumping mining truck, motional crusher, 3,000 cubic meters/hour and more bucket excavator, 5 cubic meters and more mining loading machine, and full-section tunneling machine 33. Design and manufacture of new appliance and equipment for oil exploration and development 34. Manufacture of clearing equipment for electro-mechanical wells and production of medicines 35. Manufacture of electronic endoscope 36. Manufacture of medical X-ray unit with high- frequency technology, direct digital picture processing technology, and radiation quantity less than 80 kW 37. Manufacture of high field-intensity super-conductive MRI device 38. Manufacture of single plasma-drawing instrument 39. Manufacture of automatic enzyme immunoassay equipments (functions include adding-samples, enzyme linked immunosorbent assay, washing templates, hatching, and post-data handling, etc.) 40. Manufacture of new technology and equipment that control the quality of medicines 41. Manufacture and development of new analytical and extraction technology and equipment for the effective substances of traditional Chinese medicine 42. Wrapping materials and container for new medicines and other advanced pharmaceutical equipment (R) Transportation Vehicles and Equipment Manufacture 1. Complete automobiles and complete motorcycles foreign equity stake may not exceed 50% 2. Engines of automobiles and motorcycles 3. Manufacture of key spare parts for cars: complete brakes, complete driving rods, gear-		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
boxes, steering knuckles, fuel pumps for diesel engines, pistons (including pistoning), valves, hydraulic tappets, shock absorbers, glass lifters, compound meters, car fasteners 4. Production of electron-controlled fuel-oil injecting systems, electronic-controlled brake and locking-prevention systems, safety aeocysts, and other electronic equipment 5. Production of key spare parts for motorcycles: carburetors, magnetors, starting motors, disc brakes 6. Cars for special purposes such as desert cars for petroleum industry 7. Technical equipment for railway transportation: design and manufacture of locomotives and main parts, design and manufacture of line and bridge facility and equipment, related technology and equipment manufacture for rapid transit railways, manufacture of equipment for communication signals and transportation safety monitoring, manufacture of electric railway equipment and instruments 8. Equipment for high-speed rail transportation in cities 9. Design and manufacture of civil planes (PRC side must have majority stake) 10. Manufacture of spare parts for civil planes 11. Design and manufacture of civil helicopters (PRC side must have majority stake) 12. Design and manufacture of airplane engines (PRC side must have majority stake) 13. Design and manufacture of civil carriers (PRC side must have majority stake) 14. Manufacture of light gas turbine engines 15. Design and manufacture of crankshafts for low-speed diesel engines for ships 16. Repair, design, and manufacture of special ships, high-performance ships (PRC side must have majority stake) 17. Design and manufacture of diesel engines for ships, auxiliary machines, wireless communication, navigation equipment and parts (PRC side must have majority stake) 18. Manufacture of fiberglass fishing boats and yachts (S) Power-generating Equipment and Manufacturing 1. Thermoelectric equipment: 600,000 megawatt (MW) (and above) supercritical units, large-scale gas turbines; 100,000 MW (and above) gas-steam combined cyclical generating equipment, coal gas integrated gasification combined-cycle plant technology and equipment (IGCC), pressurized fluidized bed combustion (PFBC), 600 MW (and above) large-		

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(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
scale air-conditioning units (limited to EJVs or CJVs). 2. Hydroelectric equipment: 150,000 MW (and above) large-scale pumped storage units, 150 MW (and above) large-scale tube-style unit manufacturing (limited to EJVs or CJVs) 3. Nuclear units: 600,000 MW (and above) unit manufacturing (limited to EJVs or CJVs) 4. Electric transmission and transformer equipment: 500 kilovolt (and above) super high-voltage direct current transmission and transformer equipment manufacturing (limited to EJVs or CJVs) (T) Electronics and Communication Equipment Manufacturing Industry 1. Digital televisions, digital video cameras, digital video players, digital audio player equipment manufacturing 2. New-type flat-panel displays, midhigh pixel color picture tube and shell production 3. Digital audio and video frequency coding and decoding equipment, digital broadcasting studio equipment, digital cable television system equipment, digital audio frequency broadcasting equipment manufacturing 4. Integrated circuit design and large-scale production of integrated circuits with a line width of 0.35 micron or smaller 5. Large and medium-sized computers, portable microcomputers, top-grade server manufacturing 6. High-capacity laser disks, disks, and parts development and manufacturing 7. Manufacture of three-dimensional CAD, CAT, CAM, CAE, and other computer application systems 8. Software development and production 9. Semiconductor and component materials development and production 10. Special electronic equipment, testing equipment, and tool mold manufacturing 11. Production of new-type electronic spare parts (slice space parts, sensitive components and sensors, frequency controlling and selecting components, hybrid integrated circuits, electric and electronic parts, photoelectric components, new type electromechanical components) 12. Production of high technology "green" batteries including nonmercury alkali-manganese batteries, dynamic nickel-hydrogen batteries, lithium-ion batteries, high-capacity omniseal safeguard-free lead-acid storage batteries, fuel cell, cylindrical zinc-air batteries, etc.		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
13. Development and manufacture of high-capacity mass storage of laser disks, disks, and parts 14. Manufacture of recordable disks (CD-R, CD- RW, DVD-R, DVD-ARM) 15 Design and manufacture of civil satellites (PRC side must have majority stake) 16. Manufacture of satellite payloads (PRC side must have majority stake) 17. Manufacture of spare parts for civil satellites 18. Design and manufacture of civil carrier rockets (PRC side must have majority stake) 19. Manufacture of equipment for satellite communications 20. Receiving equipment for satellite navigation and key parts (WFOEs not allowed) 21. Manufacture of optical fiber prefabricated stick. 22. Manufacture of microwave communication systems more than 622 MB/S 23. Manufacture of photo timing digital serial communication systems of more than 10 GB/S 24. Manufacture of broadband cut-in communication system 25. Manufacture of digital cross-linking (OXC) equipment 26. Manufacture of asynchronous transfer pattern (AMT) and IP data communication system 27. Manufacture of equipment for mobile communication system (Including: GSM, CDMA, DCS1800, PHS, DECT, IMT2000 etc.), mobile phones, base stations, exchange boards, and digital colony systems 28. Manufacture and development of high-end router and network switches more than 1GB 29. Manufacture of air-traffic control equipment (WFOEs not allowed) (U) Apparatus, Instruments, and Machines for Cultural and Office Use Manufacturing Industry 1. Development and manufacture of digital camera and key components 2. Development and manufacture of precision on-line measuring instruments 3. Manufacture of new technical equipment for safe production and environmental protection detecting instruments 4. Manufacture of new technical equipment of water quality and smoke on-line detection instruments 5. Manufacture of instruments and equipment for hydrological data collection, handling, and delivering and for flood warning systems		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
6. New-type meters spare parts and materials (mainly new switches and function materials for meters such as intelligent sensors, electrical adapters, flexible circuit plate, photoelectric switches, proximity switches, and so on) 7. Development and manufacture of new-type printing devices (laser printers, inkjet printers) 8. Maintenance of precision instruments and equipment, service after sales (V) Other Manufacturing Industries 1. Comprehensive development and use of clean coal (water-coal and liquefied coal) 2. Coal ore-dressing and washing, and the comprehensive use of coal ash (including desulfurizing gypsum), low-quality coal and coal refuse, etc.		
IV. Electric Power, Gas, and Water Production and Supply 1. Construction and operation of thermal power stations with single-unit installed capacity of 300,000 kilowatt-hour (kWh) and above 2. Construction and operation of power stations with clean coal-burning technology 3. Construction and operation of heat-power joint-generation stations 4. Construction and operation of gas power stations 5. Construction and operation of hydropower stations with the main purpose of generating power 6. Construction and operation of nuclear power stations (PRC side must have majority stake) 7. Construction and operation of new energy power stations (including solar energy, wind energy, magnetic energy, geothermal energy, tidal energy, and biomass energy, etc.) 8. Construction and operation of urban water supply plants	**IV. Electric Power, Gas, and Water Production and Supply** 1. Construction and operation of conventional coal-fired power plants whose single-machine capacity is 300,000 kWh or less (small-sized power plant excluded)	**IV. Electric Power, Gas, and Water Production and Supply** 1. Construction and operation of electricity grid.
V. Water Management 1. Construction and operation of multipurpose water resources projects (PRC side must have majority stake)		

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
VI. Transportation, Warehousing, Post and Telecommunications 1. Construction and operation of main line railways (PRC side must have majority stake) 2. Construction and operation of branch line railways, local railways, and related bridges, tunnels, ferry facilities (CJVs and EJVs only) 3. Construction and operation of highways, independent bridges and tunnels 4. Construction and operation of public dock facilities at ports 5. Construction and operation of civil airports (PRC side must have majority stake) 6. Air shipping companies (PRC side must have majority stake) 7. Airline companies for general purpose of agriculture, forestry, and fisheries (only EJVs and CJVs) 8. Periodic and nonperiodic international sea transportation business 9. International multistyle container transportation cooperative Business 10 Road transportation company 10 . Construction and operation of oil (gas) conveying pipes, oil (gas) depots, and special wharves for oil transportation 11. Construction and operation of coal piping facilities 12. Construction and operation of storage facilities relating to transportation	**VI. Transportation, Warehousing, Post and Telecommunications** 1. Public passenger transportation companies 2. Cross-border automobile transportation companies 3. Water transportation companies 4. Freight train transportation companies 5. Passenger train transportation companies (PRC side must have majority stake) 6. General use airline companies for industrial, prospecting, or photography purposes (PRC side must have majority stake) 7. Telecommunications companies	**VI. Transportation, Warehousing, Post and Telecommunications** 1. Air traffic control companies 2. Post companies
VII. Wholesale and Retail Trade 1. The wholesale, retail, and physical distribution of ordinary goods (refer to notes for Restricted.VI.1)	**VII. Wholesale and Retail Trade** 1. Commodity trade, direct sales, mail-order, on-line selling, franchise operations, commission operations, market selling agent, commercial management, and similar commercial companies, as well as wholesale, retail, and distribution of food, cotton, vegetable oil, sugar, medicine, tobacco, automobile, crude oil, and agriculturally produced materials 2. Wholesale and retail service in books, newspapers, and periodicals 3. Distribution of audiovisual products (except movies) 4. Auction of commercial goods 5. Goods leasing companies 6. Agencies (shipping, freight transport, foreign freight forwarder, advertisement, and others)	

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
	7. Wholesale of refined petroleum as well as construction and operation of gas stations 8. Foreign trade companies	
	VIII. Finance and Insurance 1. Banks, finance companies, and investment trust companies 2. Insurance companies 3. Securities companies, stock investment fund companies 4. Financial leasing companies 5. Foreign exchange brokerages 6. Insurance broker companies	**VIII. Finance and Insurance** 1. Futures trading companies
IX. Real Estate 1. Development and construction of common residences	**IX. Real Estate** 1. Leveling and development of land (limited to EJVs and CJVs) 2. Construction and operation of high-grade hotels, single unit houses, high-level office buildings, and international meeting and exhibition centers	
X. Social Service Industry (A) Public Facilities and Services 1. Construction and operation of municipal enclosed road systems 2. The construction and operation of municipal railway and tramway transportation systems (PRC side must have majority stake) 3. Construction and operation of sewage treatment plants, garbage treatment plants, dangerous waste disposal and treatment plants (incineration plant, landfills) and environmental pollution controlling and regulating facilities (B) Information and Consulting Service 1. Information consultation service about information of international economy, science and technology, and environmental protection 2. Accounting, auditing	**X. Social service industry** (A) Public Infrastructure Services 1. Construction and operation of natural gas, heating, and public sewage pipe systems in large and medium-sized cities (PRC side must have majority stake) (B) Information and Consulting Services 1. Legal consulting	**X. Social Service Industry** 1. Exploitation of wild animal and plant resources protected by the state 2. Construction and operation of animal and plant natural reserves 3. Gambling industry including horse racing 4. Pornography industry
XI. Health, Sports, and Social Welfare 1. Services for elderly and handicapped people	**XI. Health, Sports, and Social Welfare** 1. Medical institutions (limited to EJVs and CJVs) 2. Construction and operation of golf courses	

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
XII. Education, Cultural Arts, Broadcasting, and Film Industries 1. Institutions of higher education (limited to EJVs and CJVs)	**XII. Education, Cultural Arts, Broadcasting, and Film Industries** 1. Senior high-school level educational institutions (limited to EJVs and CJVs) 2. Construction and operation of movie theaters (PRC side must have majority stake)	**XII. Education, Cultural Arts, Broadcasting, and Film Industries** 1. Elementary education (compulsory education) institutions 2. Publication, general distribution and importation of books, newspapers, and periodicals 3. Production, publication, distribution and importation of audio-visual products or electronic journals 4. News agencies 5. All levels of broadcasting channels and stations, TV channels or stations, and broadcasting television transmission coverage networks (including launching stations, relay stations, TV broadcast satellites, satellite upload stations, satellite receiver platforms, microwave stations, monitoring platforms and cable television transmission coverage networks) 6. Broadcast television program production, publishing, distribution and screening companies 7. Film production and distribution companies 8. Video-tape screening companies
XIII. Scientific Research and Comprehensive Technology Services 1. Biological engineering and biomedical engineering technology 2. Isotopic irradiation and laser techniques 3. Ocean and ocean energy development technology 4. Seawater desalting and seawater use of technology 5. Ocean monitoring technology 6. Development of energy-saving technology 7. Technology for recycling and comprehensive use of resources 8. Technology for improving and monitoring environmental pollution 9. Technology for antidesertification and controlling desert 10. Application technique of civilian satellites 11. Research and development centers 12. Centers for developing new high technology and new products as well as enterprise incubation centers	**XIII. Scientific Research and Comprehensive Technology Services** 1. Surveying and drawing companies (PRC side must have majority stake) 2. Import-export commodity inspection, appraisal, and authentication companies	

continued next page

(Appendix 4 table continued)

Encouraged Foreign Investment Industries Catalogue	Restricted Industry	Prohibited Industry
		XIV. Miscellaneous 1. Projects that endanger the safety or performance of military installations
XV. All foreign investment projects in the permitted category that directly export all products	**XV. Other industries limited by the State or by international treaties that the PRC has signed or participated in**	**XV. Other industries limited by the State or by international treaties that the PRC has signed or participated in**

CJV = contractual joint venture, EJV = equity joint venture, JV = joint venture, PRC = People's Republic of China, WFOE = wholly foreign owned enterprises, WTO = World Trade Organization

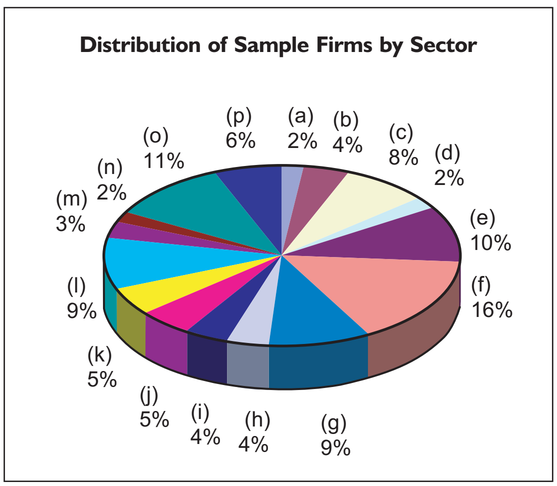
Note: Annex regarding the WTO commitments are reflected in Appendixes 4 and 5.

