

Asian Development Bank
and the People's Republic of China
Promoting Private Sector Development

The Private Sector in PRC

One of the most significant results of the ongoing reforms is the emergence of the private sector. The Constitution was amended in 1999 to recognize the role of the private sector, thereby paving the way for future changes in the legal, policy and regulatory environment to support the development of the private sector. The first State law governing private investment became effective in 2000 and regulates sole proprietorships, including the protection of the interests of their investors and creditors. On 1 July 2001, in ceremonies marking the eightieth anniversary of the founding of the communist party, President Jiang Zemin announced that for the first time private entrepreneurs could be members of the party. PRC's domestic private sector is developing rapidly in tandem with the continuing massive inflows of foreign direct investment (FDI). The private sector, including formally registered private firms, small individual businesses, shareholding companies, foreign firms, township and village enterprises and private entities operating in the agriculture sector, accounted for 63 percent of PRC's gross domestic product in 2000. The private sector also employs more than half of the urban workforce.

ADB's Private Sector Strategy

Supporting the private sector is one of ADB's major weapons in its fight against poverty. The private sector will be PRC's engine for job creation – jobs that are necessary to lift people out of poverty. ADB's private sector development strategy is designed to: (i) help establish the environment in which the private sector operations; (ii) generate business opportunities in which the private sector can participate; and (iii) catalyze private investments through direct investments by ADB and by mobilizing additional resources through its cofinancing and guarantee operations. For ADB to provide financing, projects must have clear development impacts and/or demonstration effects that go beyond the benefits captured in the financial rate of return.

Country-specific strategies are formulated taking into account the stage and status of private sector development. Priority areas for ADB's operations include financial services (including investment funds), infrastructure development and support for small and medium-sized enterprises (SMEs). Private sector participation in social sectors, such as pilot projects in health and education, is also being promoted. Themes that run through all country strategies are improving the policy/ legal/ regulatory environment and the governance regime so that the rules of the game are clear, transparent and impartially enforced. Another area of ADB involvement is to help stamp out corruption – corruption is the enemy of legitimate business.

To be eligible for ADB private sector assistance, the proposed investment should be predominantly owned by either domestic or foreign private investors. An enterprise owned jointly by private interests and the government may be eligible, provided the business is controlled or managed independently and autonomously by the private sector investors. ADB's maximum direct support for a project, including loan, equity investment, guarantee and underwriting commitment, is limited to 25 percent of the total project cost or \$75 million, whichever is lower. ADB's policy is to limit equity investments to less than 25 percent of the total issued capital. ADB will not seek a controlling interest in an investee company and will not assume any

management responsibilities. ADB, however, reserves the right to appoint its nominee to the company's board of directors and will exercise its voting rights as a shareholder.

Interest rates of ADB loans to the private sector are in line with market rates prevailing in the relevant country and sector, and factor in the country and project risks. Typically, ADB provides floating rate loans at a spread above LIBOR or equivalent inter-bank rate, depending on the choice of currency (US dollars, Yen or Euro). Fixed rates are also available. Maturity is determined based on project needs and could comprise of a grace period and a repayment period with final maturity. ADB may also charge an appraisal fee to cover its upfront costs associated with due diligence. In addition, project sponsors also reimburse ADB for certain out-of-pocket expenses such as travel expenses, legal fees and outside services.

More detailed information on ADB's private sector operations, including on how to apply for ADB assistance for private sector projects, can be obtained at <http://www.adb.org/PrivateSector/default.asp>.

ADB's Policy Partnership with the PRC

Through its technical assistance (TA) operations, ADB has been helping the Government to build an enabling environment for the private sector in two major areas: (i) creating a supportive legal, regulatory, policy and institutional framework that is transparent, predictable and accountable; and (ii) improving the policy framework for Small and Medium Enterprises (SMEs) and their access to financial resources such as venture capital funds, private sector investment funds, and the domestic capital markets. Examples of ongoing activities in these areas are summarized below.

