

3

THE FINANCIAL SYSTEM

The PRC's financial system has developed more slowly than the economy. It is particularly underdeveloped in the Western Region. This chapter identifies the reforms that will be of particular importance to the development of the Western Region.

Financial system

The PRC's financial system has progressed far from the situation of about 15 years ago when under central planning a single bank performed the functions of both the central bank and commercial banks. The financial system now has three regulatory institutions:

- The People's Bank of China, which supervises banks, credit cooperatives, and other financial institutions outside the insurance and securities sectors
- The China Securities Regulatory Commission, which supervises the securities market
- The China Insurance Regulatory Commission, which supervises the insurance sector

In each of these subsystems, financial reform and deregulation have generally lagged behind developments in the real economy.

FINANCIAL INSTITUTIONS SUPERVISED BY THE PEOPLE'S BANK OF CHINA

Four state-owned commercial banks are dominant. Each bank has a nationwide network of branches and together they account for more than 60 percent of the financial sector's assets (Tables 3-1 and 3-2).

National and regional commercial banks, credit cooperatives, postal savings banks, and trust and investment companies complement them (Table 3-2).

The institutional structure of the financial sector remains weak, especially its risk management and credit analysis functions, and the quality of the banks' portfolios. Despite efforts to establish commercial criteria in lending, banks continue to act as an extension of the treasury, recycling savings to designated SOEs rather than to the most creditworthy customers. At the same time, the Government expects banks to turn in more profits to offset its shortfalls. Subject to conflicting constraints of this sort, most domestic banks still act like state agencies, and so have little incentive to improve efficiency.

This is becoming an urgent problem in view of the fact that WTO accession portends increased

competition. The People's Bank of China (PBC) has set the following timetable for allowing foreign banks to conduct renminbi (RMB, PRC currency) business in the domestic market:¹

- On accession: Shengzhen, Shanghai, Dalian, and Tianjin
- First year: Guangzhou, Qingdao, Nanjing, and Wuhan
- Second year: Jinan, Fuzhou, Chengdu, and Chongqing
- Third year: Kunming, Zhuhai, Beijing, and Xiamen
- Fourth year: Shantou, Ningbo, Shenyang, and Xi'an
- Fifth year: All other cities and areas

This timetable will exert tremendous pressures on the operation of domestic banks.

Since 1993, the PRC financial system has undergone considerable regulatory reform, reflected in more than 25 new laws and regulations, including the Central Banking Law of 1995 and the Commercial Banks Law of 1995. However, the statutory framework is incomplete; there are no statutes for policy banks, rural credit cooperatives (RCCs), postal office savings, and other nonbank financial institutions.

SECURITIES MARKET

Under the Securities Law of 1998, the China Securities Regulatory Commission has wide-ranging powers to supervise the activities of all organizations participating in the securities markets. The securities markets are still undeveloped. There are two stock exchanges, in Shanghai and Shenzhen in the Eastern Region, with 1,088 listed domestic companies and 114 foreign-funded companies. In addition, PRC companies can issue shares denominated in HK dollars on the stock exchange of Hong Kong, China, which offers opportunities for tapping foreign funds.

INSURANCE INSTITUTIONS

Four laws and bylaws regulate the insurance market: the Insurance Law of 1995, the Probationary Regulations of Insurance Management of 1996, the

Table 3-1 Regulation of Financial Institutions in the PRC

Regulatory Institution		Regulatory Responsibilities		Financial Institutions Regulated	No.	Assets ^a (10 ⁹ yuan)
State council	People's Bank of China	Banks	Bank Supervision Department I	State-owned commercial banks • Bank of China • Agricultural Bank of China • Industrial and Commercial Bank of China • China Construction Bank	4	10,400
				Policy banks • China Development Bank • Agricultural Development Bank of China • Export and Import Bank of China	3	1,524
				Foreign-funded financial institutions	177	180
		Bank Supervision Department II	City commercial banks	90	555	
			Incorporated banks • Bank of Communications • Investment Bank of China • CITIC Industry Bank • Others	10	1,450	
			Cooperative financial institutions	Cooperative Financial Institutions Department	Rural credit cooperatives	41,755
		Nonbank financial institutions	Nonbank Financial Institutions Department	Urban credit cooperatives	836	120
				Postal saving units	31,477	458
				Trust and investment corporations • CITIC • Shanghai International Trust and Investment Co. • Zhongmei Trust and Investment Co. • China National International Trust and Investment Co. • Others	238	268 24 5 4 n.a.
				Finance companies	70	n.a.
	Leasing companies			15	n.a.	
	China Securities Regulatory commission			Securities companies	• Shenyin Wanguo Incorporated Co. • China Nanfan Securities Commission Co. Ltd. • China Huaxia Securities Co. Ltd. • Others	8
		Stock exchanges	• Shanghai Stock Exchange • Shenzhen Stock Exchange	2	265 ^b	
	China Insurance Regulatory Commission	State-owned insurance companies	• China Life Insurance Co. • Zhongbao Property Insurance Co. Ltd. • China Pacific Insurance • Xingjiang Bingtuan Insurance • Others	5	132 47 24 1 n.a.	
• Ping'an Insurance Co.			1	45		
Incorporated insurance companies		• Tian'an Insurance Co. • Dazhong Insurance Co. • Xinhua life Insurance Co. • Huatai property Insurance Co. • Yong'an property Insurance Co.	5	9 n.a.		
		• Others	6			
		Branches of foreign insurance companies	• Youbang Insurance Co. (USA) • Others	13	n.a.	
Joint-venture insurance companies		• Zhonghong Life Insurance Co. • Others	13	n.a.		

Source: People's Bank of China (2000); various other sources.

^a Total asset value.

^b Total market value.

Table 3-2 Loans Granted by the PRC's Financial Institutions, 1999

Form of Lending	(1) State Banks ^a (10 ⁹ yuan)	(2) Others ^b (10 ⁹ yuan)	(3) Total (10 ⁹ yuan)	(1)/(3) (%)
Short-term loans	5,011.3	1,377.4	6,388.7	78.4
Industry	1,678.6	116.3	1,794.9	93.5
Commerce	1,898.9	90.2	1,989.1	95.5
Construction	132.3	15.4	147.7	89.6
Agriculture	174.5	304.7	479.2	36.4
TVEs	190.5	425.6	616.1	30.9
FIEs	267.6	31	298.6	89.6
Private	30.1	27.8	57.9	52.0
Others	638.8	366.4	1,005.2	63.5
Long- and medium-term loans	2,279.2	117.6	2,396.8	95.1
Trust loans		250.5	250.5	0.0
Other loans	79.1	258.3	337.4	23.4
Total	7,369.6	2,003.8	9,373.4	78.6

Source: People's Bank of China (2000).

^a See Table 3-1.

^b Other financial institutions include joint-stock banks, regional commercial banks, rural credit cooperatives, trust and investment corporations, and finance companies.

Table 3-3 Deposits and Loans of State-Owned Commercial Banks, 1999

Regions	Bank of China (10 ⁹ yuan)	ABC ^a (10 ⁹ yuan)	ICBC ^b (10 ⁹ yuan)	CCB ^c (10 ⁹ yuan)	Total (10 ⁹ yuan)
Personal Deposits					
Eastern	286	484	720	373	1,862
Central	111	237	376	184	907
Southwest	44	126	154	86	411
Northwest	28	73	130	69	301
PRC	468	920	1,380	713	3,481
Enterprise Deposits					
Eastern	156	13	466	408	1,044
Central	53	5	192	143	393
Southwest	24	5	123	104	257
Northwest	18	7	76	69	170
PRC	251	30	858	725	1,864
Loans					
Eastern	365	648	994	477	2,484
Central	139	414	562	220	1,335
Southwest	58	226	259	119	661
Northwest	37	131	187	98	453
PRC	598	1,419	2,002	914	4,933

Source: China Financial Yearbook 2000.

^a Agricultural Bank of China.

^b Industrial and Commercial Bank of China.

^c China Construction Bank.

Probationary Regulations of Insurance Agencies of 1997, and the Probationary Regulations of Insurance Brokers of 1998. The China Insurance Regulatory Commission, established in 1998, supervises the activities of 43 insurance companies with four different types of ownership (Table 3-1).