Sources: Unofficial translation. SDPC, SETC, MOFTEC. Waishang Touzi Chanye Zhidao Mulu (Catalogue for Sectoral Guidance of Foreign Investment). Effective 1 April 2002.

ASIAN DEVELOPMENT BANK PRIVATE SECTOR ASSESSMENT: BUSINESS CLIMATE SURVEY February–March 2002

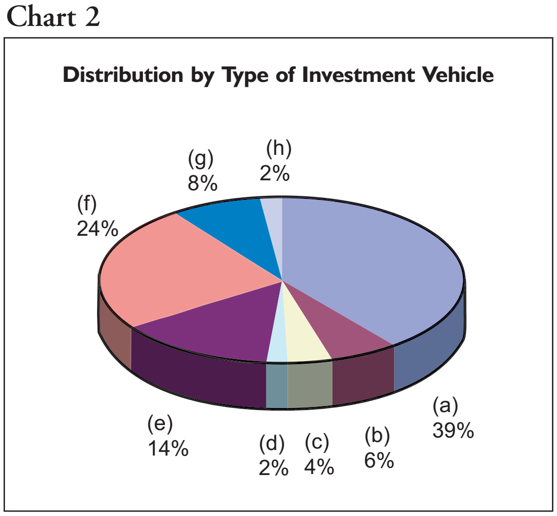
Sample Firm Profile: Sample firms number 108 companies (the member firms of foreign chambers of commerce and business councils from Australia; Canada; Hong Kong, China; Italy; Japan; Republic of Korea; United Kingdom; and United States). By industry sector, general manufacturing (industrial products) accounts for 16%, followed by services (legal, tax/accounting firms), financial sector and utilities (Chart 1). Over one third of the sample firms are representative offices (Chart 2). Small companies with employees under 500 account for 86%, while large firms 14% (Charts 3 and 4).

Chart 1



a. Agriculture and Agribusiness (2%)
b. Oil, Gas, and Chemicals (4%)
c. Metal and Mining (8%)
d. Construction and Construction Materials (2%)
e. General Manufacturing- Consumer Products (10%)
f. General Manufacturing- Industrial Products (16%)
g. Financial (banking, insurance and financial services) (9%)
h. Real Estate (4%)
i. Retail/Distribution (4%)
j. Transportation (5%)
k. Telecom (5%)
l. Utilities (electric, gas, and water) (9%)
m. Information Technology and E-commerce (3%)
n. Services (leisure, hotels, etc) (2%)
o. Services (legal, tax/accounting, consulting) (11%)
p. Others (6%)

Chart 2



a. Representative Office (39%)
b. Branch Office (6%)
c. Holding Company (4%)
d. Trading/Distribution Company (2%)
e. Wholly Foreign-Owned Enterprise (14%)
f. Equity JV (24%)
g. Cooperative JV (8%)
h. Company Limited by Shares (2%)

Chart 3

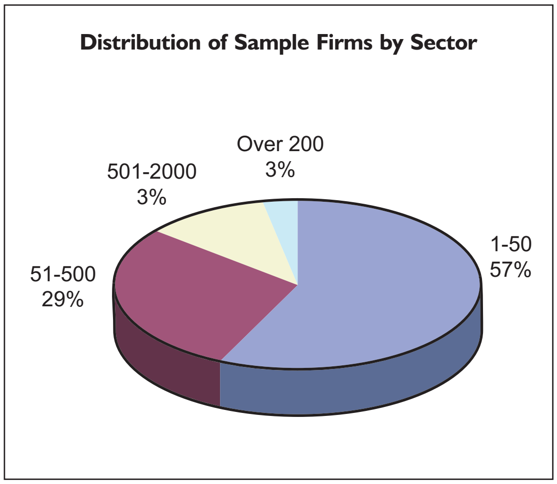
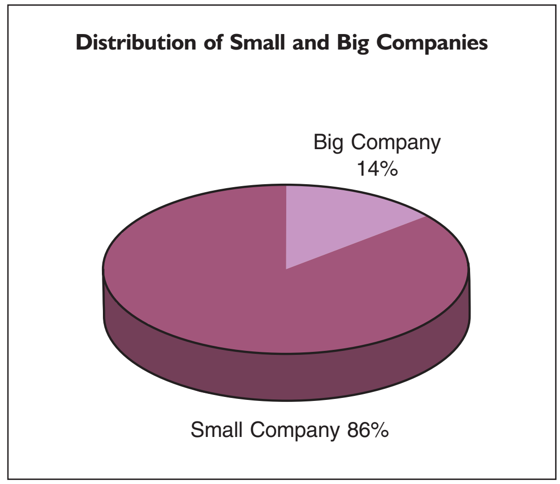


Chart 4



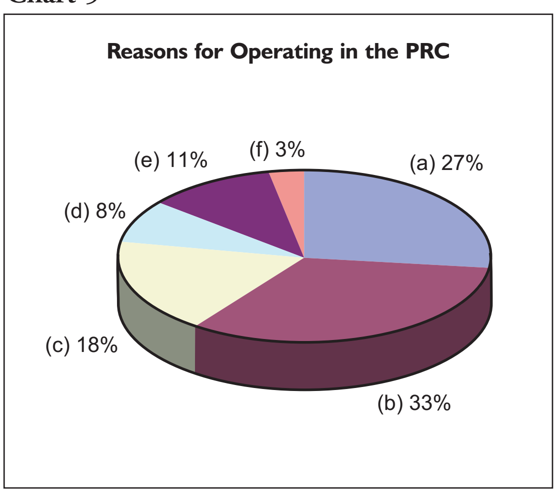
Market potential was cited as a top reason for operating in the PRC (33%), followed by the PRC as a high-priority emerging economy for company's global strategy (27%) (Chart 5).

Expansion Plans: Close to 90% of the sample firms will expand their operations in the next 5 years, of which 22% will expand rapidly rather than gradually (Chart 6).

Western and central regions are within the scope of expansion for 59% of the sample firms (Chart 8). Potential market is a major reason for considering to expand into the regions (Chart 9).

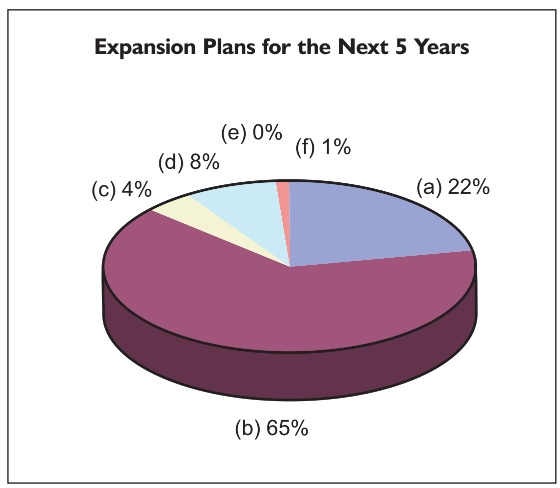
Infrastructure constraints and underdeveloped consumer markets are two major reasons why 41% of the sample firms are not considering to expand into western and central regions (Chart 10).

Chart 5



a. The PRC as high-priority emerging economy for company's global strategy (27%)
b. Market potential in the PRC (33%)
c. Preemptive investment to develop dominant market position in sector (18%)
d. Low cost of operations (8%)
e. To serve multinational clients operating in the PRC (11%)
f. Others (3%)

Chart 6



a. Expand rapidly (22%)
b. Expand gradually (65%)
c. Stay the same (4%)
d. Wait and see (8%)
e. Pull back (0%)
f. Pull Out (1%)

Chart 7

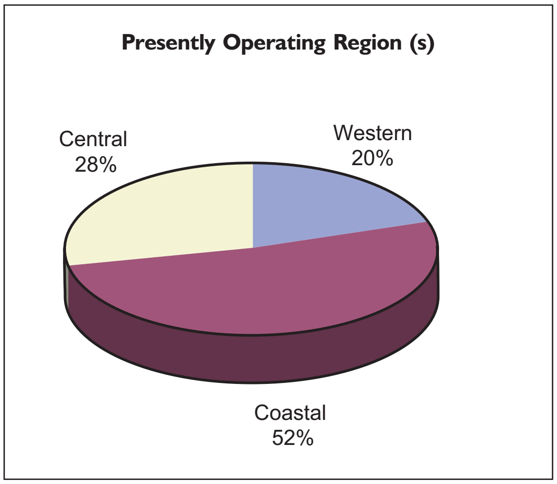


Chart 8

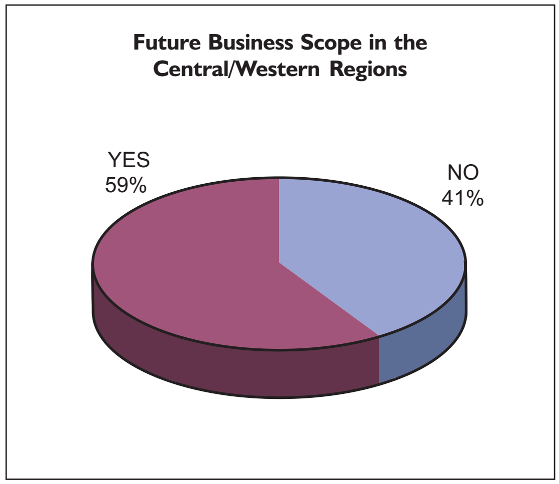
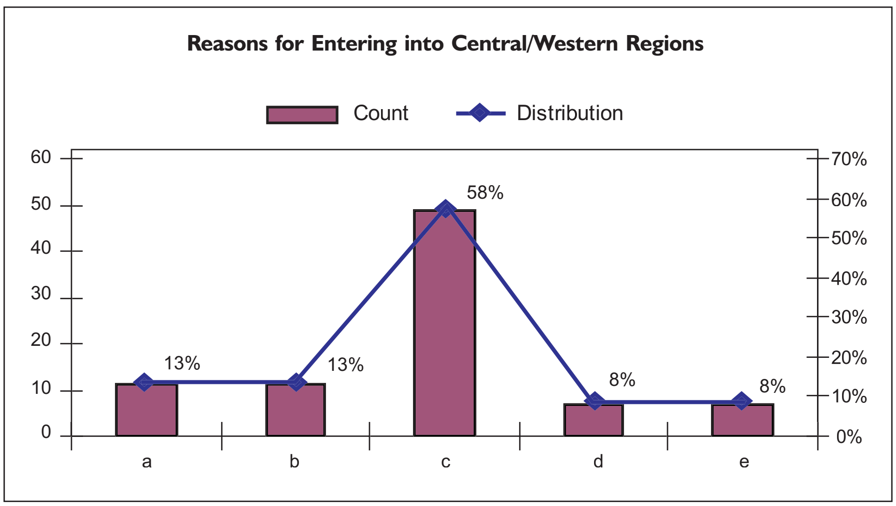
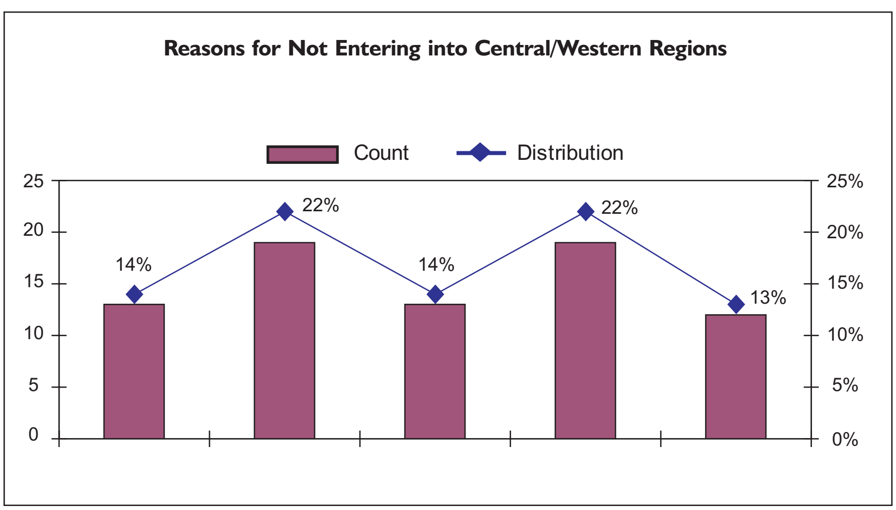


Chart 9



a. Investment incentives (13%)
b. Abundant resources (13%)
c. Potential market (58%)
d. Solid industrial foundation (8%)
e. Strong science and technology capability (8%)

Chart 10



a. Lagged economic development (14%)
b. Infrastructure constraints (22%)
c. Little market awareness (14%)
d. Underdeveloped consumer market (22%)
e. Human resources (13%)

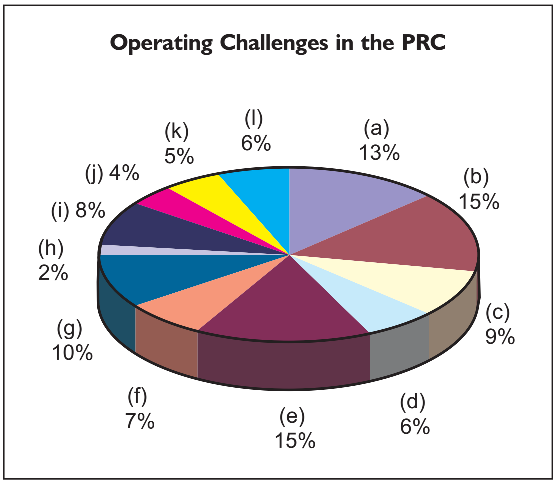
Transparency problems and bureaucracy are biggest operating challenges faced by the sample firms (Chart 11).

