

PROPOSED ADB PRIVATE SECTOR DEVELOPMENT STRATEGY

A. MAJOR FINDINGS AND RECOMMENDATIONS

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

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

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

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

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

Table 26: ADB Strategic Thrust for PSD in the PRC

Creating Enabling Environment	Generating Business Opportunities	Catalyzing Private Investment (PSO's input)
<p>Financial Sector Reform</p> <p>Support for SMEs both from supply and demand sides through policy dialogue:</p> <ul style="list-style-type: none"> • expand credit guarantees models, introduce pilot program for collateral guarantees; • strengthen the commercial banking sector; • develop alternative financing for SMEs through capital markets, leasing, investment funds; and • support capacity building of central and local governments and local chambers of commerce to be service providers to SMEs. <p>Support to develop social security system (legal and regulatory framework), governance (support for capacity building for financial market supervisors), and policy dialogue on microfinance (support for policy dialogue to support a legal framework, deregulate interest rates, and refocus program)</p>	<p>Information Services</p> <p>Generate business opportunities (training, advisory services) by facilitating capacity building of local chambers of commerce and partnerships between foreign and local chambers of commerce.</p>	<p>Capital Markets</p> <p>Investment in funds to support the development of SMEs, infrastructure projects, energy conservation and environment safekeeping, disposal of nonperforming loans, and other themes in line with PRC and ADB's development strategies.</p> <p>Restructure loan and equity investments in specific companies in commercial banking, insurance, and asset management industries.</p>
<p>Public-Private Partnership in Infrastructure</p> <p>Continued assistance in financial management and corporate governance for regulators and operators</p> <p>Policy dialogue on sector-specific laws, regulations, and administrative orders affecting private participation in infrastructure</p>	<p>Project Contractors</p> <p>Improve access of domestic and foreign contractors to ADB and publicly funded projects.</p> <p>Increase fair business opportunities through public-private partnership infrastructure projects (BOT).</p>	<p>Private Participation in Infrastructure</p> <p>Demonstration projects involving public-private partnerships in the infrastructure sector</p> <p>Projects that test the enabling environment and provide opportunities for continuing policy dialogue in the sector</p>
<p>Private Participation in Social Sector</p> <p>Policy dialogue for creating a better regulatory framework for private medical practice in the PRC</p> <p>Policy dialogue for facilitating private participation in higher business education and corporate training for domestic business managers</p> <p>Regulatory and Legal Environment</p> <p>Creating a rule-based business environment (WTO) by helping further modify existing laws, and improving transparency by assisting in establishing a system that facilitates public consultation, accessibility, and enforcement.</p> <p>Knowledge Dissemination</p> <p>Findings of TA projects, best practices, and lessons learned from ADB projects and TAs to facilitate creation of an enabling environment for the private sector</p>		<p>Pilot Projects in Innovative Areas</p> <p>A pilot project in health (medical JVs such as hospitals and pharmaceuticals)</p> <p>A pilot education project (i.e., for-profit educational institutions)</p>

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

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

B. CREATING AN ENABLING ENVIRONMENT

I. Financial Sector Reform and SME Support

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

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

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

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

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

- (iii) In addition to bank financing and guarantee schemes, ADB should further explore alternative financing options for SMEs (i.e., capital markets, leasing, VC) and identify what policy and regulatory changes are needed to make alternative financing options available to SMEs.
- (iii) As for capital markets, ADB's policy dialogue with CSRC on how to improve the functioning of the capital markets as a source of funding for private enterprises, including SMEs, will be important.
- (iv) Regarding leasing, there is a need for a legal and regulatory framework for the leasing industry to revive. Strengthening the Contract Law would help create a pro-leasing business environment.
- (v) VC funds have the potential to play a bigger role as a source of funds for SMEs, particularly startups and technology SMEs. The prevailing legal framework is inadequate for VCs to function fully and effectively reach SMEs in need of seed money and a subsequent injection of capital. Revisions to the Company Law could facilitate the further development of VCs.
- (vi) ADB should work with the Government in building the capacity of central and local government agencies and local chambers of commerce to enable them to play a better role as service and information providers to SMEs.

