EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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