The sample firms consider the PRC market environment as being characterized by overregulation and lack of discipline in market competition (Chart 12).

As high as 79% of the sample firms face market restrictions. If combined, government permit and government policy account for two thirds of market entry constraints (Charts 13 and 14).

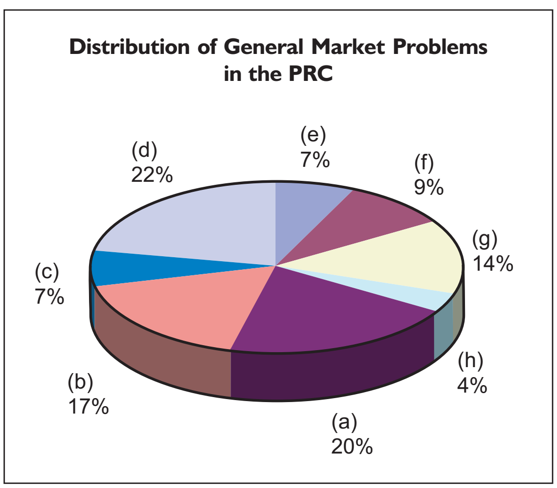
Around 43% of the sample firms experienced infringements on intellectual property rights (IPRs), of which one third cited their experiences as serious, including material losses (Charts 15 and 16).

Chart 11



a. Human resources issues (13%)
b. Transparency problem (15%)
c. Market access barriers (9%)
d. Strategic market development; understanding the market (6%)
e. Bureaucracy, red tape, and arbitrary approvals or business transaction interference (15%)
f. Foreign exchange management and repatriation of foreign exchange (7%)
g. Increased competition (10%)
h. Distribution problems (2%)
i. PRC partner relationship/management of the venture (8%)
j. Cultural or language barriers/misunderstandings (4%)
k. Quality issues (5%)
l. Corruption and integrity problems (6%)

Chart 12



a. Unfair market competition (20%)
b. Local protectionism (17%)
c. Monopoly (7%)
d. Overregulation (22%)
e. Fake products (7%)
f. Intellectual Property Rights (IPR) protection (9%)
g. Taxation (14%)
h. Others (4%)

Chart 13

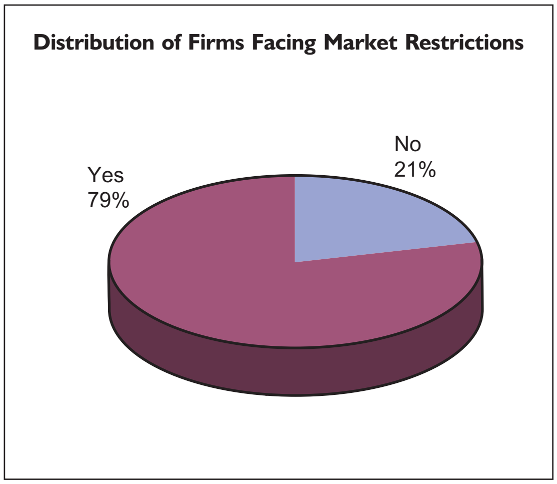
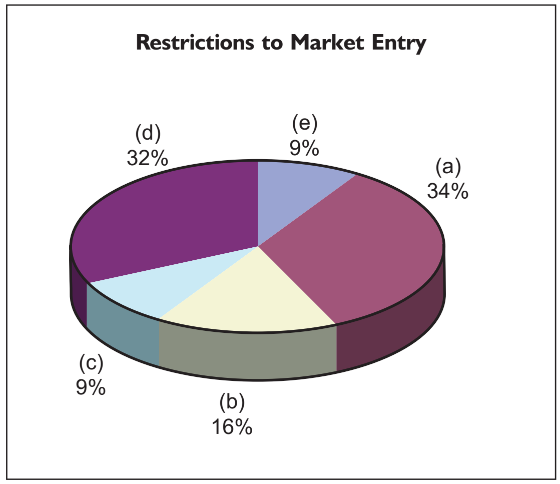


Chart 14



a. Government permit (34%)
b. Regional protection (16%)
c. Management limitation (9%)
d. Government policies (32%)
e. Market size (9%)

Chart 15

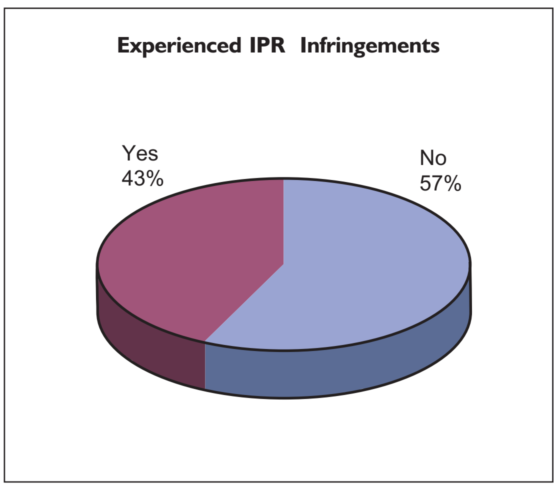
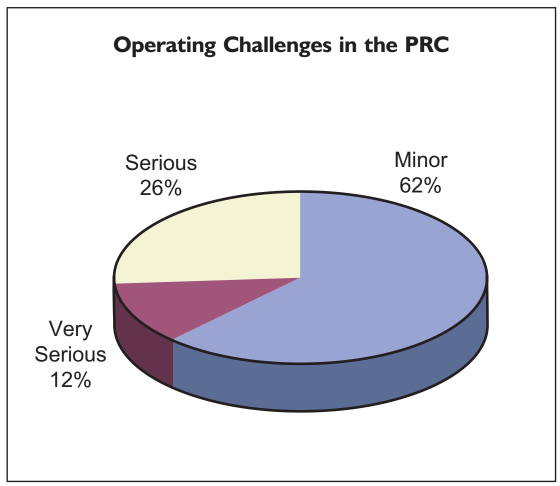


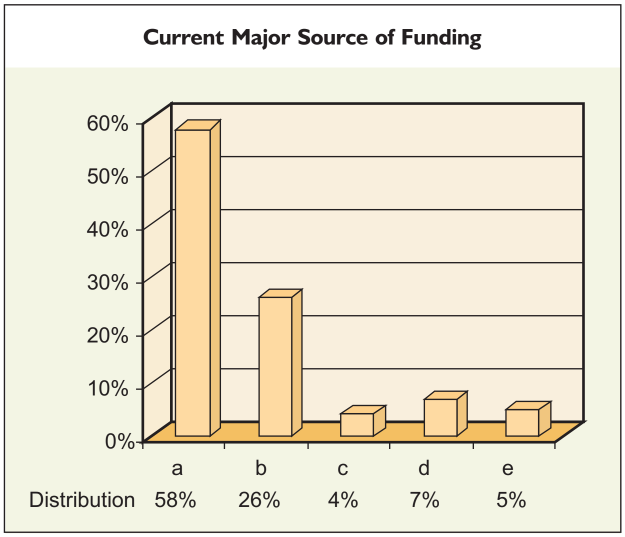
Chart 16



Major sources of financing for the sample firms are internal resources, followed by bank loans (Chart 17).

About 50% of large companies with more than 500 employees rely mainly on bank loans, while small companies rely on internal resources (Charts 18 and 19).

Chart 17



a. Internal resources
b. Bank loans
c. Capital markets
d. Venture capital fund
e. Others

Chart 18

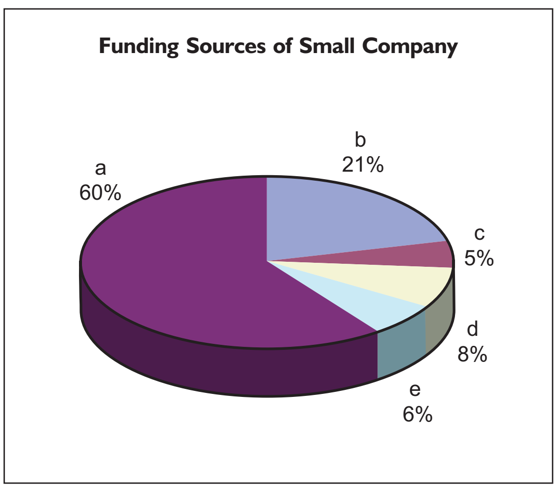
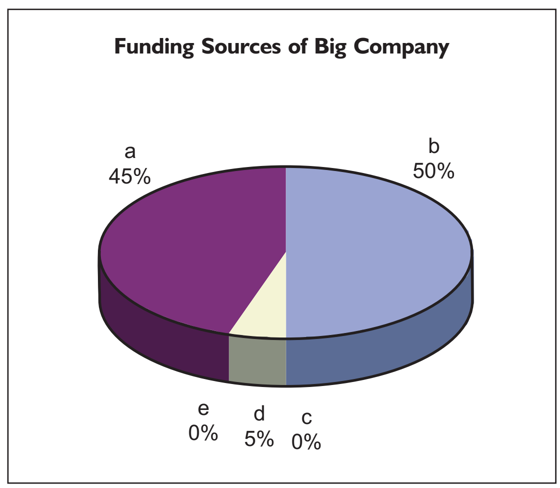
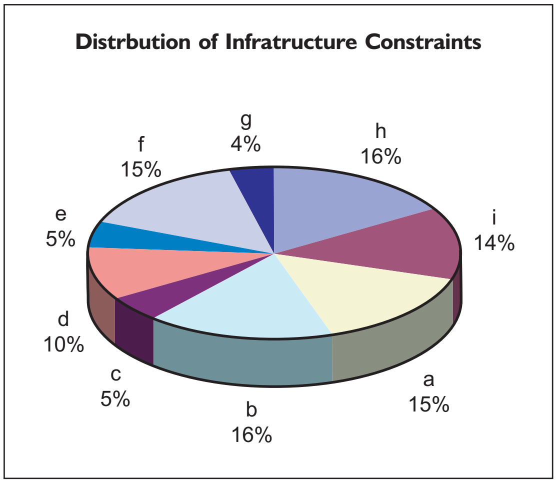


Chart 19



The following sample firms cited that improvements are necessary in various aspects of physical infrastructure: transportation, environment and sanitation, telecommunication facility and Internet.

Chart 20



a. Telecommunication facility (15%)
b. Road communication (16%)
c. Water supply (5%)
d. Electricity (10%)
e. Mailing system (5%)
f. Internet (15%)
g. Fuel, oil, and natural gas (4%)
h. Environment and sanitation (16%)
i. Land and building space (14%)

About two thirds of the companies responded that the PRC's entry into WTO will affect their PRC operations positively, followed by those commenting that it is not clear at this point; no or little impact; and negative impact. Also, 55% responded that WTO will have positive impact on their investment strategy (Charts 21 and 22).

The reasons cited by those who consider the PRC's entry into WTO as positive include (i) to improve transparency, (ii) to minimize regulations, and (iii) new market access (Chart 23).

A very small number of companies responded that the PRC's entry into WTO will affect negatively their operations due mainly to increased competition (Charts 24 and 25).

Chart 21

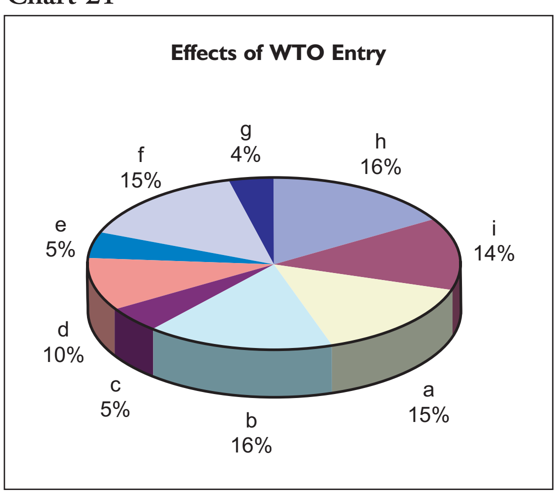


Chart 22

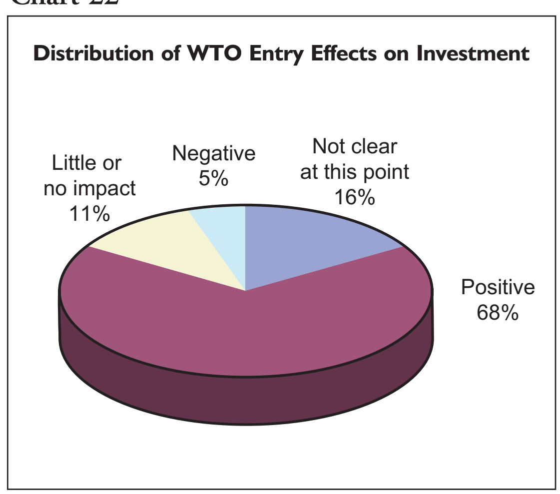
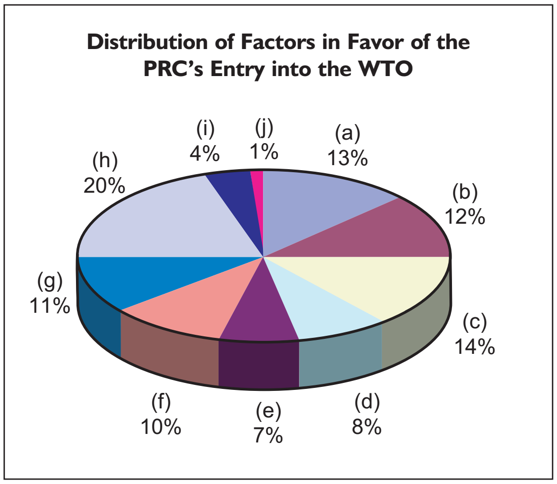
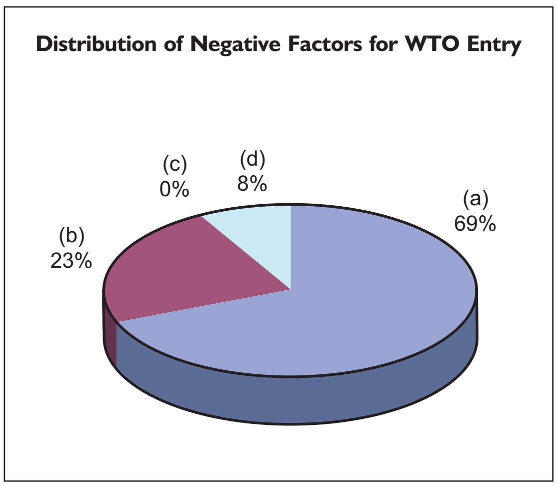