Financial system in the Western Region

There is a great gap between the financial industry in the Eastern Region and that in the Western Region. The economy of the Western Region now accounts for only 15 percent of GDP, and GDP per capita is only 63 percent of the national average. Inevitably the financial industry is underdeveloped, has insufficient funds, and has little capability to support economic growth. This is evident from the following characteristics:

- Small scale of lending
- Lack of incentives for lending
- Lack of direction in the activities of the policy banks
- Slow development of local financial institutions
- Lack of equity finance
- High concentration of financial markets
- Primitive insurance industry
- Absence of foreign banks
- Difficulty of obtaining loans

SMALL SCALE OF FINANCE

In the Western Region, the scale of finance is small, and most loans are from the state-owned banks. At the end of 2000, financial institutions had savings balances of 2,031,100 million yuan, or 16.4 percent of the national total, and loan balances of 1,728,000 million yuan, or 17.4 percent of the national total. The savings balance per capita is only about 65 percent of the national average. The added value of banking and insurance industries accounts for 15 percent of the added value of the two industries throughout the PRC (1999). By the end of 2000, the savings balance of the state-owned banks in the Western Region was

79.5 percent of that of all the financial institutions in the PRC and 6.1 percent higher than the national average, while their loan balance was 82.4 percent of that of all the financial institutions and 5.5 percent higher than the national average.

The state-owned banks' loans in the Western Region are of poor quality and profitability. The high ratio of bad loans is due to historical reasons, such as the reform of poorly performing SOEs prevailing in the Western Region. Other than Sichuan, Yunnan, Gansu, and Xinjiang, the state-owned banks have a higher ratio of bad loans than the national average, adversely affecting profitability and the ability to make further loans.

After corporatization, the commercial banks have been more interested in shifting savings from the Western Region to the more profitable Eastern Region. This has contributed to the shortage of loan finance in the Western Region.

LACK OF INCENTIVES FOR LENDING

Banks have less incentive for lending to the Western Region because they perceive the risks to be high. The inflexible interest rate system also prevents banks from charging a higher interest rate or transaction fee to compensate for the risks. Reforms that focus on slowing the accumulation of nonperforming loans make banks averse to risk. Indeed, the central bank requires all banks to implement a policy called Responsibility to Individuals, which makes each credit officer personally responsible for loans. Most banks in the Western Region are state-owned and face limited competition, so the profit incentive is weak. Therefore, they show little interest in riskier projects that have higher net present value.

Adding to their reluctance are controls on interest rates and restrictions on transaction and monitoring fees. Inability to flexibly adjust interest rates discourages banks from providing loans to risky projects. Projects must be rationed to obtain finance, encouraging rent seeking and corruption. Progress has been made to relax restrictions; for example,

interest rates on loans to SMEs may vary within 30 percent of the prescribed rates, and RCCs can charge interest up to 50 percent higher than the basic interest rate.² Further liberalization is necessary to encourage lending to the Western Region.

Collateral and guarantees could overcome the risk barrier. In the Western Region, the lack of suitable guarantees and collateral is the most frequent reason for an enterprise not being able to obtain a bank loan. Although local governments and other firms are allowed to provide guarantees, recently such guarantees have contributed in large part to the soft budget constraints for firms, especially in rural areas.

Because the central bank discourages both government and firm-to-firm guarantees, providing collateral has become the only way for most firms to obtain a bank loan. Yet many firms are unable to provide adequate collateral. A recent study by the International Finance Corporation (IFC)³ revealed that about 75 percent of private firms in the Western Region regard collateral as a moderate or major obstacle to obtaining bank loans.

PROBLEMS OF POLICY BANKS

In 1994, the PRC set up three policy banks: the Agricultural Development Bank of China (ADBC), the China Development Bank (CDB), and the Export and Import Bank of China. At the end of 1999 their combined assets were equivalent to 15 percent of the combined assets of the big four state commercial banks. After several years' operation, they have demonstrated awareness of their social obligations, but they also have some problems. They compete against commercial banks in the use of funds and lend to profit-making operations, a diversion from the pursuit of social objectives.

In the case of ADBC, which is perhaps the most relevant to the Western Region, around 50 percent of loans were lent to the Central Region, 15 percent to the Western Region, and 28 percent to the Eastern Region (Table 3-4). In 1998, the State Council intervened in ADBC operations to curb the diversion of funds to loss-making enterprises, leading to big

Table 3-4 ADBC Loans, 1999 and 2000

Region	1999		2000	
	Amount (million yuan)	%	Amount (million yuan)	%
Eastern	201,000	28	199,500	27
Central	349,300	48	373,900	51
Western				
Southwest	59,200	8	60,900	8
Northwest	75,500	10	74,600	10
Unclassified	42,500	6	31,300	4
PRC	727,500	100	740,100	100

Source: *Almanac of China's Finance and Banking 2001*.

Table 3-5 RCCs' Contributions to the Financial System, 2000

	RCCs (%)	Other Financial Institutions (%)	All Financial Institutions (%)
All deposits	12.2	87.8	100.0
Savings deposits	19.2	80.8	100.0
All loans	10.6	89.4	100.0
Agriculture loans	73.4	26.6	100.0

Source: People's Bank of China (2001).

Table 3-6 Deposits and Loans of Rural Credit Cooperatives, 1999 and 2000

Region	County Population (million)	Deposits (million yuan)		Loans (million yuan)		Per Capita Loans in Counties 2000 (million yuan)
		1999	2000	1999	2000	
Eastern	279,000	832.3	945.7	577.6	659.7	2,364.5
Central	286,900	289.9	330.5	192.7	218.1	760.2
Western						
Southwest	170,100	147.7	162.0	107.9	118.4	696.1
Northwest	75,200	66	74.6	44.4	52.6	699.5
PRC	811,300	1,335.8	1,512.9	922.6	1,048.9	1,292.9

Source: *Almanac of China's Finance and Banking 2001*.

improvements in the bank's grain purchasing closed-fund operation.⁴ With the State Council's adjustment in Grain Reform Policies and implementation of the Reforestation of Arable Land Project and the Planting Grass and Trees Project, ADBC's grain purchasing operation will continue to shrink. However, because

ADBC has a defined scope of operation, there is scope for expanding the ADBC policy role in new directions.

SLOW DEVELOPMENT OF LOCAL FINANCIAL INSTITUTIONS

Local financial institutions—which include national and regional commercial banks, trust and investment companies, RCCs, urban cooperative banks, and urban credit cooperatives—are growing slowly. They have a high ratio of bad loans and the number of branches has begun to shrink. The state-owned commercial banks have a monopoly position in the Western Region, while the local financial institutions are less developed. From 1997 to 2000, the loans granted by legal local financial institutions contributed only 7 percent to GDP.

Rural credit cooperatives

Under Article 8 of the Constitution, RCCs are collectively owned by the working people. During their life of 50 years, RCCs have gained momentum in developing the rural economy and have now become an important tie connecting farmers to the financial system. By the end of April 2001,⁵ savings in RCCs throughout the country had reached 1,580,000 million yuan, making up 12 percent of the total savings in the financial sector. Loans by RCCs totaled 1,050,000 million yuan, or 10 percent of all financial sector loans. RCCs are even more important in lending to the agriculture sector. Although RCCs contributed only 10.6 percent of total loans in 2000, they accounted for 73.4 percent of loans to the agriculture sector (Table 3-5).

RCCs also had a slightly higher profit rate in the 1990s than the ABC.⁶ Their average profitability was 1.2 percent, which compares favorably with the profitability reported by the ABC (0.4 percent). Their profit rate declined recently because of the low recovery rate of TVE financing and the accumulated bad loans.

However, the Western Region is falling behind in the development of RCCs:

- Per capita RCC loans in the Western Region in 2000 amounted to only around 700 yuan per county person, less than one-third of the level in the Eastern Region (Table 3-6).
- RCCs have less incentive than the state-owned commercial banks to provide loans to the Western Region. In 2000, the Western Region received 23 percent of the loans of state-owned commercial banks but only 16 percent of RCC loans (Table 3-7).
- RCCs have a high percentage of nonperforming loans in the southwest (Table 3-8).

A snapshot of a balance sheet of RCCs also reveals that RCCs may not be using their liabilities effectively (Table 3-9).

In the last quarter of 2000, RCCs had excess reserves (cash in vault) of 32,700 million yuan, accounting for 14.5 percent of total reserves and 2.3 percent of total assets. As identified by the State Council,⁷ RCCs had less incentive to supply loans for higher-risk projects. In the case of defaults, RCCs receive either less or no government guarantee than other state-owned commercial banks.