2. Financial Sector Reform: Social Security

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

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

3. Financial Sector Reform: Governance

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

Recommendations. ADB should support capacity building for financial market supervisors to function as transparent regulators. ADB should encourage government agencies concerned to

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

4. Financial Sector Reform: Microfinance

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

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

5. Public-Private Partnership in Infrastructure

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

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

Recommendation (1). Continued efforts are needed to select issues and topics that are critical to private participation in infrastructure in each subsector. In the roads and highway sector, ADB should continue policy dialogue on the transfer of highway asset rights and assistance in financial management and corporate governance. Building on the findings of TA PRC-2952: *Corporatization, Leasing and Securitization in the Road Sector Project*, efforts should be intensified to create an enabling environment and apply the recommendations to ongoing and future projects. In the railway sector, ADB should continue to support the ongoing reform process,

particularly commercialization of railway operations with full cost recovery, to ensure financial sustainability. In the water sector, tariff policies have a key role in managing risk when private sector participation is introduced. ADB should continue to assist in creating an improved enabling environment for the private sector to participate in water projects by facilitating (i) corporatization of public water companies, holding them accountable for profitable operations; and (ii) associated tariff reforms to achieve full cost recovery of operations. In the power sector, ADB should continue to assist in ongoing restructuring plans to help create an enabling environment for the private sector. ADB should continue negotiations with central and local governments regarding the Meizhouwan project (Box 12).

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

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

6. Private Participation in the Social Sector

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

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

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

Major Findings for the Education Sector. ADB surveys and other sources highlight the need for intensified efforts to improve managerial capacity and retain skilled professionals and workers. The SME survey also reveals that a majority of firms sampled believe that they need training in corporate strategies and marketing. Foreign firms consider that better managerial and professional skills are essential for further development of their firms and that the PRC needs more managers with expertise in information technology, strategic management, and reengineering

business processes. The education sector has not been able to serve and respond to such increasing needs. The training subsector is an unregulated and fragmented market, which lacks sophisticated topics such as corporate strategy and governance. Foreign investors are not allowed to operate in the distance learning (e-learning) subsector.

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

7. Legal and Regulatory Environment

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

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

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

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

8. Knowledge Dissemination

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

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

C. GENERATING BUSINESS OPPORTUNITIES

1. Information Services

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

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

2. Project Contractors

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

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

Box 13:

Level of Awareness of ADB's Private Sector Operations

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

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

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

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

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

"Yes, I only have general information."

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

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

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

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

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

Source: *ADB Business Climate Survey 2002.*

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

D. CATALYZING PRIVATE INVESTMENT

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

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

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

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

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

ADB's private sector operations in the PRC should focus on: (i) effective and innovative public-private partnerships to allow sharing of risks and costs in the development process, especially in the provision of infrastructure; and (ii) development of the domestic private sector, including SMEs that are a major source of employment and income, to anchor development more firmly in domestic capacity and promote wider participation. In addition, ADB should consider exploring possible interventions through private participation in social sectors such as health and higher education.

1. Capital Markets

Major Findings. There is a need for continued restructuring of financial intermediaries to enable them to function effectively in transforming savings into productive investments, particularly in the private sector. Domestic SMEs have faced both internal and external constraints, particularly financing. Alternative financing through capital markets will facilitate further development.

Recommendations. ADB should explore opportunities to provide support for (i) investment funds that target SMEs; (ii) infrastructure investments; and (iii) projects involving energy conservation, pollution abatement, development of the central and western regions, and the disposal of NPLs.

ADB should also consider taking equity positions in existing and new commercial banks, insurance companies, fund management companies, and other domestic financial institutions to broaden ownership, improve corporate governance, and introduce international best practice standards. ADB should consider making loan and equity investments in companies in fledgling and nascent industries, such as leasing and VC, under a new legal framework and enabling environment. By so doing, ADB can play a catalytic role in mobilizing investors to follow suit and provide a wide range of financing services to SMEs.

Such bottom-up investment funds can test a new policy environment. Some international case studies indicate that investing in the first or second pioneering leasing companies in a region (or in a country) after an adequate enabling environment is in place can make both substantial financial and development impacts. Margins earned by the early investments were roughly twice as much as those earned by private investors following in later years when there is more competition. ADB's private sector operations should focus on recouping profits while playing a catalytic role in inviting other investors and making a substantial development impact in the nascent industry.

2. Infrastructure

Major Findings. Infrastructure constraints are one of the main reasons why foreign investors do not consider entering the central and western regions. Both foreign and domestic investors face varying infrastructure constraints, depending on geographical locations (e.g., transportation is cited as a major constraint by enterprises in the west). Private participation can help the PRC finance its infrastructure needs.

Recommendations. Enormous investments in infrastructure are envisaged during the Tenth Five-Year Plan. Funding these projects cannot be done by the public sector alone. The involvement of the private sector is another way to mobilize the necessary financing.