Chart 23



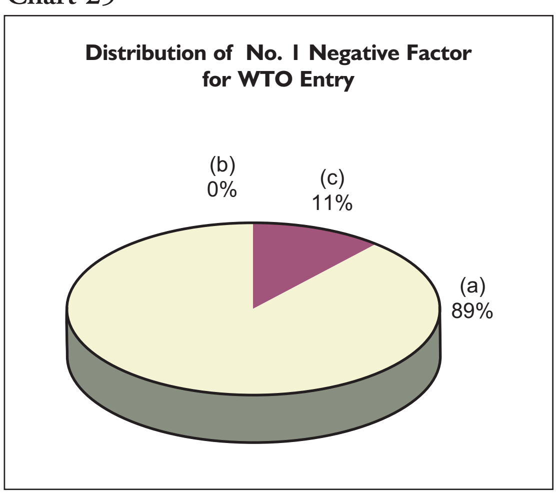
a. New market access (13%)
b. Lower taxes and tariffs (12%)
c. Minimize regulations (14%)
d. Will increase demand, improve macroeconomic environment (8%)
e. Fewer import restrictions (7%)
f. Level playing field for foreign companies (10%)
g. Increase attractiveness in the global economy; attract investment (11%)
h. Transparency will improve (20%)
i. More investment options (4%)
j. Provide a forum for dispute resolution (1%)

Chart 24



a. Increased competition
b. Higher cost of operation
c. Increased compliance and reporting requirements
d. Others

Chart 25



APPENDIX 6

SUMMARY OF SELECTED SURVEY FINDINGS–DOMESTIC PRIVATE ENTERPRISES

	ADB TA 3543-PRC	**IFC**	**DRC of State Council and JBIC**
Sample Firms	756: Beijing, Shenyang, Xi'an, Nanhai, Wenzhou, 82 CEO interviews	600: Beijing, Shunde, Chengdu, Wenzhou CEO interviews	1,121: Liaoning, Guangdong, Yunnan, Hubei SMEs by sector: SOE-35%; Collectives-31%; Private—11%; Sino—F JV—7%; Others—17%
Industry Distribution	63% manufacturing 9% retail 22% other services 35% electronics and apparatus 29% machinery	14% garments and other light products 10% metal, nonmetal manufacturing 8% chemicals 4% foods, cigarettes	24% manufacturing¯capital goods 26% intermediate goods 26% consumer goods
Operating Challenges	• Lack professional management • Poor marketing w/ no importance attached to "brand" • Access to information • HR deficiencies (senior management and skilled workers) • Labor disputes: one out of five firms • Access to finance • Physical infrastructure • Market barriers	• Access to finance • Managerial capacity • Domestic competition • Access to technology • Market information • Skilled labor	• Lack of funds • Lack of market demand • Excessive competition in the market • Lack of human resources • Market disorder • Lack of marketing capability
Funding	**Source of funding** • 26% individuals or family savings • 20% capital accumulation that is rolled over • 18% bank loans • 16% internal company funds **Reasons for not receiving bank loans** • 26% no credit guarantee • 22%¯not state-owned; • 16%¯lack of connections • 15%¯small scale of business	**Source of funding** • 95% self-financed • 4% bank loans • 2.6% other financial institution • 2.9% others **Reasons for not receiving bank loans and equity** • Lack clear title to assets • No transparent financial statement • Unequal treatment of private sector by local governments • PBOC's policy known as "responsibility to individual," (to deal with NPL issues) discourage credit officers to lend PS	**Source of funding** Finance over 80% of fixed investment through internal funds 62% Overall; 55% SOEs; 62% Collectives; 72% Private 78% Sino—F JV; 29% Lianying Finance over 80% of fixed investment through bank credits 7% Overall; 15% SOEs; 2% Collectives; 1.6% Private; 3% Sino—F JV Do not use bank loans for fixed investment 67% Overall; 61% SOEs; 69% Collectives; 78% Private; 86% Sino-F JV; 25% Lianying

continued next page

(Appendix 6 table continued)

	ADB TA 3543-PRC	IFC	DRC of State Council and JBIC
		• Lack clear title to assets and weak corporate governance (nonstate firms account for 1% of firms listed on the Shanghai and Shenzhen stock markets) (equity)	**Reasons for not receiving bank loans** • Not satisfying financial criteria for bank loans • Underdeveloped collateral, credit guarantee systems • Lack of lenders' experience and expertise to make loans to SMEs
Market Environment	**Market environment:** • 41% unfair market competition • 19% fake products • 11% taxation • 10% local protectionism • 9% overregulation **Market entry restrictions** • 25% regional protectionism • 23% market size • 19% government permit • 16% individual management	**Market restrictions** • 48% weak market demand in relation to existing capacity; tax breaks, subsidies, and preferential access to resources and markets available to JV. • 30% domestic competition • 18% regulatory barriers, legal restrictions; only limited list of private firms have direct export rights; and numerous sectors continue to be reserved for SOEs • 15% lack of distribution channels • 12% foreign competition	**Market restrictions** • 35% market size and restricted sales • 27% lack marketing measures, channels • 18% price competitiveness • 14% market disorder **Most critical factor** • SOE, Collectives, Private—Lack of marketing measures • Sino-F JV—Market size and restrictions

ADB = Asian Development Bank, CEO = Chief Executive Officer, DRC = Development Research Center (of the China State Council), HR = human resources, IFC = International Finance Corporation, JBIC = Japan Bank for International Cooperation, FJV = foreign joint venture, NPL = nonperforming loans, PBOC = People's Bank of China, PRC = People's Republic of China, PS = private sector, SME = small and medium enterprise, SOE = State-Owned Enterprise, TA = technical assistance

SUMMARY OF SELECTED SURVEY FINDINGS–FOREIGN INVESTORS

	ADB Private Sector Assesment	American Chamber of Commerce Survey 2002	Swiss Chamber of Commerce (EU Position Paper)
Sample firms and industry	108	172	65
	16% manufacturing (industrial goods) 11% services (legal, tax/accounting, consulting) 10% manufacturing (consumer goods) 9% utilities 9% finance	36% manufacturing 25% services 13% telecom 7% energy 19% others	(Various industry group member companies) 66% industrial sector 23% services sector
Views on PRC	**Top Reasons for Operating in the PRC** 33% market potential 27% a high priority in global strategy 18% preemptive investment 11% clients operating in PRC	**General Views** 41% optimistic 51% cautiously optimistic	**General Views** Long-term prospective promising
Expansion Plan	65% expand gradually 22% expand rapidly 8% wait and see 1% stay the same	67% expand gradually 20% expand rapidly 7% stay the same 6% wait and see	85% expand 15% remains the same 0% reduce/withdraw
Operating Challenges	• Transparency issues • Bureaucracy, arbitrary approvals • Human resources • Increased competition • PRC partner relationship	• Weak transparency • Bureaucracy • Weak enforcement of law • Business scope restrictions • Protectionism • Management level HR constraints	• Lack of rule of law (various aspects) (1) Transparency of laws and regulations (2) Consistency of law enforcement
Market Environment	**Market Environment** • 22% overregulation • 20% market disorder • 17% local protection • 14% taxation • 9% intellectual protection • 7% fake products **Entry Restrictions: Yes 79%; No 21%** • 34% government permit • 32% government policy • 16% regional protection • 10% market size • 9% management limitation		• Local protectionism • Intellectual property rights protection • Taxation (transparency of tax system and consistency of tax law enforcement) • Import/export and distribution as serious problems for those who want to distribute their products within the PRC

continued next page

(Appendix 7 table continued)

	ADB TA 3543-PRC	IFC	DRC of State Council and JBIC
IPR	**IPR Infringements:** **Yes 43%; No 57%** • 12% very serious • 26% serious • 62% minor		• 74% concerned about the general respect for IPR • 73% concerned about public education on IPR
WTO Impact	**WTO Impact on Operations** • 68% generally positive • 11% little or no impact • 5% generally negative • 16% not clear **Positive Reasons** • 19% improved transparency • 16% minimize regulation • 14% lower tariffs • 13% new market access **Negative Reasons** • 73% increased competition • 18% higher cost of operation **WTO Impact on Investment Strategy** • 53% generally positive • 19% no or little impact • 28% unclear	**Sensitivity of 5-Year Business Plan** • 59% somewhat sensitive • 23% very sensitive • 18% not sensitive **Positive Reasons** • 85% increased transparency • 81% increased business scope • 66% increased investment options **Negative Reasons** • 86% WTO agreements ignored • 84% New regulations to counter WTO • 83% Increased protectionism **WTO Impact on Investment Strategy** • 66% increased investment options	
Information Acceess	**Market** -54% difficult; 44% not difficult **Tax/accounting** -42% difficult; 49% not difficult **Legal:** 39% difficult; 51% not difficult **HR:** 42% difficult; 42% not difficult	**Effects of Management Level HR Constraints** • 47% strongly negative impact • 37% no impact • 16% slightly negative impact	**Difficult to Access** • 65% information on existing laws/regulations on environment protection

ADB = Asian Development Bank, EU = European Union, HR = human resources, IPR = intellectual property rights, PRC = People's Republic of China, WTO = World Trade Organization

IMPLICATIONS FOR THE BANKING SECTOR OF WORLD TRADE ORGANIZATION'S OBLIGATIONS

1. **Implications for Domestic Banks.** World Trade Organization (WTO) accession is likely to produce significant competitive pressure on the People's Republic of China (PRC)'s domestic banking sector. In the short to medium term, domestic banks' net interest margins will narrow and profitability will be squeezed. Weak banks with low capital bases and poor asset quality may have to exit the market, possibly upsetting the stability of the domestic banking system. WTO accession is expected to cause short to medium term costs as follows.

   (i) The market share of domestic banks will fall. Some estimates suggest that 10 years after the PRC becomes a WTO member, foreign banks' market share will increase from the current 2 % to about 20-30 %;
   (ii) Local banks will become less profitable. Some high-quality, creditworthy clients, particularly those in coastal areas, will shift to foreign banks, leaving the less creditworthy clients. The shift will pose a major threat to domestic banks as a large proportion of the sector's profits come from the top 20% of quality clients.
   (iii) Increased competition from international banks will adversely affect the performance of local banks as funds gradually shift from local to foreign banks. Given the high proportion of bad assets of local banks, especially state-owned commercial banks, the loss of liquidity will increase their risks.
   (iv) Foreign banks, given their flexible management and better pay, will attract skilled personnel from domestic banks. The "brain drain" will threaten domestic bank operations and management and force up domestic salary scales. Competition for personnel has already started, with about one third or more of foreign bank managers in Beijing and Shanghai now coming from local banks.

2. At the same time, however, the PRC's entry to WTO will also subject domestic banks to foreign competition and put pressure on them to improve efficiency, the range of products offered, and customer service. Some domestic banks will form strategic partnerships with international banks to meet the post-WTO challenges. The banking system as a whole will improve its capacity and efficiency to allocate the capital and help finance the rapidly growing private sector, which so far has little access to financing from the formal financial sector. Consequently, to face the challenges from international banks after WTO accession, financial sector reform must be accelerated.

3. International experience shows that in the long run, increased foreign participation in the banking sector has a positive effect on countries as a whole.

   (i) Global integration and competition will catalyze bank reform and improve efficiency, and thus accelerate economic development.
   (ii) Internationalization can help build robust and efficient financial systems by (a) introducing international best practices, standards and governance, (b) improving the quality and efficiency of financial services, and (c) attracting more stable sources of funds.

(iii) Domestic banks that survive the competition will learn to provide more sophisticated services and establish systems that meet international standards and increase productivity.

(iv) Global financial integration will facilitate the PRC's access to international markets and the opening up of PRC banks to international operations.

(v) A liberalized and efficient financial sector will significantly contribute to overall economic development. Better and more efficient banking services will stimulate the development of the industrial, agricultural, and service sectors.

4. **Implications for Foreign Banks.** According to the ADB business climate survey, as well as various surveys conducted independently by foreign chambers of commerce, however, foreign banks' views on the post-WTO operating environment is not necessarily positive. They are also under tremendous pressure due to expected increased competition that they may have to face during a transition period. The gradual opening, as outlined in the WTO agreement, may prove too slow to counter very limited opportunities for profitable business in the PRC for foreign banks, which are also burdened by an unusual amount of bureaucratic requirements (European Union 2002). Commercial banking business in the PRC is characterized by "plain vanilla"[1] operations and is not likely to offer more sophisticated foreign banks with the opportunity to exploit their superior product know-how and trading skills.

5. Foreign banks have limited appetite to lend to PRC companies whose transparency is still far from international standards. Some also fear that a reduction of market share in their core customer segment will occur as the larger foreign companies are actively targeted by local PRC banks, which will take advantage of places like Beijing where foreign banks are unable to serve these foreign customers directly for renminbi (RMB) business. PRC banks are also able to benefit from lower funding cost in RMB, whereas foreign banks have to negotiate very expensive bilateral limits with PRC banks to secure funding.