Postal savings banks

Postal savings banks are another unexplored source of loans to the Western Region. In 2000, such banks had total saving deposits of 80,900 million yuan in the Western Region. Under the current management arrangements, all postal savings have to be kept in the PBC in the form of cash reserves (Table 3-10).

Postal savings banks and RCCs are competing in the savings deposit market; postal savings enjoy the advantage of being a safer form of deposit, with PBC as the guarantor. On the other hand, postal savings banks and RCCs do not compete in the loans market because postal savings banks are not allowed to lend to clients.

Table 3-7 Regional Distribution of RCC Loans, 2000

Region	State-owned Commercial Banks		RCCs	
	Amount (10 ⁹ yuan)	%	Amount (10 ⁹ yuan)	%
Eastern	2,484	50.4	659.7	62.8
Central	1,335	27.1	218.1	20.7
Western				
Southwest	661	13.4	118.4	11.2
Northwest	453	9.2	52.6	5.0
PRC	4,933	100	1,048.9	100

Source: *Almanac of China's Finance and Banking 2001*.

Table 3-8 Nonperforming Loans of RCCs, 1999

Region	Accumulated Loans at the End of 1999 (million yuan)	Receivable Nonperforming Loans (million yuan)	Percentage of Nonperforming Loans (%)
Eastern	637,400	53,800	8.4
Central	124,800	13,400	10.7
Western			
Southwest	73,300	16,500	22.6
Northwest	36,600	4,800	13.1
PRC	872,100	88,500	10.2

Source: *Almanac of China's Finance and Banking 2000*.

Table 3-9 RCC Balance Sheet, Fourth Quarter, 2000

Assets		Liabilities	
Type	Amount (million yuan)	Type	Amount (million yuan)
Reserve assets	223,250	Liabilities to nonfinancial sector	1,512,890
Required reserves	190,540	Demand deposits	228,830
Deposits with the PBC		Time deposits	38,810
Cash in vault	32,710	Household deposits	1,235,530
Central bank bonds		Other deposits	9,720
Claims on Central Government	50,070	Liabilities to central bank	39,970
Claims on other sectors	1,116,190	Liabilities to nonmonetary financial institutions	290
Claims on nonmonetary financial institutions	3,550	Bonds	
		Paid-in capital	71,600
		Other items (net)	-231,690
Total	1,393,060	Total	1,393,060

Source: *Almanac of China's Finance and Banking 2000*.

Table 3-10 Postal Savings Deposits, 2000

Region	Amount (million yuan)
Eastern	231,300
Central	145,700
Western	
Southwest	43,600
Northwest	37,300
PRC	457,900

Source: *Almanac of China's Finance and Banking 2001*.

LACK OF EQUITY FINANCE

Stock markets

Equity finance has been small in percentage terms and narrow in range of application, and the capital markets are expanding slowly. Economic growth has depended mainly on loans. The stock

market has so far served primarily to finance SOEs and help them take the first steps to diversifying their ownership. Private firms have had limited access. Although no explicit rules in the Securities Law of 1998 or in administrative regulations prevent nonstate firms from making it to the stock market, either by making an initial public offering (IPO) or by buying into listed companies, of the 976 companies listed on the Shanghai and Shenzhen stock exchanges, only 11 are nonstate firms. In 1998 and 1999, only four nonstate-firm IPOs took place. Table 3-11 illustrates the discrepancy between listed companies in the Western Region and other regions of the PRC.

From the perspective of the sources of funds, the percentage of liabilities is too high, while the percentage of equity is far too low. In 1999, there

Table 3-11 Comparison of Listed Companies in the Western Region, 1999

Region	Listed Companies			Total IPOs			Average IPO		
	No.	% of Listed Companies		Outstanding Shares (millions)	% of Listed Companies		Outstanding Shares (millions)	% of Listed Companies	
		In the PRC	In the Western Region		In the PRC	In the Western Region		In the PRC	In the Western Region
Southwest									
Chongqing	22	2.4							
Shaanxi	20	2.2	12.2	745	1.9	12.1	3,702	89.4	98.8
Gansu	10	1.1	6.1	403	1.1	6.6	4,028	97.3	107.5
Qinghai	7	0.8	4.3	192	0.5	3.1	2,742	66.2	73.2
Ningxia	8	0.9	4.9	295	0.8	4.8	3,681	88.9	98.3
Xinjiang	14	1.5	8.5	524	1.4	8.5	3,717	89.8	99.2
Inner Mongolia	14	1.5	7.4	754	2.0	10.2	5,383	130.0	140.0
Northwest									
Shaanxi	20	2.2	12.2	745	1.9	12.1	3,702	89.4	98.8
Gansu	10	1.1	6.1	403	1.1	6.6	4,028	97.3	107.5
Qinghai	7	0.8	4.3	192	0.5	3.1	2,742	66.2	73.2
Ningxia	8	0.9	4.9	295	0.8	4.8	3,681	88.9	98.3
Xinjiang	14	1.5	8.5	524	1.4	8.5	3,717	89.8	99.2
Inner Mongolia	14	1.5	7.4	754	2.0	10.2	5,383	130.0	140.0
Western Region	164	17.8	100.0	6,143	16.1	100.0	3,746	90.5	100.0
PRC	923	100.0		38,217	100.0		4,140	100.0	110.5

Source: *China Securities Yearbook 2000*.
Note: Employees' shares are not included.

were 164 listed companies in the Western Region, accounting for 17.8 percent of all the listed companies in the PRC. Together, they pooled 61,428 million yuan, accounting for 16.1 percent of the national total.⁸

Difficulties in listing

Listing difficulties are among several obstacles to the development of equity markets in the Western Region. Until recently, the region had several regional stock markets for SMEs. These markets were under the control of local governments; some ran quite well and helped finance the growth of local firms. During its reform of financial markets, however, the Government closed these regional markets. Nonstate firms are now trying to gain access to the market by buying a controlling (often relative rather than absolute) interest in an SOE. In March 2000, the China Securities Regulatory Commission announced that the system of quotas for listings would end, and underwriters would determine the timing and pricing of new issues. Private firms should then have greater opportunity to attain long-term funding from the equity market. During the current transitional period, however, many SOEs approved for listing under the quota system have yet to come to market. Therefore, a bottleneck in offerings still prevents nonstate firms from coming to market.⁹

Restrictive listing requirements

Listing requirements are rather restrictive, such that many private firms in the Western Region are too small or have not operated long enough to qualify for listing. Also, they may not qualify because of poor profitability, although many high-technology companies are attractive investments despite low profitability in their initial years. Under proposed listing rules for the Second Trading Board, companies would not have to demonstrate a history of profitability to be listed. Furthermore, their proportion of intangible assets could be as high as 70 percent, but they would have to disclose their corporate information every three months. The capital required

to obtain a listing is expected to drop from the main boards' 30 million yuan to 20 million yuan. This is progress, although the need for such a high minimum level of capital can still be questioned.

Difficulties in share buybacks

An investor must be able to sell his shares if an IPO is not possible. One alternative as part of the investment arrangements would require that a company or its major shareholder buy back the investor's shares at some point in the future. A company buyback would result in the cancellation of the shares, and the law does not permit a company to repurchase its own shares, except when canceling shares in order to reduce the company's capital or when merging with another company or companies that hold its shares. Otherwise, cancellation of shares must be subordinated to the consent of the investor, the other shareholders, and the company's creditors, either through a stipulation of the possibility of cancellation in the company's articles of association or through a subsequent amendment approved by the stockholders. These rules were instituted to protect the rights of the investor, creditors, and shareholders. In the case of a company buyback negotiated by the investor, there is no question of any infringement of the investor's rights. Creditors have other means at their disposal—such as covenants to prevent management actions detrimental to their position—that are far more meaningful than any detriment arising from the erosion of capital through share cancellation. These means seem sufficient to protect shareholders. A simple solution would be to amend company law to permit share buybacks from investors unless expressly forbidden by a company's articles of incorporation (which themselves could be amended by shareholders).