1. Developing the Legal/ Regulatory Framework

ADB is helping to develop the type of legal/ regulatory framework that is needed in a market economy. For example, ADB helped to draft the Securities Law and the Land Administration Law that became effective in 1999 and the Trust Law that was adopted in 2001. Under a \$1.4 million TA grant ADB is supporting the drafting of several key economic laws such as the Company Law, the Bankruptcy Law, the Social Security Law, the Registration of Commercial and Industrial Organizations Law and the Administrative Licensing Law. ADB is also helping to strengthen the regulatory systems for the capital markets and the insurance industry. Through two ongoing TAs, ADB is helping draft the implementation regulations for the 1999 Tendering and Bidding Law and a government procurement law. These will promote the use of transparent and competitive bidding procedures for government contracts.

ADB is helping PRC meet the challenges of WTO accession by helping to: (i) make foreign trade laws and regulations compatible with the WTO principles, rules and obligations, (ii) outlining the institutional set-up to regulate the foreign investment in the form of mergers and acquisition and transnational licensing, and (iii) increasing transparency by making legal information public and clarifying foreign trade and investment related laws and regulations. This work, which will cover trade in goods, trade in services and foreign direct investment, will help to create a more transparent, rules based system in which the private sector operates.

2. Developing the All China Federation of Industry and Commerce

ADB is working with the All China Federation of Industry and Commerce to: (i) identify and promote appropriate policies and conditions for private enterprise development, and (ii) strengthen its business support services. ADB's assistance will support the preparation of an enterprise-level study to assess the status of private sector development, identify impediments to future development and assess the need for finance and business support services. A strategy for developing the Federation's business support and information services at central

and local levels will be prepared and basic business courses will be developed for private entrepreneurs. Training programs will be put on for Federation staff and selected local chambers of commerce involved in the provision of business advisory services and training.

3. Assisting Small and Medium Enterprise Development

The development of Small and Medium Enterprise (SMEs) is one of the Government's current priorities. There are more than eight million SMEs in the industrial sector, of which more than six million are private businesses. Although SMEs have the potential to contribute to economic growth, they face numerous constraints and challenges, including the lack of access to financing and business advisory services. Less than half of one percent of bank lending to industrial enterprises has been channeled to privately owned SMEs.

ADB is helping the Government to develop a policy/regulatory framework to promote the growth of SMEs and to address the financing and related problems. At the national level, ADB is assisting the State Economic and Trade Commission develop suitable SME financing policies and mechanisms and strengthen the policy framework for SME credit guarantee schemes. Policy inputs from this ADB TA were used in drafting the Law for the Promotion of SMEs, which was enacted in June 2002. ADB will further assist in developing the alternative financing mechanism in accordance with the SME Promotion Law. ADB is also working with the Shanghai Municipal Government to help develop a comprehensive SME credit support system. The development of appropriate SME credit and credit guarantee mechanisms will help increase bank lending to the most efficient and viable SMEs.

How does private sector benefit the poor?

ADB has positioned private sector development 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, and will create jobs and increase incomes that are necessary to lift people out of poverty. Recent studies have revealed strong empirical evidence of these two links; namely, (1) links between growth and private investment; and (2) links between job creation in the private sector and poverty reduction.¹

The study on the relationships between private and public investment, growth rates, and income levels in 50 selected developing countries from 1970 to 1998 indicate that higher growth rates are strongly associated with a higher ratio of private investment to GDP by a wide margin than that of public investment to GDP. Also, the other study on the relationship between job creation and poverty reduction in 80 countries from 1987-1998 has proven that private firms created four to eighty times as many jobs as public sector firms, depending on the country. Moreover, 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.² Most poverty escapees found jobs in private firms, not the public sector. In this sense, the private sector can play a sustainable effect on poverty reduction.

PRC's experience is more complex due to the size of the country. However, the above hypothesis is applicable to PRC as well. Private sector development 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 much lower poverty.³ The relationship between per capita GDP and the share of private sector employment in total

¹ International Finance Corporation. *Path Out of Poverty*. PP.1-6. The report introduces several surveys including: *Growth Is Good for the Poor* by David Dollar and Aart Kraay.

² Guy Pfeffermann. *The Role of Private Enterprise in Reducing Poverty*. The Asia and Pacific Forum on Poverty. Asian Development Bank. February 2001.

³ ADB. *Asian Development Outlook (ADO) 2001*. P.70.

employment in 30 provinces clearly indicates 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 RMB164 (\$20) in per capita GDP.