[1] Commercial banking activities in the PRC are limited to basic operations: taking deposits, making loans, settling trades, transacting foreign exchange, and brokering.

OBSTACLES TO THE DEVELOPMENT OF THE VENTURE CAPITAL INDUSTRY IN THE PRC

1. In the mid-1980s, the fact that most funds came almost exclusively from government sources rather than the private sector hindered the healthy development of venture capital (VC). Funds had to be invested in the respective local region due to sponsorship of such investment by the local government. Uncertainty also prevailed with respect to additional and continuous capital injection. Many VC firms in the PRC are in a state of chronic undercapitalization due to a lack of stable capital resources in support of their development. Savings are not available to VC funds because the PRC has not established a legal mechanism to channel savings into these funds. PRC's pension and mutual funds are still in their infancy (Asia Law and Practice 1999). Most PRC companies are short of capital and have little money to spend on high-risk, long-term investment.

2. Little or no market principles were applied in making investment decisions in the early years. VC funds were often managed by local government officials rather than by nonprofessional fund managers. These funds became another channel for delivering state funds to projects to promote local economic development. Most funds demonstrated mediocre or lackluster returns; VC returns in the PRC are generally in the single digits (Lau 1999). The first PRC VC fund, China Venturetech, which was established under government auspices, collapsed only 3 years after its establishment. The reasons cited by experts include poor management and investments, which were not related to its core business and based on little or no market principles. VC in the early days was basically nothing more than loans and guarantees, rather than equity investments. Their scale was too small, (the average capitalization was below 1 million yuan [CNY]) and they could not meet the financial requirements of the vast majority of start-up companies.

3. Most observers agree that the lack of a reliable exit channel is the biggest restraint on the development of VC in the PRC. There are no channels for a venture capitalist to cash out of its investment through an initial public offering (IPO) or other exit method after a certain period (usually 3-7 years after its initial investment), when the company has reached a sufficient stage of maturity. In the PRC, the capital market is not only underdeveloped but heavily controlled and regulated by government through administrative methods lacking in transparency. The Government recently dropped the much-expected establishment of the equivalent to the National Association of Securities Dealers Automated Quotation in the PRC for Small and Medium Enterprises (SMEs) with a small capitalization and short operating history. This was a major blow to the VC industry.

4. Several legal obstacles to further development of VC include the following.

   (i) Weak intellectual property protection. The enforcement of intellectual property rights (IPR) laws is needed for any high-tech start-up company relying on technological advantage for a competitive edge over bigger and more established firms. However, infringement of IPRs, especially in software and other sophisticated technology, is rampant.

(ii) The upper limit ratio set for intangible assets to total assets has hindered the development of technology-oriented ventures, which results in lack of attractive deal flow.

(iii) The PRC adopted its first partnership law in 1997, which does not allow limited liability status for VC funds. Article 2 of the PRC Partnership Enterprises Law provides that the name of a partnership cannot contain the words "limited" or "unlimited." Furthermore, Article 8 states that all partners shall bear unlimited liability. As a result, VC cannot be structured as a limited partnership which, through its pass-through tax attribute, usually eliminates double tax issues and reduces the liability exposure of limited partners. Foreign VCs thus set up an overseas VC fund to invest the PRC, while for a domestic VC fund, no such option is available due to the PRC's strict restrictions on overseas investment and foreign exchange control.

(iv) Restriction on share transfer and issuance of bonds and multiple classes of stocks such as preferred stocks has been an obstacle to the development of VC. Share transfers need to be confirmed by the other parties and approved by the original examination and approval authority as stipulated in Sino-foreign joint investment. In accordance with the Administration of Convertible Company Bonds Tentative Procedures, only listed companies and important state-owned enterprises are eligible for issuing convertible bonds. "Important state-owned enterprise" is defined as a well-established, large-scale state-owned enterprise. Therefore, convertible bonds, as a means of raising money, are not available to small or medium-sized high-tech companies. Also, to compensate for the high risk of early investment in start-up companies, VC investors require preferred shares that give them certain priorities over common shareholders and bank lenders. There is no legal precedence for establishing such priorities.[2]

(v) Lack of certainty on the legality of employee incentive schemes such as stock options and rights issues is another obstacle. PRC law is silent on employee stock options and other employee benefit plans, especially in relation to private companies. Contrary to the belief held by most westerners that if the law is silent, you can do it, in the PRC silence of the law on a point does not necessarily have an enabling effect.

(vi) A new bankruptcy law is being designed. This law may give companies that become bankrupt an opportunity for a fresh start and enable the quicker channeling of resources away from companies that are not competitive, similar to procedures provided under the US bankruptcy law. Alternatively, the law may be modeled after similar laws in many European and Asian countries, where a declaration of bankruptcy carries a stigma that frequently destroys an entrepreneurs' future (Nuechterlein 2000).

2 The PRC Company Law is silent on the issuance of different classes of common stock or preferred stock. Under Article 130, the phrase "each (common) stock of a company limited by shares shall have the same rights," is widely interpreted to prohibit a company limited by shares from issuing more than one class of shares. Article 135, however, states that the State Council can formulate rules on issuance of other kinds of stocks, other than stocks governed by the Company Law. To date, the State Council has yet to formulate any rules governing the issuance of other kinds of stocks. In an earlier regulation, the Standardizing Companies Limited by Shares Opinion issued by the State Reform Commission in 1992, it is clearly stated that a company limited by shares can issue preferred stock. Nevertheless, the opinion was supposed to have been substantially replaced by the Company Law. It is thus unclear whether the provisions of the opinion relating to preferred stock are still valid. Thus the issue of whether a company can issue more than one class of common stock or preferred stock is currently unsettled under the PRC law.

PRIVATE PARTICIPATION IN INFRASTRUCTURE

	Road	Water	Power
Investment in the past and Private Participation	$27 billion p.a. (2.5% GDP) for 1998-2000 $1.5 billion from private sector at the end of 1999, of which none were green-field projects 1980s (0.3% GDP) **Past 5 Years** • Highway (25,500 km), of which 8,000 km expressway • Trunk rail lines (4,000 km) • Track rehabilitated, doubled, or electrified (3,000 km) **Private Participation** 10% of investments, making the PRC a leader among developing countries in acquiring private funds for HW, of which 80% was invested in coastal provinces and proven brown-field projects. Most equity investment is from HK.	$9.5 billion (1990-1998) in water supply infrastructure $6 billion in sanitation infrastructure (the capacity of water production plants and distribution networks increased by 50%) • Municipal water capacity grew by 17% (volume) and 10% a year (sewer network length). • 7.5% p.a. growth of water supplied by municipal water companies to nonindustrial users • 200 liters per capita per day consumption in urban (higher than industrial countries) due to 30-40% leakages in distribution **Private participation** Lagged behind other infrastructure sectors. $700 million, representing only 4% (3.8%) of total investment in water and sanitation infrastructure (1990-2000).	The PRC's power generation capacity exceeds 300 gigawatts, making it the world's second largest system. Over the past 2 decades, electricity demand grew by nearly 9% a year (except in 1997 and 1998 when annual growth slipped below 5% due to the Asian financial crisis). **Private participation** Private investments have been allowed only in generation.
Future Demand Investment	**Tenth Five-Year Plan** • 150,000 km, total investment RMB950bn, of which a major portion is expected to be allocated to the western region • $115 billion cost necessary (including high-capacity roads and expressways, $34 billion) • $20-25 billion private investment A 20-year highway development program for the 12 central and western provinces ($200 billion)	**Tenth Five-Year Plan** • $11 billion for water supply (equivalent to the capital cost of 103 BOT Chengdu water supply projects), $9 billion for urban water supply • $15 billion for sanitation and infrastructure The Government has declared the development of water and wastewater infrastructure as a national priority.	**Tenth Five-Year Plan** • At least 5% demand growth a year through 2005 • Assuming 5-9%, additional 20 gigawatts of generation capacity a year through 2010 • At least $16 billion investment in power generation a year through 2010, at a capital cost of $800 a kilowatt • Estimated private investment: 25-30% of the cost both from domestic and foreign Tenth Five-Year Plan promotes the renovation and construction of large coal mines (300-600 megawatts) using clean coal technology and the development of hydroelectric power and some nuclear power, with a view to phasing out the old, small, inefficient power plants.

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(Appendix 10 table continued)

	Road	Water	Power
Policy and Institutional Structure	"Provisions on the Establishment of the Foreign-funded Construction Enterprises (1995)" prohibit wholly foreign-owned enterprises from engaging in civil engineering projects.	1. "Regulation on Management of Pricing of Urban Water Supply" 1998—first national guidelines on water tariffs, with the principle of full cost recovery through tariffs. 2. 1999—"Circular on Strengthening the Collection of Wastewater Treatment Tariffs" came into effect. While these tariff regulations provided a legal basis for further tariff reform, they have not yet been effectively enforced nationwide.	The PRC's power sector has been undergoing institutional and organizational reforms for several years, due mainly to separate policy and regulation from ownership and management.
Models for PPI and Potential Issues	1. Cooperative JV (80 projects in 11 provinces, plus Shanghai and Tianjin); CNY112 billion, of which 61 billion (54%) was private funding. 2. International Debt Financing in the 144A Market. In the absence of a well-structured legal and regulatory framework, most mainland companies do not have access to large institutional investors. Major HK developers w/ large project portfolios and relatively lower credit risk are able to issue corporate bonds in the US-based 144A market. The 1997 Project Finance Measures give international creditors no access to any assets, revenues, or guarantees outside a project and almost halted commercial project financing of infrastructure projects. 3. Securitization of existing highway assets. Since 1998, eight expressway development companies have been listed on the domestic stock exchanges, five listed in HK, bringing about $2 billion for the rehabilitation and expansion of existing transportation projects. 4. BOT—No such schemes for highway projects involving foreign investors have been implemented. Review of the existing BOT framework for use in road project is necessary; it should cover the allocation of risk between public and private partners.	Most private ventures in the water sector are BOT schemes for water supply sponsored by international developers. 1. Management contract. 2. BOT contracts. Most fall under $30 million threshold for SDPC approval, with exceptions of Shanghai Dachang ($73 million), Chengdu ($107 million); and Jinan ($90 million). • Negotiated cooperative JV BOT schemes (most PRC's projects fall into this category; provide a guaranteed return or priority access to dividends to the private partner; cannot tap international financial markets and cannot be promoted as a sustainable model: currently guaranteed returns are discouraged by the central government and guaranteed return deals are now being renegotiated. • Negotiated wholly privately owned BOT schemes—local government to act as granting authority and regulator but do not take equity stake in the project company (Shanghai Dachang); access international financial markets on a limited recourse basis. • Official or tender BOT scheme (ADB) involving competitive bidding, substantial central government involvement (a state guarantee on currency convertibility and transfer), off-taker credit support provided by provincial or municipal government (Chengdu). Some commenters note that BOT circular not being ratified; legal enforceability of this guarantee is unclear.	Most power projects involving private participation have been "non-concessional." 1. JV (61% private investments in power; 75% of the number) 2. BOT schemes (JV or wholly foreign enterprises)—24% by private investment value; 14% by number • BOT not so popular because of • delayed development of a comprehensive legal framework for BOT projects; • BOT regulations seen as complementing existing laws rather than superseding them; • BOT tendering process does not result in cheaper projects; • BOT projects, except Laibin B, not expected to receive significant attention and government support at all levels; • BOT projects require sufficient pre-bid preparation and competitive tendering, which are not yet widely accepted by PRC parties who are used to preparing projects with assistance from their JV partners; 3. Securitization through IPOs, accounted for 12% of private power investments by value; and 4. Divestitures of existing plants through trade sales and BOTs (3%).

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(Appendix 10 table continued)

	Road	Water	Power
Issues and Challenges	Road projects in the eastern regions: (i) unclear government policy on public and private financing; (ii) lack of transparency in the approval process; (iii) weak contract enforceability; and (iv) defaults on loans and bonds, discouraging international investors in the sector.	Full cost recovery and associated water tariffs: (i) water tariff levels too low to achieve cost recovery to induce private participation; (ii) a complex institutional framework; (iii) lack of proper regulation that clearly separates the provision of services and regulation; and (iv) prohibition of private participation in the urban network.	IPP Power Purchase Agreement reopened and not abided by local governments in power oversupply situation. Individual projects in the power sector, which is in the midst of a transition period, tend to be subject to changes in central and local government sector policies. Risks exist that agreed contracts may not be honored and commitment may not be secure.
	1. Corporatization or legal separation of government agencies in charge of toll road development, in order to raise debt financing. Corporate governance and financial management need to be improved. • The above reforms needed if public funds and other resources are to be allocated more efficiently to the west. • Private funding to be introduced to the west to take over a "brown-field" project (or a pool of projects that are perceived less risky) only after a basic road network has been built with public funding and traffic has stabilized to a certain extent. 2. The efficiency of transport services must also be improved to derive the full benefits of the new infrastructure. ADB's future assistance can address the service sector.	1. Municipal Government—accelerate reforms, including implementing tariff adjustments, corporatizing water and sewerage services, and promoting private participation to separate regulation from service provision. 2. Central Government—clarify the roles and functions of the Ministry of Construction and Ministry of Water Resources on water and sanitation activities; help local governments restructure water and sewerage services, including establishing systems for sharing information and benchmarking various water and sanitation companies; and implement pilot concessions of complete urban water and sanitation systems.	1. A consistent legal and regulatory framework is established based on the principles of efficiency through competition. 2. A market governance structure is established. 3. Access to information is enhanced. 4. Existing power purchase agreements are protected. 5. Financial securities market is adapted to the competitive electricity market so that hedging techniques can be used to manage the risk of movements in market prices. 6. Creditworthiness of market participants is improved by requiring provincial power companies to increase disclosure of their financial information. 7. A divestiture program is implemented for generation assets. 8. Fuel markets are deregulated to ensure that there is no dislocation between a deregulated power market and a regulated inefficient fuel supply market.

ADB = Asian Development Bank, BOT = build operate transfer, GDP = gross domestic product, HK = Hong Kong, China, IPO = initial public offering, IPP = independent power projects, JV = joint venture, p.a. = per annum, PRC = People's Republic of China, RMB = renminbi, US = United States, SDPC = State Development Planning Commission

Source: ADB, The World Bank.