CONCENTRATION OF FINANCIAL MARKET

Table 3-12 lists the concentration of financial activities in the Western Region. Xi'an and Chengdu dominate financial loans of rural credit cooperatives,

Table 3-12 Financial Activities in the Western Region, 1999

	Bonds Issued by Companies (%)	Loans			Representative Agencies of Foreign Banks (no.)	Branches of Foreign Banks (no.)
		Rural Credit Cooperatives (%)	Urban Credit Cooperatives (%)	Commercial Banks (%)		
Southwest						
Chongqing	12.4	11.2	0.0	9.6	4	1
Sichuan	23.0	34.7	57.8	20.7	7	1
Guizhou	0.5	3.7	0.0	6.5	0	0
Yunnan	1.3	10.7	0.0	12.6	1	1
Tibet	0.0	0.0	0.0	0.6	0	0
Guangxi	15.2	10.5	0.0	8.3	2	0
Northwest						
Shaanxi	15.4	15.0	42.2	13.0	0	0
Gansu	2.5	5.3	0.0	7.2	0	0
Qinghai	5.3	0.5	0.0	2.6	0	0
Ningxia	6.3	1.1	0.0	2.6	0	0
Xinjiang	4.8	0.0	0.0	8.6	0	0
Inner Mongolia	13.2	8.6	0.0	7.7	0	0
Western Region	100.0	100.0	100.0	100.0	14	3

Source: *Almanac of China's Finance and Banking 2000*

urban credit cooperatives, and commercial banks in the region. Foreign banks are also more likely to choose Chengdu as the place to set up branches or representative agencies.

INSURANCE INDUSTRY

The insurance industry in the Western Region is backward, and there is relatively low demand for and supply of insurance. By the end of 2000, only two insurance companies had registered in the region. Seven nationwide insurance companies had 226 branches, and there were 28,000 insurance practitioners. These are far less than the standards in the Eastern Region. By the end of 1998, the premium income in the Western Region was 18,300 million yuan, or 14.7 percent of national premium income. Property insurance premiums amounted to 8,370 million yuan, 45.7 percent of total premium income in the Western Region, while life insurance premiums totaled 9,930 million yuan, or 54.3 percent. The ratio of premium income to GDP (insurance depth) in the Western Region is 1.55 percent, compared with Shanghai's 2.79 percent; premium income per capita (insurance density) is 64.2 yuan, compared with the PRC's 99.9 yuan, Shanghai's 788 yuan, and Guangdong's 181 yuan. Compared with the Eastern Region, the insurance industry is yet to develop. The insurance companies are slow in developing new products, and are more labor-intensive. Their

management is relatively weak and the practitioners are relatively poor-quality.

ABSENCE OF FOREIGN BANKS

The financial industry in the Western Region is less open to the outside world. By the end of 1999, there were 162 branches and subbranches of foreign banks in the PRC; of these, 93 (57.4 percent) were in Shanghai, Shenzhen, Beijing, and other eastern cities, but only three (1.85 percent) were in the Western Region. Five provinces in the northwest, as well as Guizhou and Tibet, have none. Foreign financial institutions have not yet stepped into the securities and insurance market of the Western Region.

FOREIGN DIRECT INVESTMENT

International financial flows have underpinned the growth of the PRC's economy. The flows fall into two main categories: external loans (\$10,212 million in 1999) and FDI (\$40,319 million in 1999).¹⁰ External loans alone, the smaller category, amounted to 0.3 percent of the PRC's GDP in 1999.

There was a surge of FDI in the 1990s. In 1998 the PRC was the third largest recipient after the US and the UK. The \$43,751 million in FDI that year was 74 percent of the peak achieved in 1995, inflows having dropped with the Asian financial crisis. Most of the FDI goes to the Eastern Region (Table 3-13).

In December 1999 the Government announced tax concessions for FIEs to apply to the Central and Western regions.

The main attractions of the PRC for FDI are the size of the domestic market (mainly a medium- and long-term attraction) and the low manufacturing wages for the assembly of goods for the export market (the immediate attraction). The tax concessions are unlikely to have much impact on FDI, and the tax concession approach is unsatisfactory for the reasons stated in Chapter 2.

The Government's other approach is to guide foreign investment to the Central and Western regions through a catalog of projects¹¹—a list of projects in primary, secondary, and lower-level demand in a given industry. In reality, this represents hope rather than expectation. From December 1997, the *Guiding Catalogue of Foreign Investment Industries* extended tax concessions to certain industries in the Western Region. In June 2000, the *Advantageous Industry Catalogue of the Foreign Investment in Central and Western China*¹² introduced further concessions.

If the policy objective is to promote FDI for the assembly of goods for the export market, the Eastern Region is bound to attract most of the FDI. However, the more the Government accepts FDI for sales to the domestic market, then the more attractive the Western Region's position will become. The Government measure most likely to encourage FDI in the Western Region would be to further open up opportunities for FDI in the process of SOE reform and corporate restructuring, that is, through mergers and acquisitions. The SOEs that restructure most quickly would gain a competitive edge, thus raising the potential return to foreign investors. Another point is that Western Region SOEs account for a much larger share of local industrial output than do SOEs in the Eastern Region.

LOANS AND ASSISTANCE FROM INTERNATIONAL FINANCIAL ORGANIZATIONS

The Ministry of Finance is responsible for the management of overseas borrowing by the Central

Table 3-13 Foreign Direct Investment in the PRC, 1999

Region	Projects		Contracted		Actual	
	No.	%	Amount (US\$ million)	%	Amount (US\$ million)	%
Eastern	13,953	82.5	35,065	85.1	35,434	87.9
Central	2,100	12.4	4,118	10.0	3,747	9.3
Western	865	5.1	2,040	4.9	1,139	2.8
PRC	13,953	100.0	41,223	100.0	40,319	100.0

Source: *Almanac of China's Foreign Economic Relations and Trade 2000*.

Government and local governments. The major lenders are the World Bank, the Asian Development Bank (ADB), the Japan Bank for International Cooperation, and various foreign governments (Table 3-14).

CONCESSIONAL EXTERNAL ASSISTANCE

There has been a decline in concessional financial assistance to developing countries from bilateral and multilateral organizations. Total concessional assistance to developing countries in 1998 was \$32,700 million, 2.1 percent below the 1997 level and 27 percent below the 1990 level. As developed countries tighten their fiscal spending, concessional financial assistance will continue to decrease. Therefore, there could be intensive competition for these funds in the future.

Empirical studies have shown that under a stable environment with sound economic policy, financial assistance from bilateral and multilateral organizations could induce private investment and reduce investors' perception of risk.¹³ This will create an environment conducive to attracting private investment to the Western Region.

The PRC has established bilateral credit relations with 19 countries and regions. Japan accounts for two-thirds of loans from foreign countries. In 1998–1999, the PRC contracted \$4.82 billion in loans with Japan for 44 projects, including many related to Western Region development. The PRC has

Table 3-14 Summary of External Assistance to the PRC

External Source	Period	Ordinary Loan (US\$ million)	Soft Loan (US\$ million)	Mixed Credit/Export Credit (US\$ million)	Grant Assistance (US\$ million)
Multilateral Assistance					
ADB	1999	1,258.5			19.9
UNDP	1996–2000				194.1
World Bank	2000	2,127.0	25.0		
Bilateral assistance					
Australia	2000				32.9
Canada	1998				47.4
France	1997		50.8		
Germany	1998		601.8 ^a	12.8	76.2
Italy	1996–1998		235.8 ^b		14.0
Japan	1998	791.5 ^c	3,714.3 ^d		140.0
Spain	1997		600.0 ^e		n.a.
United Kingdom	2000–2001		16.0	n.a.	30.0
United States	1997			700.0	

Source: Asian Development Bank (2000a)

^a Includes \$304 million in market funds.

^b Includes export credits.

^c Untied loans from Japan Export-Import Bank.

^d Financial year 1999–2000.

^e Includes some mixed credits and export credit.

established a stable and cooperative relationship on a long-term basis with international organizations.

ADVANTAGES OF FOREIGN LOANS FOR THE WESTERN REGION

There are many benefits from loans from bilateral and multilateral agencies.

International links

With the PRC's accession to the WTO, the Western Region will open further to the outside world. Thus, developing relationships with bilateral and multilateral agencies are important to help the world understand the PRC and its influence on world economic development. The use of loans from international agencies will give the outside world confidence in the economic prospects of the Western Region, and thereby create a favorable environment for FDI.

Technical advantages

The World Bank and ADB play important roles in institutional innovation, sustainable growth, support for the private sector, environmental protection, and poverty alleviation. The projects are carefully planned and controlled by the Government to the benefit of

key strategic government policies. By its very nature, the process of economic reform takes government agencies into areas in which they lack technical expertise.