ADB's private sector operations should focus on its existing strengths to mobilize capital for large and medium-scale infrastructure projects. Multiproject financing schemes such as the World Bank's Public-Private Infrastructure Advisory Facility could be used to enable ADB to reach out to smaller projects. ADB will consider financing infrastructure projects that involve private sector participation in power generation, gas transmission, roads, ports, telecommunications, water supply, wastewater treatment, and solid waste management. Additional investments in the power sector, however, will depend on ongoing negotiations on the Meizhouwan project (Box 12) with central and local governments. Priority will be given to pioneering projects and those that can serve as models for structuring private sector investments. While private sector operations will mostly be in the coastal region, efforts will be made to encourage projects in the central and western parts of the country. ADB's infrastructure financing will be for both "greenfield" projects and "brownfield" projects.

ADB will support private participation in projects that operate within a regulatory framework that protects the interests of the poor. Experience has shown that efficiency gains from privatizing infrastructure services can benefit all income levels. But with effective regulation that ensures appropriate tariff policies, lower-income groups tend to gain relatively more than higher income groups, improving the distribution of income. ADB's private and public sector departments will ensure effective regulation of infrastructure projects that are not subject to market competition. Pro-poor growth from infrastructure projects that extend essential services to the poor at affordable tariffs requires a close partnership with the Government. Such projects can include concessions that require bidders to provide service to poorer areas (for example, low-tariff public standpipes or loss-making transport systems), with the associated cost to be borne by the Government in the form of lower concession revenues.

3. Social Sector

Major Findings. The health sector is currently going through structural changes. Private medical practice in rural areas is increasingly important for the poor. For-profit medical JVs have been allowed to operate to bring in advanced medical technology and equipment, making up the shortage of local funds, and improving techniques and facilities. WTO accession will also bring about new opportunities in direct distribution of pharmaceutical products. The education sector is still highly regulated. For-profit JVs for higher education are not allowed. Distance learning and training, however, may offer investment opportunities. Both subsectors are very fragmented markets and training programs for corporate staff are an unexploited niche.

Recommendations. ADB's private sector operations may wish to pursue investment opportunities in the health sector. Selection criteria for private sector operations potential investments based on rigorous market research are necessary. One possibility is to make investments in a JV hospital in a high-end market segment targeting expatriates or a growing segment of the upper-middle class in cities, with a view to filling the gap in public fund shortages that should be used for the poor. Rural private medical practice is becoming increasingly important, and an area for consideration and further research. Investment opportunities in the education sector remain limited for private sector operations. However, training and domestic distance learning (e-learning) subsectors can be tapped through an investment fund. It is unlikely that there will be walk-in "investable" proposals for private sector operations unless ADB conducts active outreach marketing in the social sector. ADB should utilize TA funds for private sector operations to further research the sectors and identify potential investment opportunities.

E. INSTITUTIONAL RESPONSE TO PRIVATE SECTOR DEVELOPMENT IN THE PRC

ADB should reevaluate whether or not its current institutional setup is appropriate to respond to increasing opportunities in the PRC's private sector. The recent reorganization is definitely a step forward in responding to the challenges ahead. However, much remains to be done to further improve the current institutional setup, especially to strengthen public-private partnerships and private sector operations at the PRC Resident Mission and mainstream private sector operations in the PRC operational strategy. For the period from July 2000 to December 2001, the PRC Resident Mission received 124 private sector-related inquiries and speech requests. The Private Sector Operations Strategic Directions and Review (ADB 2001) states the following.

The Private Sector Group's experience, especially in the recent past, has demonstrated the critical importance to private sector operations of an effective local presence through the ADB's resident missions (RMs). There is simply no substitute for reliable, accurate, and timely local information and response when identifying, processing, and administering private sector projects. On this basis, and in line with ADB's policy on RMs, local inputs for private sector operations must be bolstered by more appropriate arrangements to promote private sector operations in local markets, to assist with the processing of new projects, to undertake on-the-ground portfolio administration, and to address risk management issues. — The need for substantial RM support is critical in at least four DMCs: PRC, India, Indonesia, and Pakistan.

There is substantial interest in ADB operations in the PRC. The ADB business climate survey shows that much remains to be done to promote ADB's efforts in PSD (Box 13). A local presence of PSD/operations personnel in the PRC Resident Mission would enable ADB to conduct an active outreach marketing response to growing demands for financial sector and infrastructure operations and identify potential investment opportunities.