APPENDIX 11

PRIVATE SECTOR DEVELOPMENT ACTIVITIES IN THE PRC BY FUNDING AGENCY

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
Australian Agency for International Development (AusAid) Australian Embassy 21Dongzhimenwai Dajie Beijing 100600 Tel: 6532-2331 ext.400 Fax:6532-4944 E-mail: AusAid@austemb.org.cn www.ausaid.gov.au	China Technical Assistance Trust Fund (IFC)	MOFTEC (MOF)	The first of its kind in the PRC, the fund was established to finance activities that contribute to the capacity of the PRC Government to create an environment that facilitates private sector development. Such activities could include, for example, a project to develop ways to improve the policy framework to attract private foreign investment and expertise in the reform of SOE, and the development of an urban microcredit program.	1998-2000 A$1 mn
	Economics and Foreign Trade Training Project	MOFTEC	This project aims to provide an increased appreciation by PRC trade and economic officials of the rights and obligations that WTO membership provides, and an increased awareness of the benefits of open trading system.	1998-2001 A$5.341 mn Rmb12.468 mn
	Reemployment and Venture Creation for Laid-off Women Workers Project (UNDP)	Tianjin Women's Federation	This project aims at identifying solutions to the emerging urban poverty in the PRC through job creation and reemployment for laid-off women workers by means of employment information and consultancy networking, strengthening of training capacity, and new venture creation services. Project activities will be carried out initially in Tianjin as the location for pilot interventions, and later in Beijing as the location for experience assessment and policy recommendation regarding reemployment of laid-off women workers. At the end of the project, there will be a series of activities aimed at nationwide dissemination and promotion of ideas generated by the Tianjin experience. AusAID participation will involve support for the Business Incubator component of the project, as well as a supplementary grant to the microfinance loan program.	May 1999-March 2002 $1,142,900

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
British Department for International Development (DFID), British Embassy 11 Guang Hua Lu, Jianguomenwai Dajie Tel: 6532-1961 Fax:6532-0901 www.britishembassy.org.cn	Economic Reform Initiatives	MOFTEC SETC/ MOF/ MOLSS	DFID supports activities with the common aim of containing and reducing poverty through the promotion of pro-poor growth, and enhancing the economic and social rights of poor people.	—
	(1) SOE Reform	Liaoning: ETC (provincial level) SCOFTEC provincial level in Sichuan and ETC at city level A 3-year	SOE reform project addresses two main issues—enterprise restructuring and enterprise development— in Sichuan and Liaoning. The enterprise restructuring element will develop models for the survival of enterprises that would otherwise be liquidated, thereby saving jobs and reducing social dislocation in the long term. The enterprise development element is designed to help absorb labor laid off by the process of the SOE reform by providing support to small enterprises.	L19 mn (US$27,550,000 equivalent)
	(2) Private Sector Development (IFC)	Sichuan Investment Promotion Bureau/ ETC	As additional support to pro-poor private sector development, DFID plans to work with IFC and other bilaterals in implementing a private sector development project in Sichuan.	US$3 mn
	(3) Social Security Reform	MOLSS, national and provincial level	The project supports the PRC in its reform of the social security system especially as it relates to broader SOE reform. In particular, its support focused on enhancing the delivery of benefits, job search, and retraining opportunities for unemployed workers.	£3 mn
	(4) Research Project on the PRC's Accession to WTO (World Bank)	Develop-ment Research Council	The research project provides insight into the policy implications of accession and the likely impact on poor people.	US$800,000
	(5) Other Policy Dialogue	Ministry of Finance	DFID provides policy-level support to the PRC's fiscal system reform given that economic growth in PRC should be equitable and that current lev-els of inequalities, i.e., between rural and urban, should not get worse.	USD1.2 mn
Canadian International Development Agency (CIDA), Canadian Embassy 19 Dongzhimenwai Dajie, Chaoyang, Beijing 100600 Tel:6532-3536 Fax:6532-3167	Economic Reform	MOFTEC	CIDA's assistance to economic reform (and to private sector development) is through the Pub-lic Policy Options Program (PPOP) and Public Sector Reform Program (PSRP). PPOP projects include Reform and Development of Chinese SMEs; Study on Financing System for SMEs; In-stitutional Approaches to Providing Indirect and Direct Financing and Socialized Support Services for SMEs; E-Commerce Development Strategy and Related Policies; Legal Environment Encour-aging Foreign Investment in Mineral Exploration and Development in China; and Strengthening Securities Legal and Enforcement Systems. PSRP	PPOP— C$5 mn PSRP— C$ 4 mn

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	**Category/ Initiative/Project**	**PRC Partner**	**Objective and Activity**	**Note** (period/value)
			projects include: Improving the Supervision Policy and Control System of the People's Bank of China on the Rural Credit Cooperatives; Exploring Canada's Experiences in Housing Mortgage and Mortgage Insurance; and Feasibility Research on Qualification Accreditation Standards for Financial Professionals in China.	
European Union 15 Dongzhimenwai Dajie Chaoyang, Beijing 100600 Tel: 6532-4443 Fax: 6532-4342	Rule of Law and Good Governance Initiative	SDPC	Public Procurement Pilot Project to support and strengthen capacities of various PRC parties involved in development of more open and competitive procurement procedures, through training programs for legislators, executors, procurement officials, and bidders.	1998-2000 ∈–728,000 (EU– ∈615,000); PRC– ∈113,000)
		MOFTEC	Intellectual Property Rights Cooperation Project to facilitate trade and to promote IPR protection across the broad base of activities, by (i) supporting the central agencies responsible for IPR activities in the PRC; and (ii) influencing the broader IPR environment, by raising local awareness of IPR issues and IPR enforcement. The project has been running successfully over the past 2 years, and an assessment of a possible expansion into the western region is under way.	3year; 1999-2002 ∈4.8 mn
		Ministry of Justice Legal and	Judicial Cooperation Program to support the PRC Government in achieving the rule of law and a system of governance through (i) training in Europe for PRC lawyers, judges, prosecutors, and officials; and (ii) a wide range of small but high-impact cooperation activities in the legal field.	1999-2003 ∈13.2 mn
	Economic and Social Reform	The economic and social reform initiatives include projects relevant to private sector development		
		MOFTEC	WTO Accession Project to assist the PRC with the process of its accession to WTO and support its preparations to comply effectively with its obligations.	3 years starting Nov 2001
		MOLSS	Social Security Reform to support the development of a health insurance system, the administration of the social security system on a sustainable basis; support the extension of social insurance protection and coverage in pension and unemployment funds. The project proposal is now being finalized.	∈20 mn
		MOFTEC PBOC	Financial Services Cooperation Project to contribute to a sound, transparent and efficient financial services sector in the PRC, thereby	

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
		CSRC CIRC	increasing the transparency and consistency of the legal framework and strengthening the institutional capacities; assisting in the development of professional qualification system and distance learning mechanisms.	3 years ∈–11 mn, (∈–8.5 mn; PRC–∈2.5 mn)
		MOFTEC Provincial Govern-ments of Shaanxi and Jiangxi	Enterprise Reform to contribute to the SME sector to create employment in Shaanxi and Jiangxi provinces through (i) the establishment and development of two provincial SME promotion and development centers and a network of municipal SME advisory and information service centers; and (ii) technical and capital assistance for the establishment and development of two provincial credit/ guarantee funds.	3 years starting June 2001 ∈–17.3 mn (EU–∈8.5 mn PRC–∈8.8mn)
German Govern-ment and Affiliates (GTZ) Tel:8527-5180 Fax:8527-5185 www.gtz.de/china	Economic and Structural Reform Initiatives	DTZ's economic and structural reform projects include (i) advisory services on social security system; (ii) Sino-German Cooperation in economic law, supporting the transformation of the PRC legal system toward a market economy; (iii) advi-sory services on law drafting and capacity building under the finance and economic committee of the NPC (including study tours on draft laws: Investment Fund Law; Bankruptcy Law; Law on Foreign Exchange Control; SME Promotion Law); and (iv) development of the new Chinese National Audit Office to establish a PRC audit system towards a market economy.		
	Small and Medium-Sized Enterprise Project	SETC	Drawn on the long German postwar tradition of promoting SMEs as well as international best practice, the project was set up to promote SMEs, which are expected to absorb a large por-tion of the labor force, but lack appropriate pro-motion structures and instruments.	DEM 4 mn (PRC–DEM 1 mn)
	Training for Managers of Medium-Sized Companies	—	Promoting participation of the private sector in a wide range of models, comprising commercial-ization of state-owned companies as well as full privatization, reforms the ownership structure of many state-owned companies. To support this process, the project enables managers of medium-sized companies to carry out their duties in an increasingly market-oriented economy by applying modern management methods and tools.	N.A.
Japan Bank for International Cooperation (JBIC) China World Trade Center 1, No1. Jianguomenwai Avenue Beijing 100004 Tel: 6505-8989 Fax:6505-1198	Private Sector Investment Finance	Private Enterprises	The Private Sector Investment Finance (PSIF) program, also called "support for private activity," is designed to support private enterprises planning to undertake business in developing countries with funds provided as either equity investments or loans. As of March 2001, JBIC's portfolio in PSIF includes equity investments in (i) an industrial zone management company in Dalian; and (ii) a property management company in Shanghai.	(1)1992–¥650 mn (40.6% equity share); (2)1995–¥2,670 mn (21.6% equity share)

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Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
	Business Environment Survey; SME Study	—	JBIC conducts an annual survey on the outlook of Japanese foreign direct investment.	Annually
Japan International Cooperation Agency (JICA) Beijing Fortune Bldg. No.1111 5 Dong San Huan Bei-Lu, Chaoyang, Beijing 100004 Tel:6590-9250 Fax:6590-9260	Housing Finance Reform Support ResearchPBOC	The master	plan is intended to assist the government in (i) analyzing issues concerning the housing policy and housing finance; (ii) developing a framework for categorizing cities into several groups; and (iii) identifying a standard housing finance system, that can be replicated nationwide.	Mar 2000-Mar 2002
	Study on SME Development Model Cities in China (Shenyang; Hanzhou)	SETC Shenyang and Hanzhou Municipal Governments	The study formulated policy recommendations for SME development planning for Shenyang and Hangzhou municipalities which serve as a model of SME development plan for other parts of the PRC, through (i) policy recommendations, (ii) enterprises diagnosis, and (iii) pilot project (building information network for SMEs).	Oct 2000-Aug 2001
Multilateral Asian Development Bank (ADB) 6 ADB Avenue Mandaluyong City 0401 Philippines Tel: (632) 632-4444 Fax: (632) 636-2444 www.adb.org	Technical Assistance Operations	MOF and Other Agencies	ADB's TA operations have assisted the PRC Government to build an enabling environment for the private sector through (i) capacity building for regulatory agencies; (ii) a supportive legal and regulatory framework; (iii) improved policy framework for the private sector, including SMEs. There are about 46 TA projects that have influenced private sector development.	
	Private Sector Operations: Loans and Investments without Government Guarantees.	Private Sector Companies	Loan equity investments in financial sector firms, infrastructure projects, and investment funds.	
International Finance Corporation (IFC) Tel:6554-4191 Fax:6554-4192 www.ifc.org	Loan and Equity Investments	Private Sector Companies	**New Approvals and Commitment:** For FY2002 (July 2001-June 2002), IFC approved investments in 12 companies, involving $207 million IFC financing and $45 million syndicated loans. Total project cost was $631 million. Invested companies encompass industrial sectors such as finance/insurance, funds, oil/gas/mining, utilities, chemicals, and industrial/consumer products. • Finance and Insurance: (i) Advantage China Holdings Ltd. ($0.25 million); (ii) Bank of Shanghai ($24.7 million); and (iii) China One Financial Ltd. ($50 million); • Oil, Gas and Mining: (iv) Sino Mining Ltd. ($16 million); and (v) Zhong Chen Energy Storage Company, Ltd. ($57 million);	FY1985 – FY2002, cumulative commitment $768 mn

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
			• Fund: (vi) China One Financial Ltd. ($50 million); • Chemicals: (vii) Ningxia Darong Chemical Industry Joint Stock Company, Ltd ($19.5 million); • Industrial and Consumer Products: (viii) Hangshou Narada Battery Group ($6.6 million); (ix) Asian Strategic Investments Corporation Group ($15 million); (x) Long Yuan Shuang Deng Power Sources Co., Ltd ($15.3 million); and (xi) Xia'an Kong Hong Information Technology Company Ltd.; • Utilities: (xii) Interstate Energy Corporation Pte, Ltd. ($25 million) IFC made 11 commitments in FY2002: (i) Advantage China Holdings Ltd. ($0.25 million); (ii) Bank of Shanghai ($24.87 million); (iii) CDH China Fund ($20 million); (iv) Chengdu Chemical Company Ltd. ($8.6 million); (v) China One Financial Ltd. ($31.5 million); (vi) Interstate Energy Corporation Pte, Ltd. ($20 million); (vii) Maanshan Carbon ($11 million); (viii) Nanjing City Commercial Bank ($26.58 million); (ix) Peak Pacific Investment Company ($25 million); (x) Sino-Forest Plantation ($25 million) and (xi) Zibo Wanjie Tumor Hospital.	
	Technical Assistance Trust Fund (a major TATF funding agency in parentheses)		Technical assistance in FY2002 includes the following. **Financial Sector** (1) helped New China Life Insurance Co. adopt international best practices for insurance, develop operational manuals, and train staff to develop and manage company's master information system (Switzerland); (2) provided training for Bank of Shanghai to improve credit analysis skills and policies (Japan); (3) helped improve corporate governance standards among Sichuan companies and financial agencies (Canada, Italy); and (4) Reviewed Chengdu City Commercial Bank's financial performance and provided advice to improve credit and risk management policies and procedures (Norway). **Business Advisory** (1) provided business advisory services to Shenyang Special Environmental Equipment Manufacturing Company Limited, a water and wastewater treatment systems company (UK).	