Financial advantages

The funding source is relatively stable as there is a minimum of influence from fluctuations in the international market. Even if incidents in the international capital market were to reduce capital inflows, loans from the World Bank and ADB could still serve as a guaranteed inflow. Loans from international organizations are mainly for infrastructure, environmental protection, social development, and poverty reduction, in line with the government's strategy for the Western Region. These loans could alleviate shortages in public finance. Under the PRC's public finance framework, loans from international organizations have a special role that FDI cannot provide.

Large scale

Foreign loans normally come in larger lumps than FDI, the typical size being \$100 million, suitable for major projects. Loans from international organizations and foreign governments are also long-term and at

low interest rates, and bring the benefits of competitive procurement to international standards. Experience has shown that with loans from international organizations and less administrative intervention, the cost of large and medium-sized projects in the PRC drops by 20–30 percent.¹⁴

DISADVANTAGES OF FOREIGN LOANS FOR THE WESTERN REGION

Repayments

In the absence of a standard system for paying off foreign debts, the local governments exhibit moral hazard and competition in seeking projects. Since the Ministry of Finance guarantees loan repayments, it is ultimately responsible for them. According to national regulations, local governments and the specific agencies are responsible for the debts, even if they are sovereign foreign debts under the charge of the Ministry of Finance. However, the experience of the Ministry of Finance in recovering debts from local governments indicates that there are some problems. Although some methods such as budgetary deduction have been adopted to solve the problem, they are just temporary solutions. As the local governments in the Western Region are financially weaker than those in the Eastern Region, the strategy of relying on loans from international agencies may prove difficult to implement.

Counterpart funds

The limit of counterpart funds is likely to become one of the main restrictions on the use of foreign loans in the Western Region. ADB loans, on average, have accounted for about one-third of the total project cost requirements.¹⁵

The local governments in the Western Region, because of their limited fiscal revenues, are incapable of meeting the repayment conditions and of providing counterpart funds. Seven provinces and autonomous regions are in the bottom ten in the ranking of per capita fiscal revenues. Four are in the bottom five (Table 3-15). All these provinces and autonomous regions rely on government transfer

payments to provide basic public services, and can hardly be expected to provide sufficient counterpart funds to complement foreign loans.

Interest rates

The phenomenon of crowding out the use of foreign loans has recently arisen. For the last three years, the PRC has followed an expansionary fiscal policy. Interest rates have fallen to a low level. Domestic commercial banks are willing to provide loans to infrastructure projects that promise good returns. The procedure of applying for foreign loans is complex and the management requirements are restrictive. These considerations have induced a shift from foreign loans to domestic loans.

Procedures and project implementation

The procedures for applying for domestic loans and foreign loans are different and hard to coordinate. There are several explanations: the special

Table 3-15 Per Capita Fiscal Revenues and Expenditures, 1999

Region	Per Capita Fiscal Revenues (yuan)	Rank ^a	Per Capita Fiscal Expenditures (yuan)	Rank ^(a)
Eastern	995.5		1,340.3	
Central	315.9		597.6	
Western				
Southwest	263.1		810.4	
Chongqing	250.1	25	489.8	25
Sichuan	248.2	27	426.6	30
Guizhou	201.6	30	463.4	29
Yunnan	414.3	12	907.0	10
Tibet	179.9	31	2,096.5	3
Guangxi	284.5	21	479.3	27
Northwest	320.9		827.7	
Shaanxi	295.0	20	572.6	21
Gansu	230.6	29	583.9	19
Qinghai	279.8	23	1,100.1	6
Ningxia	348.6	16	916.4	9
Xinjiang	403.9	13	944.5	8
Inner Mongolia	367.8	15	849.0	13

Source: *China Fiscal Yearbook 2000*.

^a Ranking is out of 31 provinces, autonomous regions, and municipalities governed directly by the Central Government.

requirements of international financial organizations, the inflexible procedures of central and local agencies that approve and evaluate loans, or the peculiarities of the various project proponents. Without adequate preproject preparations, arbitrary changes may take place in the later stages of project implementation, with adverse consequences for the completion date and procurement efficiency. Nonprofessional attitudes can damage the international reputation of the PRC.

Exchange rate risks

The exchange rate and interest rate risks are significant. The lack of financial instruments for hedging in the PRC heightens these risks. There are strict controls on the capital account, while the

current account is flexible, and the renminbi cannot be converted freely. The relaxation of controls on interest rates is progressing, but the interest rates for deposits and loans have not yet been marketized. While the long-term, large-value foreign loans cannot keep up with volatile changes in the international financial market, fixed rate and currency type are liable to cause great risks.

Implications for financial policies

A summary of policy options for the financial system is contained in Table 3-16). More discussions are in the following subsections.

Table 3-16 Summary of Policy Options for the Financial System^a

Strengthen Institutions	Strengthen Bank Incentives	Promote Nonbank Financial Intermediaries	Use Capital Market and Direct Financing	Strengthen the Informal Financial Market	Encourage Overseas Financing
Establish a complete legal framework for the policy banks, RCCs, and the proposed postal savings bank	Liberalize the interest rate scheme	Encourage RCCs to lend to the Western Region by providing interest rate subsidy	Establish a regional financial center to facilitate direct financing	Launch a public awareness program to encourage formal contracting in the informal market	Follow WTO principles and establish an integrated financial market
Institute a transparent and accountable financial system with less preferential policies to establish a level playing field	Allow banks to charge monitoring fees	Facilitate effective use of RCCs' excess reserves	Encourage more new listings and relax listing requirements	Empower the courts to guide policy and arbitrage disputes	Effectively implement policies opening up the renminbi business to foreign banks and insurance companies
Promote a diversified and overlapping banking system to enhance specialization and competition	Allow the establishment of credit guarantee companies	Fully utilize the infrastructure and expand the functions of postal savings	Broaden and strengthen the range of exit mechanisms available to investors; simplify share buybacks	Initiate government-funded demonstrations of institutional innovation by the Eastern Region in the Western Region	
	Establish credit agencies and allow banks to access external information and credit records	Establish a postal savings bank to lend to the rural poor	Establish a legal framework to develop private equity markets such as a venture capital market		
	Strengthen land use rights of farmers to facilitate financing				

^a Excludes international and bilateral assistance.

Box 3-1 A Diversified Banking System in Australia

In addition to banks, financial institutions such as building societies, credit unions, and merchant banks play an important part in the Australian financial system. In the Australian Financial Accounts, "Other Depository Institutions" are defined as those with liabilities included in the Reserve Bank's definition of broad money. Nonbank institutions included in broad money are other authorized depository institutions (building societies and credit cooperatives), corporations registered under the Financial Corporations Act of 1974 in categories D (money market corporations), E (pastoral finance companies), F (finance companies), and G (general financiers), and cash management trusts.

The following table shows the total assets of each category of nonbank deposit-taking institution.

Total Assets of Other Depository Corporations, 1998–2000

	Amounts Outstanding at 30 June (A\$ million)		
	1998	1999	2000
Permanent building societies	11,801	12,697	12,395
Credit cooperatives	18,205	19,881	19,172
Money market corporations	67,636	60,860	63,703
Pastoral finance companies	3,545	4,039	5,922
Finance companies	43,729	47,173	44,272
General financiers	16,704	18,289	20,632
Cash management trusts	18,676	21,531	23,804
Total	180,296	184,470	189,900

There are seven categories of other depository corporations.

Permanent building societies are usually organized as financial cooperatives. They are authorized to accept money on deposit. They provide finance principally in the form of housing loans to their members.

Credit cooperatives, also known as credit unions, are similar to building societies. As their name implies, they are organized as financial

cooperatives that borrow from and provide finance to their members. Credit cooperatives mainly lend for purposes other than housing. Supervision of building societies and credit cooperatives was transferred to the Australian Prudential Regulatory Authority on 1 July 1999, and from 1 July 2000 these institutions are no longer subject to the Financial Corporations Act of 1974.

Money market corporations are similar to wholesale banks and for this reason they are often referred to as merchant or investment banks. They have substantial short-term borrowings which they use to fund business loans and investments in debt securities. They are registered as category D financial corporations under the Financial Corporations Act of 1974.

Pastoral finance companies incur liabilities to lend to rural producers. They are category E financial corporations. Finance companies (category F financial corporations) borrow mainly on financial markets, for example, by issuing debentures. They lend these funds to both businesses and persons. Their lending to businesses is sometimes called commercial lending and covers, for example, financial leasing of vehicle fleets. Their lending to persons is often in the form of installment credit to finance retail sales by others. In contrast with finance companies, general financiers (category G financial corporations) are funded by their parent company or another member of their company group. Typically they lend to corporate customers which buy products produced by member companies of their group. For example, a general financier within a motor vehicle manufacturing group will lend to the group's dealers to finance their inventory of vehicles.