Good governance is also essential for private sector development and poverty reduction. It ensures the transparent use of public funds to which private firms contribute through taxes, and promotes the effective delivery of public services such as health and education. The poor are most vulnerable to public sector inefficiencies, corruption and waste.

What private sector projects has ADB supported in the PRC?

Through its lending, equity investment and guarantee operations, ADB supported private sector projects in PRC. As shown in Table 1, ADB's total private sector operations in PRC include four project loans (two power projects—the Pearl River in Guangdong and the Meizhouwan in Fujian Province—and two water supply projects - one in Chengdu and the other to China Water Utilities Group for small scale projects across the PRC) amounting to \$151.5 million and four equity investments worth \$69.3 million, mostly in the financial sector.

In 2000, three awards were conferred on the Chengdu Water Supply Project, a BOT project that was awarded to a consortium formed by Vivendi of France and Marubeni of Japan: Infrastructure Deal of the Year by Project Finance International; Project Finance Deal of the Year by Financial Intelligence Agency; and Project Finance Deal of the Year by the International Financial Law Review. In addition to the loans made from its own resources, ADB also mobilizes other sources of financing. For example, under its complementary financing scheme, ADB mobilized \$150 million from other sources for the Meizhouwan Power Project and similarly, \$21.5 million of cofinancing for the Chengdu Water Supply Project.

An example of ADB's equity investment is the \$25 million investment made in 2000 in a \$150 million fund aimed at supporting SMEs. ADB's partners in the fund, the New World Development Company Limited of Hong Kong and the Liberty Mutual Insurance Company of the United States, are well known for their economic expertise and financial strength. This fund is designed to identify high growth, small to medium-sized enterprises and to help increase their competitiveness by initiating the best corporate governance and management practices, thus bringing them in line with international standards. The fund is focusing on four core business sectors: healthcare, consumer products, building materials, and automotive mid-stream and down-stream services. The goal is to attract FDI into PRC and help promote quality domestic brands into the global market. Upon proven success, the Fund will replicate and extend the project platform across the country.

The most recent private sector loan of \$35 million to China Water Utilities Group was approved by ADB on 2 July 2002. The loan will be used as part of a water infrastructure development facility to finance small scale projects in the water supply and wastewater sector in the PRC.

In October 2002, ADB approved a US\$10 million equity investment to establish the first venture capital fund dedicated to the environment sector in the People's Republic of China (PRC). The China Environment Fund will invest in enterprises in the PRC's environmental service sector, selecting those with strong growth potential and which involve the private sector. The targeted enterprises will include those that engage in treating hazardous or medical waste, environmental monitoring and data management, water sector services, air pollution control, solid industrial waste recycling, and water and energy use management.

The Fund aims to mobilize up to US\$40 million of equity capital. LESS has agreed to invest an initial US\$15 million and could increase this to up to US\$60 million in this and similar funds over the next several years.

The PRC is also among the countries covered by three regional investment funds supported by ADB investments, as shown in Table 2. ADB has invested \$75 million in these regional funds that support mostly private sector financed infrastructure projects.

Table 1: Private Sector Investment/Loans in PRC

Name of Company	Amount Approved (US\$ million)			Year of Approval
	Loan	Equity	Total	
Xiamen International Bank	-	10.3	10.3	1991
China Assets Holdings	-	4.0	4.0	1991
Guangzhou Pearl River Power Company	50.0	-	50.0	1992
China Everbright Bank	-	20.0	20.0	1996
Fujian Pacific Electric Co., Ltd (Meizhouwan Power Project)	40.0	10.0	50.0	1998
Chengdu Generale des Eaux-Marubeni (GEM) Waterworks (Chengdu Water Supply Project)	26.5	-	26.5	1999
Liberty New World China Enterprises	-	25.0	25.0	2000
Water Infrastructure Development Facility	35.0	-	35.0	2002
China Environment Fund		10.0	10.0	2002
Total (as of end December 2002)	151.5	79.3	230.8	

Table 2: Regional Funds Investment/Loans in PRC

Name of Fund	ADB Investment (US\$ million)	Fund Size (US\$ million)
Asian Infrastructure Fund	20.0	780
Asian Infrastructure Development Co. Ltd.	30.0	400
Asian Infrastructure Mezzanine Capital Fund	25.0	245