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
			Environment (1) developed skills of local consultants and specialists to undertake environment review and mitigation work according to international standards (Denmark). **FDI** (1) supported mining investment conference in Xi'an and program to improve investment climate for sustainable mining development (Australia). **SME** (1) helped China Project Development Facility develop techniques and models for delivering technical assistance to SMEs (Switzerland).	
	China Project Development Facility (CPDF) (Australia, Switzerland, UK)	MOF SMEs in Sichuan Financial Institutions in Sichuan	CPDF is a new international initiative to develop SMEs in the interior of the PRC, with an initial focus on Sichuan Province. CPDF is the sixth such multidonor facility to be managed by IFC. The objectives of CPDF are fourfold: to provide (i) enterprise level support program, by helping local SMEs prepare bankable business plans to be presented to financial institutions; (ii) financial institutions strengthening program, by helping local partner financial institutions downscale to lend to SMEs in Sichuan; and (iii) training, capacity building, by developing local SME supports services; and (4) business environment assistance program, by helping identify and relieve key constraints smaller companies face in the local business environment.	US$17 million
Organisation for Economic Co-operation and Development (OECD) www.oecd.org	Policy Dialogue and Research —	Since 1995,	OECD and the PRC Government have engaged in a policy dialogue on many issues of common interest in the framework of a comprehensive programme of cooperation managed by the Centre of Co-operation with Non-Members. OECD recently published a synthesis report, *China in the World Economy: The Domestic Policy Challenges,* covers various policy issues that influence private sector development: foreign direct investment: prospects and policies; the role of competition law and policy; priorities for development of PRC's capital markets; challenges to China's banking industry.	—
United Nations Development Programme (UNDP) Tel:6532-3731 Fax:6532-2567 www.unchina.org/undp	Small Credit Guarantee Fund	SETC	The Fund was set up to enable SMEs to have better access to credit. The Fund, piloted in Jiangsu, is considered a model and may be replicated across the PRC to provide direct support to the development of the private sector in the PRC. The Fund also allows enterprises to supply improved services to large multinational companies. UNDP has	

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
			become active in guaranteeing and sometimes lending to start up SMEs in poverty reduction programs. UNDP guarantees in those programs can cover more than 100% of the loan to secure also the interest payments for the loan.	$300,000
	Capacity Development of Chinese Business on IPR Compliance	CICETE and QBPC	The project, as part of UNDP's public-private partnership initiative, aims at assisting the PRC in its effort to better address counterfeiting issues, one of key challenges in IPR protection. Based on findings of a survey conducted in one of the counterfeiting "hot spots" in Fujian Province regarding causes of the IPR infringement, UNDP, the PRC Government, and QBPC of over 70 multinational companies operating in the PRC, reached a consensus to forge partnerships to assist the capacity development of business associations to replicate the Guanzhou model to other parts of the PRC. The business association has played a crucial role in helping promote its members' products as well as deepening IPR compliance awareness among its members by setting up regulations to be abided by all its members. Expected results (i) capacity development of local business associations in localities as wide as possible through demonstration effects; awareness building of key IPR and environmental legislation through the model, which will strengthen enforcement; (ii) creation of a better level playing field for enhancing the rule of law; and (iii) development of the project to be brought to the attention of the top-level authority in the PRC for replication in other parts of the PRC.	2001 Nov–2002 Dec.
	Training Professional for the West	Ministry of Personnel	The project is expected to focus on training senior professionals, who are in need, particularly in the PRC's western regions, where large-scale development projects were started years ago.	US$1 mn (proposed) 2002-2004
United Nations Industrial Development Organization (UNIDO) Tel:6532-3440 Fax.6532-6315 www.unchina.org/unido	Development of the Western Region Initiative	MOFTEC (CICETE, FIA); DRC, SDPC, SETC	This joint initiative between the government agencies and UNIDO is a pilot program to be set up in Shaanxi Province to provide technical cooperation for industrial restructuring. The model is expected to be replicated in 11 other provinces. The program consists of seven components, distributed under four levels of intervention: (i) strategy; (ii) strengthening and development of support institutions and support mechanisms; (iii) industrial restructuring; and (iv) environment and energy	4 years, 2002–2005 $10 million

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
			sustainability. The second intervention directly addresses development of SMEs: • Industrial Investment Promotion, by establishing and strengthening venture capital mechanisms and FDIs; • Development of Competitive SMEs, by creating enabling conditions for business development; • Information Technology and E-Commerce, by networking for the benefits of SMEs; • Food Agro-Industrial Development, by providing a support mechanism to strengthen the assessment of the feasibility of investments in technological upgrading.	
	Investment and Technology Promotion (six ongoing projects)		• Tumen River investor services • Implementation of the BOT framework • Assistance to Shanghai Foreign Economic Relations and Trade Commission/Shanghai Foreign Investment Commission • Capacity Building for Enhancing Project Development and Management • Investment Promotion for Hunchun Border Economic Zone • Strengthening the investment and technology promotion system through capacity building and networking.	US$365,400 US$ 73,474 US$223,125 US$100,000 US$ 74,000 US$265,486
	Entrepreneurship Development		Towns and Village Enterprise Development Study	US$120,000
World Bank Tel:6554-3361 Fax:6554-1686 www.worldbank.org	Private Sector Development		The World Bank's assistance for private sector development is designed to help countries develop needed legal and regulatory frameworks and institutions in a way that protects the interest of poor people. As for enterprises reform, the World Bank remains involved in the PRC's important corporate reform agenda by providing policy advice, technical analysis, and policy seminars, often in conjunction with IFC. The study, *Bankruptcy of State Owned Enterprises in China – An Agenda for Reforming the Insolvency System,* is assisting the PRC to build an improved insolvency system with an appropriate legal framework for both state and nonstate enterprises. The corporate governance study, one of the World Bank's focal areas, is expected to assist the PRC deal with issues arising in the process of ownership transformation of state enterprises. Training in corporate governance issues by the World Bank Institute has already been provided in the PRC through the Global Development Learning Network.	2001 June Total commitments $34.8 billion for 234 projects. (this covers Bank-wide assistance)

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
			The World Bank-IFC joint efforts to support private sector activities include (i) World Bank-IFC Private Sector Advisory Service and the SME Program; and (ii) creation of the global product Groups. Other World Bank efforts to support private sector development include: (i) assessment of the PRC's knowledge economy and requirements for technological innovation, in collaboration with OECD; (ii) the Economic Law Reform Project, which is financing the preparation of economic laws; and (iii) the Accounting Reform Project which is helping government auditors curb waste and other misuse of resources and strengthen public sector financial management.	
Public-Private Infrastructure Advisory Facility (PPIAF) www.ppiaf.org A multidonor TA facility, built on the World Bank Group's Infrastructure Action Program **Bilateral:** Canada, France, Germany, Japan, the Netherlands, Norway, Sweden, Switzerland, and UK **Multilateral:** ADB, UNDP, and World Bank	Regulatory and Institutional Reform in the Telecommunications Sector		The objective of the project is to review the market, policy, and regulatory environment for greater private participation in telecommunications; to identify sustainable reforms; to conduct a study tour of countries that are leaders in reform; to draft policy options and a reform agenda for consideration by the national government; to present the options at workshops for stakeholders.	Target completion date: Dec 2001 US$295,000
	Privatization Strategy for Competitive Electricity Generation at the Provincial Level		The objective of the project is to develop a market-led strategy with stakeholders (consumer groups, government entities, and the private sector) focusing on divesting state-owned power and generation assets at the provincial level and creating independently owned firms with an expanded share of the private capital in the sector.	Target completion date: March 2002 US$620,000
	Options for Private Participation in Water and Sanitation Services in Chongquing		The objective of the project is to explore options for private participation in water supply and sewerage services in the municipality of Chongqing. The municipality's capital (also Chongqing) serves as a pilot case, showing the potential for improving the utility's operational efficiency and the quality of service while reducing costs.	Target completion date: March 2002 US$380,000
World Resources Institute (NGO) Washington, DC, www.wri.org Ford Foundation International Club Office Building Room 501 Jianguomenwai Dajie No. 21 Beijing 100020	Environmental SMEs Capacity Building Program	Lead-China Tel:6857-0592 Fax:6857-9950 www.lead.org.cn	An environmental NGO, the World Resources Institute, in collaboration with its local partner, Lead-China, has started a capacity building program for SMEs. The main objectives are to assist SMEs in building their capacity for sustainable business to qualify for international investment, and to fill the gap between potential investors with lack of deal flow and already trained SMEs by organizing a forum in which both sides can meet. The capacity building program is implemented in a phased manner. Phase I, funded by the Ford	

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(Appendix 11 table continued)

Bilateral/ Multilateral Funding Agency	Category/ Initiative/Project	PRC Partner	Objective and Activity	Note (period/value)
Tel: 6532-6668 Fax: 6532-5495 www.fordfound.org			Foundation, has trained over 400 SME managers of seven provinces (districts), including Beijing, Guanxi, Heilongjiang, Henan, Jiangsu, Shandong, and Tianjin Currently, the program is seeking funding for Phase II, which is expected to train 200 SME managers a year who will form a pool of candidates for investment. In Phase III, the follow-up consultation for SMEs with promising projects and for interested investors will be organized (i.e., an investor forum).	

ADB = Asian Development Bank, AusAID = Australian Agency for International Development, BOT = build operate transfer, CICETE = China International Center for Economic and Technical Exchanges, CIDA = Canadian International Development Agency, CIRC = China Insurance Regulatory Commission, CPDF = China Project Development Facility, CSRC = China Securities Regulatory Commission, DFID = Department for International Development (United Kingdom), ETC = Economic and Trade Commission, FDI = Foreign Direct Investment, GDP = gross domestic product, GTZ = German Agency for Technical Cooperation, HK = Hong Kong, China, IFC = International Finance Corporation, IPR = Intellectual Property Rights, JBIC = Japan Bank for International Cooperation, MOF = Ministry of Finance, MOFTEC = Ministry of Foreign Trade and Economic Cooperation, MOLSS = Ministry of Labor and Social Security, NGO = Nongovernment Organization, NPC = National People's Congress, OECD = Organisation for Economic Co-operation and Development, PBOC = People's Bank of China, PPI = private participation in infrastructure, PPIAF = public-private infrastructure advisory facility, PRC = People's Republic of China, PSIF = Private Sector Investment Finance, QBPC = Quality Brands Protection Committee, SCOFTEC = Sichuan Commission of Foreign Trade and Economic Cooperation, SDPC = State Development Planning Commission, SETC = State Economic Trade Commission, SME = small and medium enterprise, SOE = State-owned Enterprise TA= technical assistance, TATF = Technical Assistance Trust Fund, UNDP = United Nations Development Program, UNIDO = United Nations Industrial Development Organization, WTO = World Trade Organization

ASSISTANCE FOR SME DEVELOPMENT BY FUNDING AGENCY

Funding Agency	Project Title	Specific Result
ADB	1. Liberty New World China Enterprises Fund 2. Development of Financing Policies and Mechanisms for SME 3. Development of Financing Policies and Mechanisms for SME	1. (a) Establish a fund to invest in SME companies; and (b) investor in the Fund realize reasonable risk-adjusted returns that will raise investor confidence in investing in PS enterprises in the PRC. 2. (a) Comprehensive policy recommendations prepared and adopted by Shanghai Government; and (b) lending policies, procedures, and changes recommended to local banks. 3. (a) Increase bank lending and equity financing for SMEs; and (b) develop relevant policy guidelines and mechanisms.
CIDA	1. Institutional Approaches to Providing Indirect and Direct Financing and Socialized Support Services for SMEs 2. Reform and Development of Chinese SMEs 3. Study on Financing System for SMEs	1. Recommend policies to the government (SME Department, SETC). Develop improved institutional infrastructure and the associated polices, programs, and regulations for improving access to capital and support services. 2. *The Policy Framework for Supporting and Promoting SME Development in China*–A program for financial loan guarantees to SMEs–was approved on 8 April 1999 by the State Council. An SME Department was created in SETC. 3. Recommend policies to the State Council, which issued a policy document for SME development in September 2000. 83 municipalities established SME credit guarantee centres; 8 provincial level re-guarantee centers.
DEG	DEG Long-Term Equity and Loan Financing	Provide long-term equity and loan financing to SMEs in Beijing, Guangzhou, Jiangsu, Shanghai, Sichuan, and Zhejiang (€20 million per annum).
DFID	SOE Restructuring and Enterprise Development Project	(a) Deliver comprehensive enterprise restructuring programs in six municipalities in Liaoning and Sichuan provinces through establishment of sustainable restructuring agencies; (b) Support small business creation and development through the establishment of sustainable information and advice centers in each participating municipality; (c) mobilize finance for small business development through the establishment of sustainable credit guarantee funds in each participating municipality; and (d) replicate successful approaches within provinces and disseminate lessons learnt from provinces to a national level.
EC	EU-China Enterprise Reform Project	(a) Two established provincial SME promotion and development centers in Shaanxi and Jiangxi provinces provide support to SMEs through network of municipal SME advice and information centers; and (b) two provincial CGFs provide counterguarantees to municipal CGFs to permit them to support the provision of loan finance to SMEs.