Cash management trusts are investment funds that are open to the public. They invest the pooled monies of their unit holders mainly in money market securities such as bills of exchange. As with other public unit trusts their operations are governed by a trust deed and their units are redeemable by the trustee on demand or within a short time. They are not subject to supervision by the Australian Prudential Regulatory Authority or registered under the Financial Corporations Act of 1974.

STRENGTHEN INSTITUTIONS

The banking system in the PRC needs institutional strengthening to provide better services to the Western Region. The Government should consider these policy options:

- Establishing a complete legal framework to grant statutory provisions to all financial institutions. Particular attention should be paid to the statutory provisions of the three policy banks, numerous RCCs, and the proposed postal savings bank.
- Promoting a diversified banking system to deepen financial market penetration and promote competition. A diversified banking system helps to serve various clients with different needs and requirements. In Australia, there are seven types of quasi banks

complementing the operations of four commercial banks (see Box 3-1).

- Establishing a level playing field for SOEs and the private sector so that firms gain equal access to bank finance irrespective of ownership.
- Requiring state commercial banks to pay attention to the financial risks, and to determine loan applications and interest rates according to the financial risks involved.
- Paying attention to the ratio of loan financing and equity financing. To increase enterprises' capital through equity financing, there is a need to develop equity markets.
- Coordinating policy-oriented and commercial financing. The policy banks should stick to their core functions while the commercial banks expand commercial lending.

- Coordinating domestic and foreign funds, and attracting foreign funds to the Western Region in order to expand the total investment.
- Introducing incentives for system innovation, more activity by financial institutions, and better performance of financial services.

Direct the central bank to support commercial financing

The central bank should direct and support the development of commercial financing in the Western Region. It should not stipulate the legal reserves requirement of financial institutions only on the basis of differences between regions.¹⁶ Rather, the central bank could implement differentiated legal reserve requirements for the small and medium cooperatives or joint-stock financial institutions in the Western Region. In doing so, it would facilitate central bank operations and increase the funds to be used in the Western Region.¹⁷

Encourage lending by policy banks

In the short term, the policy banks should take the lead in increasing investment in the Western Region. However, in the long run the major source of funds should be commercial funds. Commercial financing will generate the momentum for the sustainable development of the Western Region.

The construction of major infrastructure needs medium- and long-term loans. Hence, the State Council has decided to appropriate more funds from treasury bonds, fiscal revenues, and favorable loans from international financial institutions toward the development of the Western Region. However, the amount of treasury bonds and fiscal appropriation is limited. Policy banks should therefore be encouraged to participate.¹⁸ In the process of developing the Western Region, policy banks should not be profit-driven and should concentrate on their core functions. The key reason that policy-oriented banks tend to diversify is shortage of funds. There is a need for effective measures to tackle this problem. The following suggestions are just a few possibilities:

- Policy banks could issue a rolling 20- or 30-year-term Western Region Development Bond with the guarantee of fiscal revenue. The bonds could be sold to commercial banks, individuals, and corporate entities. They could be listed on the stock exchange and should have the status of treasury bonds.
- Some part of postal savings funds and pension funds can form the fixed source of funds of policy banks.
- The central bank can re-lend to policy banks and extend the loan term according to their use of funds.
- Policy banks could be allowed to get funds from foreign financial institutions and financial syndicate with the guarantee of the State.

Given the shrinkage in ADBC's operation, its scope of operation in the Western Region can be adjusted or expanded. ADBC should do more in respect of the following to replace its activities in purchasing, reserving, and appropriating grain:

- Sharing the burden of developing the Western Region with CDB. While CDB supports large-scale infrastructure projects, ADBC could support small- and medium-scale infrastructure projects, environmental protection projects, and industries characterized by strong competitive advantages as a result of special geographical location, climate, or culture.
- Taking over the management of the Beautiful Mountains and Rivers Projects to improve environmental conditions in the Western Region.
- Taking over agriculture development loans from commercial banks, and special loans and antipoverty loans from the central bank.
- Managing an Area Planting Fund to utilize the proceeds of a carbon tax (Chapter 4).

In order to contribute more to the development of the Western Region, CDB should set up branches and provide long-term credit to support the construction of infrastructure.

Policy banks should learn from the World Bank and ADB and provide technical assistance funds to the

Western Region for use in preparing and analyzing the projects to which they will be making loans. This will increase the possibility of loan success and reduce the financial risks.

Use state-owned commercial banks to finance large-scale projects

The state-owned commercial banks have the advantages of larger scale and assets. They are more suited for the financing of large-scale projects, based purely on commercial principles. Government subsidies to projects should preferably come from policy banks. The policy banks should increase medium- and long-term loans to the Western Region to improve infrastructure. This in turn can foster a favorable environment attracting large amounts of commercial funds into the Western Region.

STRENGTHEN BANKS' INCENTIVES

An important step would be to strengthen profit incentives through private ownership and competition. At present, the ownership structures of the real sectors do not balance with those of the financial sectors. Private ownership in the financial sector is practically nonexistent. The Government should allow the entry of private financial institutions, especially as WTO membership will open up opportunities for foreign financial institutions. To ease regulatory concerns, particularly in the light of recent financial crises, there could be strict prudential requirements for private financial institutions.

Private financial institutions are likely to be more independent of political considerations and more profit-oriented. They are not likely to compete directly with state-owned banks, although the new competition will have an invigorating effect on the state-owned financial sector. New banks tend naturally to focus on underserved market niches, especially younger and smaller firms, which constitute the bulk of the private sector today. They do not tend to discriminate among customers on the basis of existing relationships, and in their struggle to

establish themselves in the market, they are more prone to trying innovative ways of doing business.

The big state-owned banks are likely to dominate the domestic financial landscape in the Western Region for the foreseeable future. Strengthening profit incentives would therefore have a major impact on improving private firms' access to bank loans. Corporatization, listing, and strategic partnering with foreign financial institutions are some of the ways to reach this objective.

Monitor the impact of financial sector consolidation on incentives for SME lending

With consolidation taking place in urban and rural credit cooperatives, rural credit funds, and investment and trust company sectors, financial institutions are likely to become larger and credit decisions more centralized. Given the important role these financial institutions play in SME financing, any gains made in terms of financial stability should not have an adverse effect on information and relationship capital, which would tend to reduce SMEs' access to financing.

Further liberalize interest rates

Evidence suggests that further liberalization of interest rates is needed to improve private firms' access to bank loans. Such a measure is not likely to have a significant impact on the borrowing costs of these firms. Most private enterprises able to borrow already pay effective interest rates that are significantly higher than the ones prescribed by the PBC. Entrepreneurs also indicate that access to financing is more important than the costs of funds.

Allow banks to charge transaction (and monitoring) fees

Banks find that loans to private companies, the bulk of which are smaller and less transparent, carry higher unit transaction costs. Therefore, if they use uniform procedures that do not differentiate between different types of borrowers, they are likely to discriminate against small firms.

Transaction fees would, to some extent, unbundle the decision to look at a project proposal from a credit standpoint. They would also prompt banks to consider the proposals of a larger number of smaller firms and, hence, to develop a more service-oriented culture and to actively promote greater transparency and better accounting standards. Banks would need to adopt new procedures and develop skills in areas such as cash flow analysis, project finance, and risk management. The introduction of transaction fees would also be an important aspect of the realignment to international practices in banking, which seems inevitable with WTO membership.

Improve incentives in credit guarantee schemes and management of risks

In the first half of 1999, the State Economic and Trade Commission issued guidelines entitled Establishing Credit Guarantee System Pilot Projects for Small and Medium-Size Enterprises Guidance Opinion to stimulate bank lending to SMEs. By November 1999, 70 cities had established credit guarantee agencies with a total capitalization of 4,000 million yuan.

Credit guarantee agencies are treated as nonfinancial institutions and are outside the regulatory scope of the PBC. International experience suggests that credit guarantee schemes can sometimes play a useful transitional role in improving SMEs' access to loans. With proper supervision, such schemes can reduce transaction costs for banks, improve risk management through more flexible guarantee schemes (if guarantee funds and borrowers are free to negotiate them), and alleviate the collateral difficulties of small, mostly private, firms. However, credit guarantee schemes also entail risks, which are potentially high in the PRC. Local governments could use credit guarantee schemes as a means of continuing to interfere in credit allocation and as a substitute for policy lending. Also, at present there is no risk sharing between guarantee agencies and banks; this creates non-ideal incentives in lending decisions. The 2002 Law in Promoting Small and Medium Enterprises provides a legal basis for such guarantee mechanisms.

Furthermore, guarantee schemes should not divert attention from reforms of risk management in bank lending. There is a need for a system for registering assets used as collateral (especially movable assets), a better system for auctioning machinery and equipment (and for creating secondary markets in such assets in general), and a better system for enforcing collateral. Conditions in the Western Region suggest that the Government could consider revising the Land Administration Law of 1998 to allow the use of land as collateral. Such a reform could also facilitate adjustment of landholdings. However, the Government would want to avoid the phenomenon of rural landless labor (which so bedevils other countries) by limiting the application of this reform. In the long term, national social security rather than landholdings should ensure basic living standards.

Allow financial institutions access to external information

A financial institution must efficiently access information about a potential client's credit history and the nature of any claims outstanding against property offered as collateral. The PRC needs to create institutions such as real estate registries or credit bureaus to allow financial institutions access to the credit records of their clients.

PROMOTE NONBANK FINANCIAL INSTITUTIONS

Encourage the operations of rural credit cooperatives

The Government should consider the following measures to promote RCCs:

- Putting RCCs' excess reserves to better use
- Providing interest subsidy for loans made by RCCs to the Western Region to overcome the risk factor and weaker repayment ability of farmers in the region and therefore provide an incentive for RCCs to invest in the local market
- Using RCCs as a vehicle for developing microfinance in the Western Region
- Introducing a law to govern the operations of RCCs

Fully utilize the postal savings infrastructure

Postal savings points are more extensive than RCCs and for farmers in remote areas are the only banking facility. They provide an excellent infrastructure for expanding financial services in remote areas where most of the poor now live. The network is underutilized and only takes deposits, issues postal checks, and helps to sell insurance policies and government bonds. At the end of 2000, the accumulated postal savings deposits amounted to 458,000 million yuan, of which 31,477 million had been deposited during the year.

To fully utilize this infrastructure in an overall strategy of diversifying the banking system, the Government should consider establishing a postal savings bank to take deposits and make loans to a wide range of communities, especially in remote areas. The bank should be under the regulation of the PC and provide normal banking services as well as some microfinance services (along with RCCs).

The Ministry of Information Technology Industry, which is responsible for post offices, may have some concerns. Postal savings points cross-subsidize other post and parcel businesses that are making losses. Pricing reforms or institutional reforms should therefore precede postal savings bank initiatives.

USE CAPITAL MARKET AND DIRECT FINANCING

Using various investment funds available through the bond and stock markets, the Western Region could issue securities to fund the construction of infrastructure.

FOSTER THE GROWTH OF A FINANCIAL CENTER IN THE WESTERN REGION

The Government should foster the growth of a financial center in the Western Region. Xi'an and Chengdu are the strongest candidates in terms of manufacturing base, commercial facilities, financial institutions, technology base, universities and colleges, tourism resources, and international reputation. They are the centers of finance,

commerce, technology, manufacturing industry, and tourism in the northwest and the southwest, respectively.

Xi'an, the capital of Shaanxi province, is in the eastern portion of the Western Region. It is the gateway to the northwest. Although it is situated inland, it can be regarded as a coastal city like Shenzhen. It links the western and eastern regions through communications and cooperation in economic activities, technology, information, and funding.

Chengdu is a large city in the southwest and has the strongest links with foreign markets of any city in the Western Region.

Promote access to domestic capital and equity markets

In developed countries and an increasing number of developing countries, there has been a shift in intermediated finance to disintermediated finance (e.g., bonds and equities). Raising funds on the capital and equity markets is a very important source of finance to fund long-term development in the Western Region. This is the major source of capital in developed economies (e.g., the recent injection of private funds into the equity markets in developed economies to develop the information technology sector).

As the people of the PRC become richer, they will look for sources of investment other than banks for private savings. The focus needs to be on how to mobilize private domestic capital to fund long-term development projects in western PRC.

The PRC Government should facilitate access to public equity markets by taking the following measures:¹⁹

- Facilitating more new listings. The decision to abolish the quota system and allow underwriters to determine the timing and pricing of new issues should be well implemented.
- Relaxing listing requirements. Listing requirements regarding the size of firms, operating histories, and minimum years of

profitability could be relaxed to lower the barriers for the listing of small, new, and high-tech firms on the stock exchanges.

- Broadening and strengthening the range of exit mechanisms available to investors. The establishment of a second trading board would provide a mechanism for investors to exit from the market and therefore give them more incentives to invest in risky projects.
- Simplifying share buybacks. Regulations and rules should be revised to simplify the buyback of outstanding shares to improve the mobility of capital.

Improve the efficiency of private equity funds

Legal and taxation instruments are necessary for private equity funds to develop. The main issues relate to the legal organization of funds (whether joint-stock company or contractual), the need for trustees to protect investors from the adverse actions of the fund manager, and the use of a fund manager and tax treatment to avoid double taxation. Previously the law did not clearly define the rights and obligations of the investor, the fund manager, and the custodian; the relationships between them was uncertain, and the role of a trustee who can represent the fund in legal proceedings was ill defined. The 2001 Trust Law provided a much clearer definition of the obligations and rights of the parties.

The investment industry in general would benefit considerably if the State acted less as a patron of the companies in which it invests and more as a protector of efficient competitive markets. As a transitional step, the State could use indirect mechanisms to ensure that venture capital flows are strong, stable, and accessible to a wide range of companies, including private ones. The experience of the Small Business Investment Corporation program in the US exemplifies one transitional mechanism to ensure that small companies with an attractive future but not the high returns that private venture capital

demands also have access to prelisting equity capital.²⁰

ENCOURAGE THE ESTABLISHMENT OF THE INSURANCE INDUSTRY

People in the Western Region lack awareness of insurance. This restricts the development of the insurance industry. Property insurance should take the lead, providing insurance service to important infrastructure projects such as highway, railway, airport, telecommunication, and water conservation projects. Insurance companies can also provide risk management services for medium- and large-scale and high-tech projects. They should devise insurance packages to exploit the tourist market. The State should encourage the operation of joint-stock insurance companies in the Western Region and develop the insurance intermediary market. The State may show preference in approving the setting up of insurance agency companies and insurance brokers. There is a particular need for research on the insurance needs of farmers in conditions of unreliable rainfall in the northwest, and on the new risks arising from the switch to cash crops and exposure to fluctuations in international prices. One of the best ways of meeting many of these policy objectives is simply to open up the insurance market in the Western Region, and to encourage foreign insurance companies to set up branches in the region.

STRENGTHEN THE INFORMAL MARKET

About half of the sample firms in the recent IFC survey²¹ have at some point resorted to the informal market to finance their activities. While the informal market provides more flexibility in financing small-scale loans,²² it will encounter serious problems when its scope extends beyond friends and family members. The most prominent of these problems are defaulting and cheating, which are difficult to control because the parties cannot turn to the law for protection, especially in the absence of written contracts, as is typically the case.²³

Some promising institutional innovations in the area of informal financial markets are happening in the Eastern Region of the PRC. A *hui* is a collection of households that are willing to contribute a fixed amount of money to a common pool with either implicit or explicit contract. The collected money is then used to finance projects undertaken by each household in an agreed order. A *hui* could be as small as a couple of households, or as large as a thousand households. Most *hui* use houses or other fixed assets as collateral. The cost of default includes the confiscation of collateral, loss of face (reputation), permanent exile from the *hui*, and other financial punishments.

A public awareness program is needed to bring the *hui* contract in line with the Contract Law and empower the courts to police and arbitrate the disputes.

With its lower level of urbanization and strong family ties, the Western Region could find that the informal system becomes an important complement to the formal financial system. Residents in the Western Region will be willing to adopt the institutional innovations in the Eastern Region if some government-funded information demonstrations could be arranged.

ENCOURAGE OVERSEAS FINANCING

Though overseas financing remains limited, its role appears to be increasing. In the same IFC survey, 23 percent of the sampled firms wanted to form joint ventures with foreign firms in order to get capital in the future while 11 percent said they were willing to borrow from foreign banks.

Following WTO principles, the Government should remove all those barriers that prevent foreign banks from having access to renminbi business in the PRC. An integrated financial market could then evolve.

As stated earlier, the Government could encourage FDI in the Western Region by opening up more opportunities for such investment in SOE reform and corporate restructuring.