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(Appendix 12 table continued)

Funding Agency	Project Title	Specific Result
Ford Foundation	Capacity Building for SMEs	(a) Provide capacity-building training to over 400 SME managers of seven provinces (districts), including Beijing, Guanxi, Heilongjiang, Henan, Jiangsu, Shandong, Tianjin, as Phase I of the SME project implemented through partnership between an international and local environmental NGOs, the World Resource Institute and Lead China; (b) Phase II, is expected to train 200 SME managers a year who form a pool of candidates for investment; and (c) Phase III, the follow-up consultation for SMEs with promising projects and for interested investors, will be organized (i.e., an investor forum).
GTZ	Small and Medium Enterprise Promotion in the PRC	(a) Set up institutional structure for implementation phase; (b) Work out binding implementation concept in coordination with all other German development cooperation agents (DEG, GTZ, KfW, SEQUA); and (c) develop a location-specific implementation concept for cooperation regarding 'public-private partnerships.
IFC	China Project Development Facility (CPDF)	Establish a project development facility based in Chengdu to provide (a) enterprise-level support, i.e., to assist local entrepreneurs to develop their business ideas into "bankable"business plans and address internal governance constraints at enterprise level; and (b) training, capacity development, and private sector policy work, i.e., to provide training and capacity building for SME management, local banks and financial institutions, credit guarantee facilities, and industry associations.
Italian Cooperation	Mixed Credit to Support SMEs in the PRC	Fund 23 SMEs from several provinces of the country for a total amount of about 40% of the total credit line of $131 million. Within the project the maximum amount of funds available for each enterprise is $2.7 million, of which about 54% as soft loan and 46 % as export credit.
JICA	Study on Small and Medium Enterprises Development of Model Cities in China	(a) Provide enterprise diagnosis and consulting in Shenyang and Hangzhou municipalities; (b) training, workshops and study tours; (c) study reports including policy recommendations and action plans for development of SMEs, analysis of obstacles in SME growth, results of enterprise diagnosis, and outputs from pilot projects in respective municipalities; and (d) case studies of enterprise diagnosis and consulting activities (eight enterprises for each).
KfW	Credit Programme I for SME Credit Programme II for SME	Result of subprojects financed (program measures). Are plants ready for operation?
Switzerland	Sino-Swiss Partnership Fund	Five projects invested ($7 million) to enhance cooperation and transfer of technology between the PRC and Swiss/OECD companies. More projects in the pipeline.
UNDP	Small Enterprises Reform and Development	(a) Establish SCGF with a smooth operation in about 2 years; (b) establish Small Enterprise Development Centre; and (c) the experiences of Zhenjiang and other cities provide SETC with a solid base to formulate policy. SETC has issued a series of policy papers to guide the development of SME.

ADB = Asian Development Bank, CIDA = Canadian International Development Agency, CGF = credit guarantee fund, DEG = Deutsche Investitions- und Entwicklungsgesellschaft, DFID = Department for International Development, EU = European Union, GTZ = German Agency for Technical Cooperation, IFC = International Finance Corporation, JICA = Japan International Cooperation Agency, KfW = Kreditanstalt für Wiederaufbau, NGO = NongovernmentOrganizations, PRC = People's Republic of China, PS = private sector, SETC = State Economic Trade Commission, SEQUA = Stiftung für wirtschaftliche Entwicklung und berufliche Qualifizierung, SME = small and medium enterprise, SOE = state-owned enterprise, UNDP = United Nations Development Programme.
Source: GTZ. *Donor Fact Sheets for Projects of SME Promotion in the PRC.* 2001. Interviews.

LIST OF TA PROJECTS IN SUPPORT OF PRIVATE SECTOR DEVELOPMENT (As of June 2003)

TA No.	Sector/Project Name	Total	Approval Date
	Financial Sector (15)		
1086	Institutional Support to SITCO	450,000	13 Dec 88
1491	Study of the Leasing Industry	100,000	05 Mar 91
1503	Study of the Venture Capital Industry	100,000	02 Apr 91
1516	Development of Securities Market	600,000	27 May 91
1748	Establishment of a National Securities Trading System	100,000	19 Aug 92
1800	Institutional Development of China Leasing Company Ltd. and China Science Technology Finance Corporation	600,000	10 Dec 92
1883	Credit Rating Seminar	99,000	07 May 93
1941	Study of Nonbank Financial Institutions	249,000	26 Aug 93
2214	Cooperative Banking Development	600,000	01 Dec 94
2443	Strengthening the Regulatory Framework for the Trust and Investment Industry	90,000	16 Nov 95
2512	Integration of Securities Markets	600,000	27 Dec 95
2626	Study of Foreign and Joint Venture Banks	450,000	16 Aug 96
3304	Capacity Building of the Capital Markets' Regulatory System	1,000,000	24 Nov 99
3303	Institutional Strengthening of the Cinda Asset Management Company	800,000	24 Nov 99
3890	Banking Laws and Regulations	800,000	25 Jun 02
	Subtotal	**6,638,000**	
	Infrastructure–Power (8)		
1922	Support for Power Sector Tariff and Financing Reforms	450,000	03 Aug 93
2170	Introducing BOO/BOT Concept for Shanghai Waigaoqiao Stage II	600,000	27 Sep 94
2363	Support of Corporatization Plan Preparation for Fujian Province	70,000	18 Jul 95
2510	Policy, Regulatory and Institutional Framework for FDI in the PRC Power Sector	751,000	22 Dec 95
2730	BOT Changsha Power	597,000	23 Dec 96
2917	Power Sector Restructuring	804,700	24 Nov 97
3931	Establishing the National Electricity Regulatory Commission	500,000	24 Sep 02
4117	Power Pricing Strategy	500,000	21 May 03
	Subtotal	**4,272,700**	
	Infrastructure–Transport (5)		
1517	Toll Bridge Operations and Management	760,000	28 May 91
1626	Port Management and Operations	575,000	13 Dec 91
2409	Appraisal Methodologies and Restructuring Highway Financing	740,000	28 Sep 95
2649	Facilitating the Build-Operate-Transfer Modality in the Highway	1,100,000	27 Sep 96
2952	Corporatization, Leasing and Securitization in the Road Sector	1,000,000	17 Dec 97
	Subtotal	**4,175,000**	
	Infrastructure–Water (4)		
2504	Seminar on BOT in the Water Supply Sector	100,000	22 Dec 95
2773	Water Supply Tariff Study	600,000	24 Mar 97
2804	Build-Operate-Transfer (BOT) Chengdu Water Supply	600,000	02 Jun 97
3250	Water Tariff Study II	950,000	03 Sep 99
	Subtotal	**2,250,000**	

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(Appendix 13 table continued)

TA No.	Sector/Project Name	Total	Approval Date
	Subtotal for Infrastructure	**10,697,700**	
	Law (4)		
3032	Legislation Drafting Support for PRC Securities Law	150,000	24 Jun 98
3279	Development of Economic Laws	1,400,000	19 Oct 99
3672	WTO Membership and Foreign Trade Law Reform	700,000	14 Jun 01
3971	Enforcement of WTO Rules by the Judicial System	400,000	04 Nov 02
	Subtotal	**2,650,000**	
	Enterprise Support (14)		
1683	Restructuring of Laiwu Iron and Steel Company	725,000	31 Mar 92
1923	Study of Social Welfare and Labor Adjustments for Enterprise	573,000	03 Aug 93
2037	Township and Village Enterprise Development	540,000	23 Dec 93
2257	Enterprise Accounting System Reform	467,000	21 Dec 94
2273	A Study of the Local Consulting Industry	210,000	29 Dec 94
2748	Restructuring of Insolvent State Enterprises	600,000	15 Jan 97
3493	Development of a Small and Medium-Sized Enterprise Credit System	750,000	30 Aug 00
3534	Development of Financing Policies and Mechanisms for SMEs	700,000	10 Nov 00
3543	Private Sector Development	600,000	14 Nov 00
3713	Strengthening the Accountancy Profession	600,000	05 Sep 01
3806	Study on Foreign Capital Utilization for Western Region	550,000	18 Dec 01
3930	Development of SME Alternative Financing Mechanism	150,000	24 Sep 02
3970	Hebei Provincial Development Strategy	600,000	04 Nov 02
4095	Policy Reform Support	150,000	11 Apr 03
	Subtotal	**7,215,000**	
	Total (46 TA Projects)	**27,200,700**	

APPENDIX 14

LIST OF RESOURCE PERSONS AND ORGANIZATIONS

Name	Title	Organization
Filologo Pante, Jr.	Managing Director	Asian Finance and Investment Corporation
Xia Xiaoning	Managing Director	AIF Funds Management Ltd.
Hou Zhirui	Deputy Director-General	All China Federation of Industry and Commerce, Economic Department
Lu Song	Attorney-at-Law	Beijing Tianyuan Law Firm
Paul Fisher	Managing Director	British Chamber of Commerce in China
Michael O'Sullivan	Director	British Council
Yvonne Bayer-Cheung	General Manager	Canada-China Business Council
Jeff Nankivell	Development Counsellor	Canadian Embassy
Laurier Dubeau		Canadian-China Business Council
Richard Hughes	Chief Representative	China Capital Partners, Beijing Representative Office
Gu Xinyang	Vice President	China International Economic Consultants Co., Ltd.
Zhou Ning	Assistant President	China International Economic Consultants Co., Ltd.
Qi Bin	Deputy Director	China Securities Regulatory Commission, Department of Fund Supervision
Wang Lin	Deputy Director-General	China Securities Regulatory Commission, Department of International Cooperation
Zuo Ding		China Securities Regulatory Commission, Department of International Cooperation
Liu Rujun		China Securities Regulatory Commission, Department of Listed Company Supervision
Mathew Henshall	Manager	China-Australian Chamber of Commerce
Michael Wang	Chief Representative	China-Britain Business Council
Liu Xiaoxuan	Professor	Chinese Academy of Social Sciences, Institute of Economics
Greg Wood	Chairman	CPCS Transcom
Fiona McConnon	Head	Department for International Development Section
Catherine Martine	Enterprises Development Advisor	Department for International Development Section Asada
Hidekatsu	First Secretary	Embassy of Japan
Jurg Lauber	Counsellor	Embassy of Switzerland, Economic and Trade Section
Uwe Wissenbach	First Secretary	European Union Delegation
Jolanda Jonkhar		European Union Delegation
Ying Shea	Chief Executive Officer	Go4it
Nathan Hsu	Managing Director	Hong Kong Chamber of Commerce
Atkeson Shannon	Investment Officer	International Finance Corporation, Resident Mission in PRC
Cui Jianguo	Investment Officer	International Finance Corporation, Resident Mission in PRC
Gladis Zamparo	Executive Manager	Italian Chamber of Commerce
Tomomi Tamaki	Resident Representative	Japan Bank for International Cooperation
Junko Saito	Project Formulation Advisor	Japan International Cooperation Agency China Office
Kim Woodard	Chief Executive Officer	Javeline Investments
Koo Sung-Jin	General Secretary	Korean Chamber of Commerce
Li Lailai	Director	Leadership for Environment and Development
Teresa Woodland	Consultant	McKinsey & Company, Beijing
Eugene Zhao	Chief Representative	New World China Enterprises Projects Limited, Beijing Office
Masaaki Kaizuka	Principal Administrator	Organisation for Economic Co-operation and Development
Feng Baoshan	Senior Engineer	State Development Planning Commission, Foreign Capital Utilization Department, Loan Division I
Xia Qing	Deputy Director	State Development Planning Commission, Foreign Capital Utilization Department, Foreign Direct Investment Division

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(Appendix 14 table continued)

Name	Title	Organization
Wu Yiguo	Deputy Director	State Economic and Trade Commission, Department of Small and Medium-Sized Enterprises, Division of State-Owned Enterprise Reform and Development
Tian Zheng	Programme Officer	State Economic and Trade Commission, International Exchange and Cooperation Center
David Gardner	Head of Project Finance Asia	Sumitomo Mitsui Banking Corporation
Gavin Xing	Vice President	Sumitomo Mitsui Banking Corporation
Urs Buchmann	President	Swiss-Chinese Chamber of Commerce
Pierre-alain Avyer	Director	Swiss Organization for Facilitating Investments
Michael Furst	Executive Director	The American Chamber of Commerce
Yasunao Komatsu	Secretary-General	The Japanese Chamber of Commerce and Instrustry in China
Patrick Powers	Director	The United States-China Business Council
Wei Jie	Professor	Tsinghua University, Economic Management School
Sergio M. Miranda da Cruz	Representative	United Nations Industrial Development Organization
James R. Killingsworth	Technical Officer	World Health Organization
Luiz Ros	Director, New Ventures	World Resources Institute

DFID PRO-POOR MARKET DEVELOPMENT FRAMEWORK: PARTICIPANTS

	Roles and Levels of Action			
Domain of Intervention or Collective Action	**Household and Firm**	**Community, Market and Professional Associations**	**Central Government/ Local Governmen**	**International**
Economic policy	Exercise political voice.	Dialogue with government	Macroeconomic and sectoral policy Pro-poor budgeting Consistency, for investor confidence	Stabilization and adjustment programs Debt initiatives Reform Organisation for Economic Cooperation and Development policies (trade, agriculture)
Law and Administration, governance		Self-regulation of markets	Increased accountability, effectiveness of law and public sector Assurance of freedom of association	Support to legal and civil service reforms
Political and social culture	Participate in representative organizations. Enhance gender equality.	Trade associations more inclusive	Improved accountability of political process	Support to governance programs
International markets			Policy to address supply-side constraints	Open access to developing country products
Public goods	Take part in common property management.	Collective provision Institutions for common property	Taxes/subsidies Regulation Funding or direct provision	Taxes/subsidies Regulation Funding or direct provision
Externalities		Collective action to internalize	Taxes/subsidies Regulation Funding or direct provision	Taxes/subsidies Regulation Funding or direct provision
Market power, monopoly			Competition policy Improved infrastructure Addressing statutory monopolies	Addressing international concentration
Information asymmetry		Collective investment in information flows	Regulation (e.g. product description) Investment in information	Fund information generation and dissemination
Transactions cost		Collective action	Infrastructure Contract enforcement	
Regulations antipoor, antiwomen, ethnic bias	Organize locally (e.g., women).	Reforms to associations Community education	Political and social reforms Public education Empowerment of local groups	International nongovernment organization networks

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(Appendix 15 table continued)

	Roles and Levels of Action			
Domain of Intervention or Collective Action	**Household and Firm**	**Community, Market and Professional Associations**	**Central Government/ Local Governmen**	**International**
Organizational bias		Reforms to service providing entities	Changes to regulatory frameworks Public education	Core labor standards
Social relations link to markets	Traditional authorities address inequalities. Strengthen social capital–organize locally, use kin groups.	Transparent self-regulation	Legislation for social change (e.g., bonded labor.) Core labor standards	
Market segmentation		Collective action for access to markets	Regulatory framework to reduce barriers to integration	
Risk management	Set up household support, kin groups.	Group saving Market integration	Economic policy Social policy Safety nets	Design of stabilization, adjustment Capital market reforms Debt management; support for safety nets
Linked markets	Diversify livelihood/assets. Develop child care services.	Deepened financial markets, link to insurance markets	Financial and labor market reforms	International trade reforms

Source: Department for International Development (United Kingdom)

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