The Government should take precautions in implementing the industry catalog for foreign investment. As discussed in Chapters 2 and 10, such government-guided preferential industrial policies could further distort the market. Preferential policies are also inconsistent with the “light touch industrial policy” approach analyzed and recommended in Chapter 10.

IMPROVE THE USE OF BILATERAL AND MULTILATERAL FINANCE IN THE WESTERN REGION

There is room for improving the use of loans and technical assistance from international financial organizations and foreign governments. The Government should strive to improve the use of existing loans while preparing for expanded international assistance to the Western Region. The Government should consider implementing the following measures:

- Assessing alternative financing more carefully. Consideration should be given not to interest rates alone but to the broader terms of the loans, such as duration, repayment conditions, grace period, and punishment for default.
- Intensifying the supervision of loans to local governments and improving repayment performance. Taking precautions against financial risks is a paramount objective, as is the protection of the good reputation of the Government as an international borrower.
- Considering international lending (ADB, IFC, or World Bank) to the financial sector (RCCs, financial intermediaries, etc.) rather than to local government to reduce the risk of default.
- Identifying feasible projects, to improve the structure and quality of loans. The Government wishes to utilize 70 percent of the preferential foreign loans in the Western and Central regions. Implementing this policy will require a great deal of work by local governments and Central Government departments to identify sufficient suitable projects.

- Investigating policies and terms for on-lending to local governments.
- Considering the need for government subsidies for social projects.
- Reviewing regulations and procedures relating to official development assistance. The PRC must strengthen its anticorruption measures, improve transparency of information, promote the participation of project beneficiaries in project design and implementation, and upgrade the functions of inspection and auditing.

Notes

- 1 PBC press conference, published at <http://www.china.com.cn/>.
- 2 International Finance Corporation (2000). The survey shows that in 2000 state banks were charging the firms an average interest rate of 7.9 percent, and credit unions 11.5 percent. These rates, with transaction costs factored in, were comparable to the informal market rate (the difference is not statistically significant). At the same time, most ways of circumventing restrictions on interest rates discriminate against smaller firms, and are too blunt to reflect differences in the risk profile of projects.
- 3 IFC (2000).
- 4 *Almanac of China's Finance and Banking 1999*.
- 5 *People's Daily*, at: http://english.peopledaily.com.cn/200105/29/eng20010529_71271.html.
- 6 See Meyer and Nagarajan (2001).
- 7 People's Bank of China (1988).
- 8 This is mainly due to the following: (i) There is no big regional capital market in the Western Region; the channel of financing through securities issuance is almost blocked and the volume of issue of stocks and securities is low. The first and secondary markets of treasury bonds are small in scale. (ii) The profitability of listed companies in the Western Region is poor. As analyzed in the *Annual Report of Listed Companies 1999*, the total gross profit and net profit of 160 listed companies in the Western Region amounted to 6.4 percent and 3.5 percent, respectively, of the corresponding indicators of all the listed companies' A shares. Of the 101 certified securities dealers in the PRC, only 21 are in the Western Region, and they are less developed. Their ability to sell is also low, their brokerage is facing tough competition, their human resources are insufficient, and their research and development ability is limited. (iii) The market's ability to attract funds is weak, the profit per share is 0.05 yuan less than the national average. Because of the high proportion of state-owned shares (30.4 percent) and juridical person's shares (69.57 percent) (1998), stock liquidity is low.
- 9 The stock market has so far played a minor role in financing the development of firms in the Western Region. However, a recent IFC report found that firms in the Western Region would be strongly motivated to list on the stock exchange if the incentives for managers and employees were to be improved, primarily through stock options. This is particularly the case in high-tech firms, where human capital plays a critical role in operations.
- 10 *Almanac of China's Foreign Economic Relations and Trade 2000*. The numbers in this chapter vary slightly depending on the source document.
- 11 Hu Jingyuan, Deputy Director, Department of Foreign Investment, Ministry of Foreign Trade and Economic Cooperation, "Review of Foreign Investment in China in 1999 and Prospects in 2000," in *Almanac of China's Foreign Economic Relations and Trade 2000*.
- 12 Order No. 18 of 16 June 2000, issued jointly by the State Development Planning Commission, the Economic Trade Commission, and the Economic Cooperation Bureau of the Foreign Trade Committee.
- 13 Carbaugh (2000).
- 14 Xie Ping and Xueling Wu (2001).
- 15 Asian Development Bank (2000a).
- 16 Actually, the legal reserves requirement for the branch-system state-owned commercial banks, differentiated according to the regions, is difficult

to implement. A state-owned commercial bank is registered as a single juridical entry but has many branches throughout the country. If the differentiated legal reserve requirement were implemented according to the regions, multiple ratios would exist in one bank, complicating supervision by the central bank. Moreover, these banks have more funds in the Western Region because of the low legal reserve requirement; the funds could be transferred to other branches of the banks, rendering the legal reserve requirement ineffective.

- 17 What should be pointed out is that it would not weaken the central bank's ability to indirectly macro-adjust these financial institutions when implementing the differentiated legal reserve requirement for small and medium cooperatives or joint-stock financial institutions. According to the statistics, from 1993, the four state-owned commercial banks have relied less on re-lending from the central bank and their re-loans have progressively become smaller. The balance of the central bank's re-loans to the four banks went from 1,200,000 million yuan at the end of 1995 to 490,000 million yuan at the end of 1999. Re-loans accounted for 6.3 percent of the central bank's total liabilities at the end of 1999. Besides, as the experience of many other countries has shown, avoidance of the legal reserve requirement is not likely and can be minimized as long as strict supervision is ensured.
- 18 In fact, it compensates somewhat for the outflow of funds from the Western Region by ensuring the primacy of policy-oriented financing. Over years, the national strategy favored the Eastern Region, widening the gap between the Western and Eastern regions. In the market-oriented economy, the resources in the Western Region such as funds, skills, and technology are flowing to the Eastern Regions because of its comparative advantages. Commercial financial institutions have become the main channel of outflow of funds. This trend is hard to reverse in the short run. Therefore, the

policy-oriented financial institutions can make up for some of the outflow.

- 19 For a more comprehensive discussion on the policy recommendation to improve access to public and private equity in China, see Xie Ping and Xueling Wu (2001).
- 20 While venture capital plays an important role in financing the growth of small, technology-oriented companies, it also has its limitations. Venture funds typically back only a tiny fraction of the technology-oriented businesses begun each year. Furthermore, the structure of venture investments is inappropriate for many young firms: venture capital groups are unwilling to invest in very young firms that require only small infusions. Public programs to provide early-stage financing to firms, particularly to high-technology companies, have become commonplace in many countries. As the Small Business Innovation Research program in the US has shown, successful initiatives tend to complement venture capital rather than substitute for it. If carefully implemented, such programs could play a useful role in promoting the development and commercialization of intellectual products and the associated protection of intellectual property rights.
- 21 International Finance Corporation (2000).
- 22 Lending in the informal market has several distinct characteristics: (i) It usually takes place among a closely knit network of friends or family members, among whom reputation is very important. These factors greatly reduce information asymmetry. Indeed, reputation and relationship often substitute for the use of collateral. (ii) Informal lending is usually short-term. The main reason is that individuals face tight liquidity constraints, but high interest rates are also relevant. The short maturities also reduce the risk of default. Thus, it is not uncommon for firms to buy materials for an order through an informal loan and to repay the loan when the order is settled. (iii) Informal lending has more flexible terms. Private firms often need money to complete a production cycle, which can be as short as several days in some industries.

Formal loans are usually issued for at least six months or a year and do not allow a grace period, and this is an important deterrent to private firms. (iv) Applying for an informal loan does not require much time, maybe only a day.

23 Not long ago, some semiformal financial institutions such as credit associations organized by county and township governments emerged in rural areas. They attracted savings by offering high interest rates and making loans to local firms. Many of them ran into serious problems, however, often because of the involvement of local governments. A large portion of the lending went to local TVEs and

contributed to the soft-budget problem of these entities. To avert a crisis, the Government decided to shut down all credit associations. Almost all are now closed, their debts in the hands of local governments. Wenzhou is one place where they still seem to be operating. Wenzhou has a long history of informal financial markets and had private banks in the 1980s. Its credit associations were under less government influence, and they issued loans to private firms with hard budget constraints. Their good record of management explains in large part why they still exist and shows that semiformal financial institutions are viable in such conditions.